

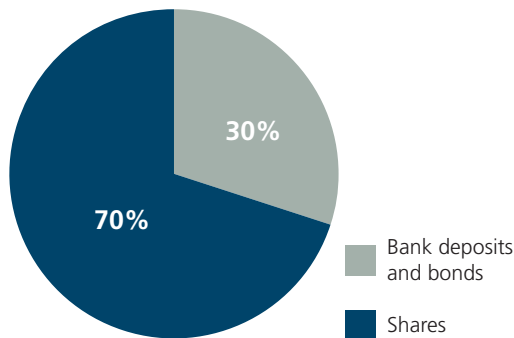
# Rethinking post-retirement asset allocation

While growth assets are widely accepted in asset allocation decisions during the accumulation phase, many investors overlook the benefit allocating to shares can provide in the way of growing tax-effective income in the post-retirement phase. This paper discusses the differences between pre-and post-retirement asset allocation and how investors can use an equity income strategy to improve income and returns with less risk.

This paper finds that utilising a simple hedging strategy over the retirement equities allocation can improve the length of time the equities allocation can support a given amount of inflation adjusted retirement spending by over 34% where the sequence of market returns are poor. This hedging strategy allows investors to safely increase their allocation to equities in a retirement context. When this is combined with non-index aware investment process that seeks out companies with high sustainable free cash flow, retirees stand to benefit from higher and faster growing income with lower risk.

During our working lives, investment strategies are typically aimed at accumulating wealth and are less concerned with year-to-year return fluctuations. During this accumulation phase it usually makes sense to skew portfolios towards growth assets such as shares in order to maximise the final value of the portfolio.

Chart 1: Illustrative accumulation asset allocation



## The two key investment considerations for retirees

### 1. Sequencing risk

Retirees do not have the luxuries afforded to accumulation investors. Not only do they not have a steady income from their workplace skills – their human capital – to supplement their financial capital, but **if they have to sell their financial capital to fund their living expenses during periods of lower prices, their retirement savings are not likely to last as long.**

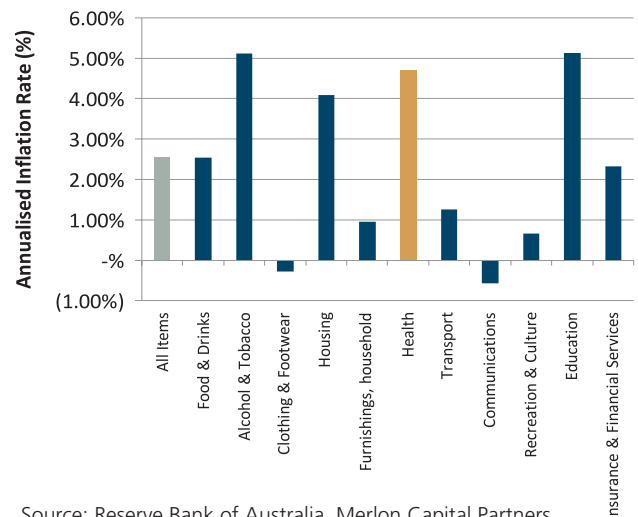
Retirees can mitigate sequencing risk by investing in low-risk assets that that have less capital value volatility, but this comes with another trade-off, known as longevity risk.

### 2. Longevity risk

Longevity risk is essentially the risk of outliving one's money. **Investing in low risk assets minimises sequencing risk, but it comes with the trade-off of potentially not generating sufficient returns to meet desired spending over the retirement timeframe.** In the current low-yield environment, traditional retirement asset allocations heavy on fixed income, term deposits and cash simply do not provide the same future expected returns that they used to.

A key component of longevity risk is inflation – which erodes the purchasing power of savings. The cost of living for retirees is actually rising faster than the broader population, largely in part due to healthcare costs.

Chart 2: Annualised Inflation Rate by expenditure category since June 2005

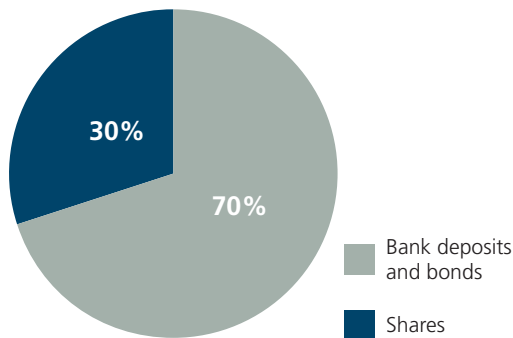


Source: Reserve Bank of Australia, Merlon Capital Partners

### Traditional retirement allocations are heavy on fixed income...

In making this trade-off, a typical retiree portfolio might skew them away from growth assets such as shares, towards less volatile assets like bonds and cash, as shown in the diagram below.

Chart 3: Illustrative retirement asset allocation

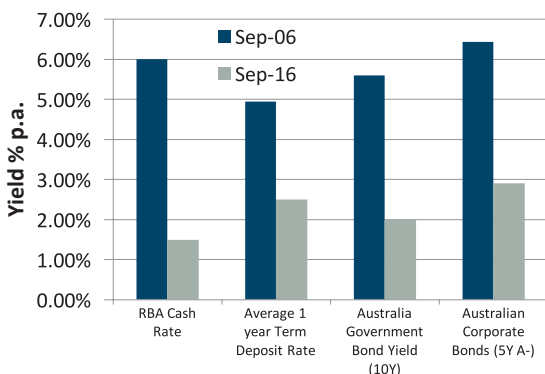


### ...yet fixed income may not be able to deliver the same absolute returns going forward.

Fixed income still remains an effective portfolio diversification tool as its returns are generally inversely related to equities over the cycle. However, future returns are more likely to be lower and more volatile. In addition, fixed-rate bonds are a poor inflation hedge – interest by definition is fixed and does not grow, nor do investors benefit from tax-effective franking credits.

Whilst falling interest rates have supported historical fixed income returns, it means that current yields – the ‘price of safety’ – are at record lows.

Chart 4: Current yields vs 2006



Source: Reserve Bank of Australia

For retirees with capital within account based pension structures, with minimum annual draw-downs exceeding 4% and rising to over 7% during the peak spending periods of retirement, current yields on the fixed income asset classes in the graph above mean that they must spend capital to meet their minimum drawdown requirements.

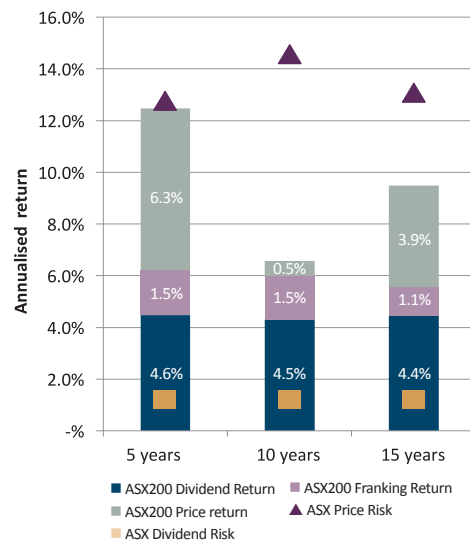
### How equity income strategies address the two key investment considerations for retirees

#### Use of equity income strategies to lower longevity risk

Australian equity yields have remained attractive compared with pre-GFC levels. Within an Australian context, retirees also benefit from the tax treatment of fully franked dividends relative to bank deposits and bonds. For retirees, franking credits are as valuable as cash dividends or interest received, and can reliably add an extra 1.5% to 2.0% in annual returns.

Importantly, dividend income streams are much less risky than many investors would assume. The returns from dividends inclusive of franking credits on the ASX200 have been consistently around 6% p.a. over the past 15 years with around 1.5% annual risk – a testament to the steady influence of dividends on overall returns.

Chart 5: The steadying power of dividends



Source: Bloomberg, Merlon Capital Partners. Returns as at 30 September 2016, inclusive of franking credits.

Shares also deliver capital returns that ensure portfolio values keep up with inflation. Companies with good competitive positioning within their respective industries have what is called ‘pricing power’, meaning that they are able to pass on increases in the cost of their inputs to their end customers, or they benefit from economies of scale that enable them to grow revenue whilst keeping their costs relatively static. Both of these factors mean that investments in well run, strongly positioned companies should benefit from cash flow streams that comfortably exceed inflation over time.

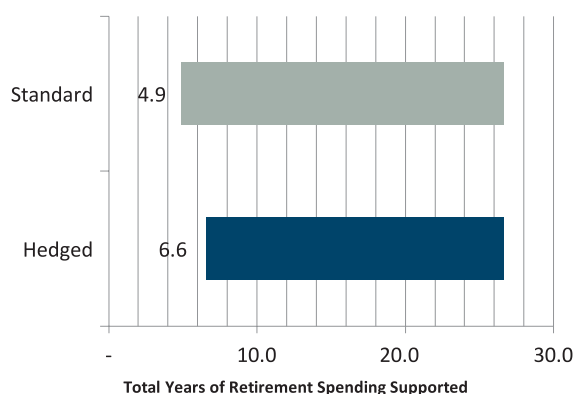
## Use of equity income strategies to lower sequencing risk

Despite the income advantages of Australian shares, retirees are left with higher price risk than other asset classes. A way to reduce this risk is to use derivatives that remove a large part of the price risk associated with a traditional share portfolio, while at the same time retaining the significant tax benefits – the access to franking credits. The net effect is that volatility is reduced, leading to less sequencing risk.

To illustrate this, we have modelled two hypothetical \$100,000 portfolios using the same average monthly returns and market volatility from the past 10 years<sup>1</sup>. The only difference between the two portfolios is that one includes hedging that reduces 30% of the price volatility of the portfolio (reducing sequencing risk) and the other doesn't.

The output is measured by how long the portfolio is able to support an inflation adjusted annual spending rate of \$10,000 p.a. before the portfolio is depleted (longevity risk). A larger number means that the portfolio is able to generate more retirement spending capacity, or in simple terms, it lasts longer.

Chart 6: Range of outcomes from simulation (worst to best case)

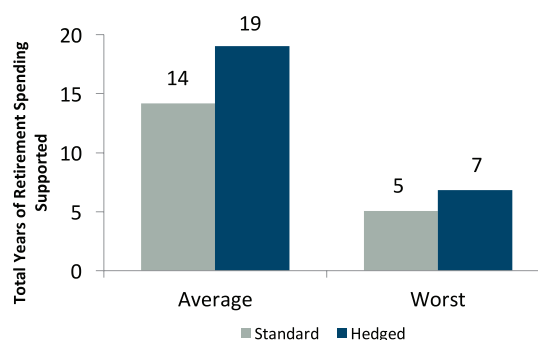


Where the volatility protection provides the most value, however, is on the downside protection. With the standard portfolio, **the worst possible outcome is that the portfolio only lasts 4.9 years**. However, with the hedged portfolio, the worst possible outcome is that the portfolio supports the desired level of spending for **6.6 years, an improvement of over 34%**.

To illustrate the difference in outcomes using some more assumptions about active management, we add assumptions around active versus passive (index) management fees<sup>2</sup>, and assume that the portfolio manager for the actively managed portfolio is able to deliver an additional 1.5% p.a. in additional dividend yield above the market through finding companies with higher levels of sustainable free cash flow and 2.5% p.a. in additional capital gains from investing in

undervalued firms rather than just following benchmark allocations (all pre fees) – thus covering their management fees and delivering additional value to the investor.

Chart 7: Retirement spending longevity



Whilst the best possible outcomes are 27 years for both portfolios, the hypothetical actively managed product supports retirement spending for **over 19 years versus 14 years** and the worst possible outcome is around **51% better** than the passively managed investment. The difference in retirement spending longevity is more pronounced with the additional value add from active management.

## Putting it all together – higher retirement income and longer lasting savings with less risk by using Merlon

Most managed funds in Australia construct portfolios with reference to an index which typically weights shares by their market values. This leaves Australian investors heavily concentrated in the banking and resource sector.

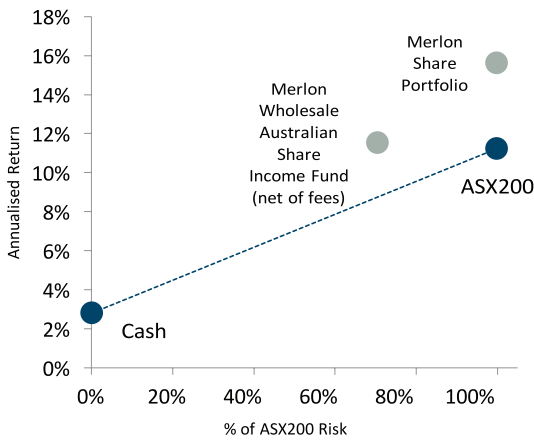
Merlon is different – investing in a smaller but more industry-diversified portfolio of companies with sustainable underlying free cash-flows from their core businesses. This ensures that the companies in the portfolio are delivering dividends which are backed by the earnings from their core businesses, not manufactured using excessive leverage or underinvestment in their businesses.

The chart below plots total return on the vertical axis and risk on the horizontal axis. Over a five year period, income is merely a component of total return and does not change the position of 'the dot'.

<sup>1</sup> Both have an initial investment of \$100,000, a \$10,000 per annum spending rate that is adjusted upwards at an inflation rate of 2.5% per annum and a consistent annualised dividend yield of 4.5% per annum that is 100% franked. To model returns, we have assumed the same level of monthly risk and average monthly returns that have prevailed over the past 10 years (which includes the global financial crisis). Monte-carlo simulation is run 50,000 times.

<sup>2</sup> 0.9% p.a. management fee for the hedged active management portfolio, 0.15% p.a. management fee for the passively run standard indexed portfolio.

Chart 8: Merlon risk vs return



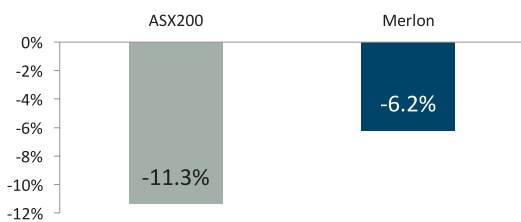
Returns for the Fund and ASX200 grossed up for accrued franking credits and the Fund return is stated after fees as at 31 August 2016. % of ASX200 Risk represents the Fund's statistical beta relative to the ASX200

Investors should be able to recreate any point on the line through a combination of cash and index investing, so active managers need to be 'above-the-line.' Merlon has achieved this over all time periods as a result of:

- Investing in undervalued companies and not starting with index positions – this improves the total return (see Merlon share portfolio above).
- The hedge overlay which reduces risk to 70% of the market, resulting in the final performance of the Merlon Wholesale Australian Share Income Fund after fees.

Furthermore, Merlon's hedging strategy and active management has reduced downside risk by approximately 60% over the past five years<sup>3</sup>.

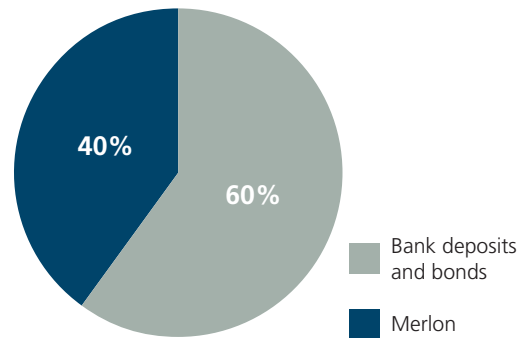
Chart 9: A simple option strategy provides downside protection



Because hedged share portfolios are less risky than traditional share portfolios, a greater allocation is justifiable for a given level of overall risk, lowering longevity risk whilst ensuring that the contribution of the share allocation to sequencing risk remains flat or declines. Put simply, there is a reasonable basis for expecting a higher overall portfolio return with the same or less risk.

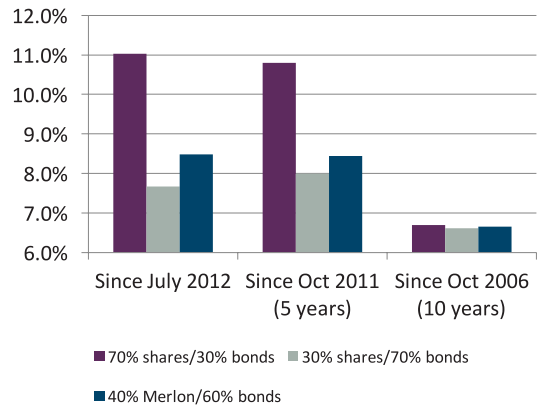
<sup>3</sup> Average drawdown of fund v market over 5 years for drawdown events over 5%. Merlon Fund return based on daily unit price after fees and assuming reinvestment of distributions.

Chart 10: Alternative retirement asset allocation



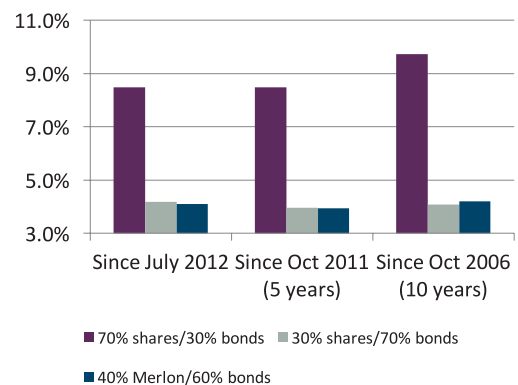
Undertaking the revised allocation would have resulted in a material increase in annual total returns for slightly less overall risk than the traditional 70% bonds / 30% equities allocation.

Chart 11: Return Comparison (% p.a.)



Source: Bloomberg, Merlon Capital Partners.

Chart 12: Risk Comparison (% p.a.)



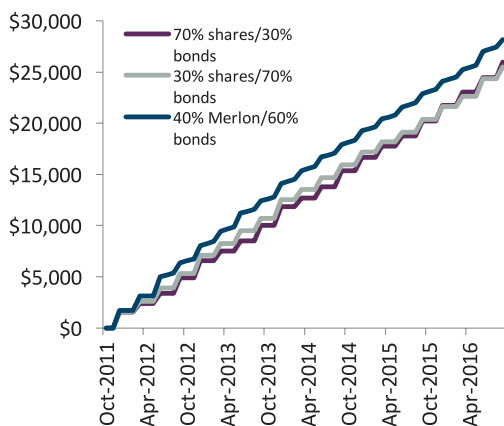
Source: Bloomberg, Merlon Capital Partners.

The comparison of total returns above reinforces the merits of employing a volatility reduction strategy over an investment strategy that delivers higher returns than the market. So on a total return basis, a higher allocation to the Merlon Wholesale Australian Share Income Fund results in a much better risk and return outcome than simply investing in an index fund.

Furthermore, not only does a higher allocation to the Fund than the traditional equity allocation outlined above, deliver higher risk adjusted total returns, but the income that investors receive outstrips the traditional allocation.

In order to assess this, we have used actual unit price and distribution data from the two largest and lowest cost index funds that track the broad Australian share market and bond market indices<sup>4</sup>.

**Chart 13: Cumulative Income Paid on \$100,000 investment over 5 years**



Source: Merlon Capital Partners, Vanguard.

<sup>4</sup> Vanguard Australian Fixed Interest Index Fund (Wholesale) and Vanguard Australian Shares Index Fund (Wholesale).

## Conclusion

Unlike accumulation investors, retirees face different challenges to maintaining an income stream sufficient to deliver the lifestyle they have been saving all their working lives for. Investing in shares allows retirees to access the strong fundamental cash flow generating capabilities of well-run companies which have the potential to generate dividend streams and capital returns which can maintain a portfolio's spending power.

Equity income strategies such as Merlon's can then overlay a volatility reduction strategy that can substantially lower the risk of the portfolio running out of money early. Combined with a fundamental research process that invests in companies that are undervalued and likely to generate sustainable cash-flows creates an equity solution perfectly suited for retirees.



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