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The Frontier Line

Thought leadership and insights from Frontier Advisors

Dynamic retirement product solutions

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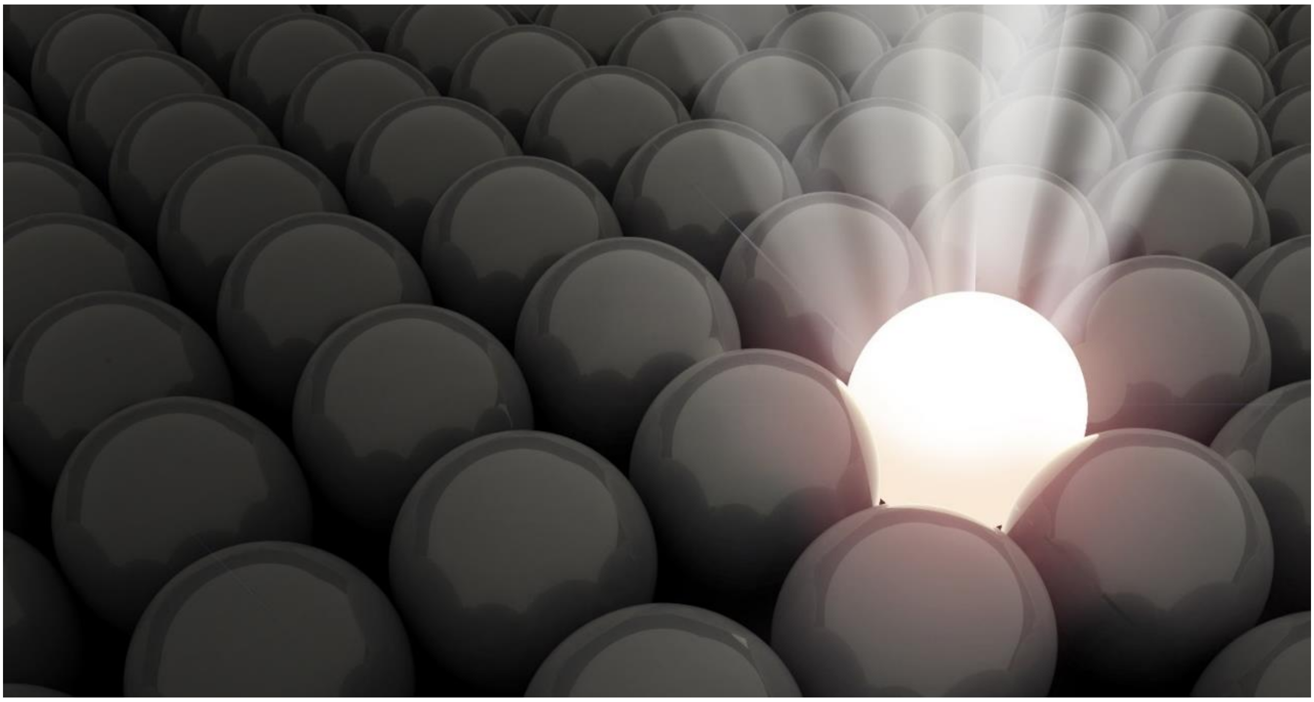

Kim Bowater is a Senior Consultant, leads our specialist retirement solutions research team and chairs the Research Management Committee that oversees Frontier's investment research program. Kim has almost twenty years of experience in the financial sector with a background in providing investment administration and strategic custody advice and global custody and actuarial/employee benefits consulting. She is a Chartered Financial Analyst (CFA), a member of the CFA Institute and holds a Bachelor of Science degree with First Class Honours in Mathematical Statistics.

Dynamic retirement product solutions

MySuper, combined with ageing memberships, has seen an increase in interest in dynamic product solutions amongst Australian superannuation funds. There are a number of approaches funds can take to try and provide the optimum outcome for their members. However, is a lifecycle approach necessarily the answer?

A dynamic product solution involves varying the investment strategy and risk profile dynamically for different member cohorts based on pre-defined factors.

The most common factor used in dynamic models is age, or more particularly, time to (or after) retirement. These product solutions are often referred to as "lifecycle" models.

As well as lifecycle dynamic strategies, which change investment strategy over time, some new retirement offerings incorporate a type of "bucketing strategy" that combine the short-term income needs of a retiree with a longer-term growth oriented investment strategy to ensure their capital continues to grow.

Funds that offer a default allocated pension with a lower risk strategy than their MySuper accumulation strategy also can be effectively considered a two-stage dynamic strategy for the default member, when considered as a whole of life solution.

So are dynamic strategies the future of the Australian superannuation market or are the benefits of a more tailored solution likely to produce roughly the same results – or even worse?

Certainly dynamic strategies are used extensively in the UK and US defined contribution markets. However, Australian superannuation funds are typically more diversified across asset classes and strategies compared to the US and UK where members are invested predominantly in equities during the accumulation phase.

This means the approach taken in Australia needs to be cognisant of these differences if we are drawing inspiration from those systems.

However, there are certainly a number of reasons why dynamic strategies can make sense in product design.

The main attraction in a dynamic solution is that it adjusts for changing member needs, including risk profile, timeframe and risk tolerances, without members needing to actively make decisions about their investment strategy. It seems clear the majority of Australian super fund members prefer to accept default arrangements.

At the same time, it seems logical the opportunities and challenges facing members of different ages, will vary significantly with their journey toward their drawdown phase.

Specifically the key benefits of a dynamic product solution, such as a lifecycle approach, are listed below.

- They adjust for changing risk tolerances of members as they age towards and into their retirement, without requiring the member to even recognise their changing circumstances and select a new appropriate investment strategy. This is critical for low engagement members and for those with low levels of financial literacy.

- They offer behavioural support by helping members remain in an effective strategy. This can reduce suboptimal switching activity from poor behaviourally led outcomes for some members trying to manage their investments – engagement doesn't necessarily always result in better outcomes.

- They allow funds to "mass customise" an investment product, providing a low-cost customised strategy for specific member cohorts, without the expense or complexity of offering individual investment solutions and advice.

- They offer implementation flexibility as models can be offered as a default MySuper strategy, or as an MIC option, and can be offered in accumulation, retirement, or as a way to bridge across both phases for a cohesive whole of life offering.

However, dynamic strategies, such as a lifecycle model, do not answer all product and investment problems, as they revolve around essentially only one element of a product's design.

So what are the challenges funds need to be aware of?

We think there are three key challenges to consider.

1. De-risking without considering the prevailing market environment is a key concern. An approach that automatically alters its strategy on a specific date may de-risk blindly following a market downturn, and lock in losses for some members. Combining a dynamic strategy with dynamic asset allocation decisions is one way to mitigate this risk.

2. The path of de-risking needs to make sense in the context of the membership. Some lifecycle strategies de-risk steeply to retirement, others retain a reasonable allocation to growth assets through retirement. Factors like the size of member balances (are members likely to take a lump sum versus using the balance to draw down income over retirement), other income sources (access to the aged pension), and behaviour (degree of risk tolerance/aversion shown by members) are some considerations that can influence the de-risking path for a particular fund or membership group.

3. The scale and timeframe for de-risking is also critical. Should the investment strategy adjust dynamically from the start of accumulation through a member's entire working life, or just as they approach retirement, or even just in retirement? Approaching, and in retirement phases are the most important times to de-risk due to lower risk tolerances and increased exposure to sequencing/path dependency risk (to reduce the dollar impact of a significant market event on balances just before retirement).

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In conclusion

From an investment standpoint, the most important challenge for funds in constructing a dynamic product solution, particularly a lifecycle based approach, is having a greater focus on risk mitigation without overly compromising returns.

Investment returns matter most when balances are highest – there is an optimal outcome to be achieved between protecting that balance and seeking to achieve a decent return. Not all members will retire at the same age and taking too conservative an approach too early could create a significant opportunity cost in missed returns while a balance is at its highest level.

Frontier Advisors has many years of experience assisting clients develop their retirement product solutions. To talk to us about helping you, please contact our Retirement Solutions team.

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Level 16, 222 Exhibition Street
Melbourne, Victoria 3000
Tel: +61 3 8648 4300

www.frontieradvisors.com.au

@frontier_adv