Bridging the retirement gap

Financing an increasingly long retirement is not a problem most Australians are equipped to handle but Legg Mason has launched two tailored products designed to bridge the funding gap. Income producing investment strategies, writes Rachel Davis, fit to fund your own mother's retirement.

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Reese Birtles
Legg Mason
head of Australian equities

A rapidly ageing population is already having an impact on government budgets around the world as they fight to balance growing health costs with the shrinking proportion of taxpayers.

A retirement can now span over decades with many people still retiring in their mid-60s but living into their mid-80s and beyond.

The average superannuation balance is only capable of funding a small proportion of a two-decade retirement with its aged care and health needs.

Legg Mason is tackling longevity risk head on with the launch of two new products, aimed specifically at producing income streams for retirees.

The Legg Mason Australian Real Income Fund is based on a portfolio of listed hard assets including A-REITs, utilities and other infrastructure such as electricity and gas grids, toll roads, ports, airports and hospitals. The portfolio aims to deliver a strong yield, inflation protection and the low risk exposure needed by retirees.

The recently launched Legg Mason Australian Equity Income Trust invests in companies listed on the ASX that have attractive but ultimately, reliable dividends. It is designed to deliver an income yield higher than the sharemarket without relying on gearing, derivatives or other complex structures.

"In the last 20 years the Australian funds management industry has been really focused on developing wealth creation products, rather than products to deliver income for retirees," said Reece Birtles, head of Legg Mason Australian Equities.

"But the rate at which the demographic is ageing means products for post retirees will become increasingly important. Looking forward, it will become a rapidly expanding sector, and it needs to be.

"We could see that there was a lack of products available on the market aimed specifically at the growth of an income yield for people who are of retirement age.

"Financial advisers often recommend their clients move to an allocated pension with a more conservative asset class mix. While this has merit, it should be noted that beneath the pension framework, the exposure to growth assets like equities is the same capital growth strategy used for a wealth accumulator, just dialed down.

"We believe there is a need to rethink portfolio construction for retirees, and that doesn't necessarily mean reducing exposure to growth assets overall. By changing the way we mix growth assets, there can be a greater role for Australian equities to play, but there needs to be a change in the way it is managed for this demographic.

"Retirees investments need to be solid and income producing. This is a new space and we need to design the right products."

The income builder

The one unique advantage that retirees have is that they are zero per cent tax payers, which bodes well for Australian equities investing given the unique benefit of additional income from franked dividends. This is what Legg Mason has sought to capitalise on for retirement focused clients.

Legg Mason has tailored their products to producing a sustainable income stream, rather than focusing on capital value as it might for pre-retirement age investors.

"Portfolio construction for retirees needs to have a greater emphasis on income producing alternatives and equities," said Birtles. "Tailoring the majority of the portfolio to defensive assets in retirement won't produce the growth in income stream needed.

"That is why our products are designed around income-generating equities and real assets like property, utilities and infrastructure. They have strong yields but their income stream is not reliant on the cycle, meaning lower volatility than the share market – as well as growth in that income stream over time.

"The actual companies we invest in are chosen with our investors in mind. We also avoid an over-concentration that could be susceptible to market swings. The typical ASX 300 based portfolio will be overly reliant on banks and commodities.

"We create a more diversified portfolio that better matches the actual spending patterns of retirees, thereby providing a degree of inherent inflation protection. Within our investment process, we screen the companies we invest in to make sure they are carrying low levels of debt and to make sure they are fundamentally and quant assessed.

"Only 90 stocks out of the ASX 300 pass our filter and 50 make it into the portfolios.

We've scanned the investment universe for appropriate stocks and have removed those with excessive financial risk.

"Retirees will require the bulk of their investment return to come from yields to sustain them through their retirement but the types of yields chosen needs to be done carefully with the investors time of life at the forefront of any investment decision.

"Overly defensive strategies like term deposits don't necessarily provide the necessary growth in line with inflation to continue to meet rising costs and sustain income.

"At the other end of the spectrum, some of the higher return assets could be too risky for investment by retirees with no income outside their investments. Retirees need a lower level of risk than what is offered in some high yielding products, which includes investment, foreign currency and liquidity risk."

Planning the difference

In the 12 months to May 2011, the Legg Mason Australian Equity Income Trust and the Legg Mason Australian Real Income Fund have delivered income streams of 9.2 per cent and 7.0 per cent respectively (the latter based on a model portfolio until it went live in December 2010). There may be higher returns to be found in the marketplace but, quite specifically, that isn't what these two products are designed for.

First and foremost, they aim to provide a sustainable income for retirees and investors seeking reliable income above cash.

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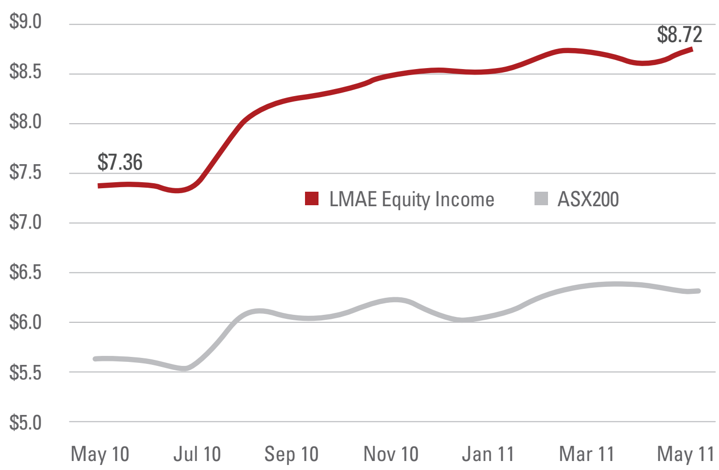
Legg Mason has backed its products with a twelve-person investment team, with a focus on Australian equity products and over 30 years managing funds. The team includes analysts, quant research and execution.

"Twelve months ago, we projected a yield on our Equity Income fund of 7.4 per cent and today that has grown to 9.2 per cent. Our expected yield going forward is 8.7 per cent, which represents an 18 per cent increase from where we were 12 months ago. This highlights the power of a growing sustainable yield which term deposits are unlikely to match.

"Our products are about finding quality companies first and about delivering income that retirees can rely on." **FS**

Figure 1. Next 12 months expected income from $100 invested at inception



Source: Legg Mason

Figure 2. Low risk by avoiding over-concentration

Source: Legg Mason