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Investing for income and growth

How to use equities in retirement and mitigate the associated risks.

Earlier this year, a study by the Centre of Excellence in Population Ageing Research (CEPAR) found that over-55s account for about 19% of today's workforce.

It's a number that has more than doubled over the last 30 years, and it's one that is expected to continue growing. CEPAR estimates that by 2050, workers over the age of 55 will make up about 40% of the national population.

The reason? More and more Australians are delaying their retirement due to mounting financial pressure.

And while COVID-19 hasn't helped the situation, it isn't all down to the pandemic. In 2013 Australian National University research showed that following the Global Financial Crisis many Australians aged 50-64 postponed their retirement.

While some may choose to do so for positive reasons, many others are forced into it by the rising cost of retirement.

According to the Association of Superannuation Funds of Australia, as at March end, for a single 65-year-old to have a comfortable lifestyle, an annual income of $44,412 is required. For a couple of the same age, $62,828 is needed.

It's not an easy income to come across either.

"When accumulating assets, investors basically seek more money with less risk, and so it is a relatively straightforward compromise between risk and return," Magellan Financial Group head of retirement solutions and data science Paddy McCrudden says.

But investing in retirement is a real challenge.

"Retirees need predictable monthly income to meet their everyday needs, capital growth, and access to that capital in the event of a large or unforeseen expense," he explains.

And providing this regular income can't come at the expense of their capital or their access to it.

"Investors have been left to deal with this problem by using a combination of the limited tools available and accepting the compromises that result, often without realising it," McCrudden says.

And as these investors get older, protecting that capital typically means minimising risk, which may not be in their best interests at a time of record low interest rates. On the flip side, the risk associated with investing in growth assets can be scary for someone with very little time on their side to recoup potential losses.

The need for a reliable or fixed income from growth assets in retirement further exacerbates this risk, McCrudden says.

"The reason is clear – selling assets to fund the required income when prices have fallen means there are fewer shares left invested when prices recover," he says.

"This is well-known in the adviser community as sequencing risk and must be addressed head-on."

Magellan Financial Group has worked hard to find a solution to this long-endured conundrum, with the team considering a multitude of alternative approaches.

For instance, investors could modify their consumption. This could mean reducing the spending rate completely or simply adjusting spending in response to equity market returns.

It's a strategy that could well work, and likely has for many a retiree over the years – but it also makes it that much harder for a retiree to meet their goals, and the uncertainty such an approach brings can wreak havoc on a retiree's lifestyle and mental health.

It was clear to Magellan that an alternative was needed and a holistic one at that; one that takes not only a different approach to the investment portfolio, but also a different structural approach.

As McCrudden explains: "The portfolio approach is about investing in a way that delivers equity market returns with lower risk."

"Meanwhile, the structural approach is about drawing from buffer assets when we are experiencing adverse markets – the 'bucketing' approach that many financial advisers are recommending is a great example of this."

The challenge remains though: how do you implement this efficiently and effectively? In answer to this question, Magellan launched its long-awaited retirement product FuturePay in June.

With a minimum recommended holding period for investments of seven to 10 years, FuturePay is designed to deliver a predictable income on the 15th of each month that grows with inflation and aims to build on capital with a focus on downside protection with daily liquidity.

In effect, the product works to replace a salary, providing greater financial comfort in retirement.

"To meet these outcomes, we combine effective and trusted investment strategies, with an innovative means of reserving," McCrudden explains.

At its foundation is Magellan's reputation for investing in high-quality defensive stocks for well over a decade, with FuturePay leveraging the fund manager's track record of investing in such companies to generate attractive returns while also reducing the risk of capital loss.

In terms of reserving, McCrudden explains, FuturePay uses an efficient system to manage sequencing risk which harnesses the benefits of mutualisation in managing the pool of reserves; something that can't be achieved if you're reserving on your own, he notes.

The quote

We combine effective and trusted investment strategies, with an innovative means of reserving.

If the underlying investments outperform inflation, a fraction of that outperformance will be reserved for when things don't run so smoothly down the track, to be drawn on when investments underperform.

"FuturePay's reserving disciplines are built into the product's workings and are the result of exhaustive analysis designed to develop an optimal reserving strategy," McCrudden explains.

And the best bit of all? Accessing FuturePay is incredibly simple. A listed, managed fund, investors can access FuturePay either directly through Magellan, via their stockbroker or on the Chi-X stock exchange. Accessing capital is equally easy, with investors able to sell their units back via the same avenues.

McCrudden says the benefits of FuturePay are clear as the product aims to address each of the investor's goals in retirement.

To provide further assurance, Magellan has also engaged actuarial consultant and researcher Rice Warner to evaluate FuturePay in the context of the retirement landscape. This includes assessing the product in terms of how it combines with or complements the Aged Pension, account-based pension products and minimum drawdown rules.

"Even with very conservative assumptions on Magellan's investment performance, the evaluation showed an allocation to FuturePay is expected to deliver outcomes with higher total return, lower total risk and higher levels of income and asset value over the investor's lifetime," McCrudden says.

Considering a typical investor's preferences, Rice Warner's analysis also found the net utility of an investor who starts with $500,000 and invests 43% of that into FuturePay is the same as that of someone who starts out with $640,000 but doesn't invest in FuturePay.

"That is an outstanding result," McCrudden says.

"We encourage financial advisers and their clients to read the Rice Warner report for the details."

Find out more about FuturePay by visiting www.magellangroup.com.au/futurepay. FS