Thought leadership and insights from Frontier Advisors

Issue 163 July 2020

'Balanced' may not be balanced for older members

25 years

Frontier Advisors

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Frontier's purpose is to enable our clients to generate superior investment and business outcomes through knowledge sharing, customisation, client empowering technology and an alignment and focus unconstrained by product or manager conflict.

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Introduction

Another financial year is over, and superannuation investment returns will soon be in. It's predicted the average balanced fund will be marginally negative for the year. A remarkable outcome given share markets dropped by about one-third as the coronavirus pandemic struck.

The market turmoil of February and March highlights that superannuation is not without risk.

However, a long-term approach has paid off for members, with the average balanced fund returning 7% per annum[1] since the introduction of superannuation in 1992.

But what do we mean by a "balanced" fund and, more importantly, for whom is it appropriate?

1. Based on figures from SuperRatings

Balanced funds

If you're a member of a superannuation fund and haven't selected your own investment option, chances are you'll be in your fund's default balanced option.

A balanced option typically has around 70% of its assets in growth investments (shares, etc) and 30% in defensive investments (cash and bonds). It's a "balanced" approach from a risk and return perspective, rather than a growth/defensive perspective. It balances the need for a high good long-term return against the risk of a negative return in the short term.

A typical balanced fund expects to experience about four negative annual returns in any 20-year period. Many funds have not had a negative return in 11 years since the GFC. Indeed, a number of funds will have successfully avoided a negative return in 2019/20.

Despite this, there is reporting from funds of heightened activity of members switching to lower-risk options such as cash when the local share market lost more than one-third of its value during February and March.
The rebound in equity markets in April was a reminder of the dangers of moving into cash after a market crash, although the market outlook is still uncertain.

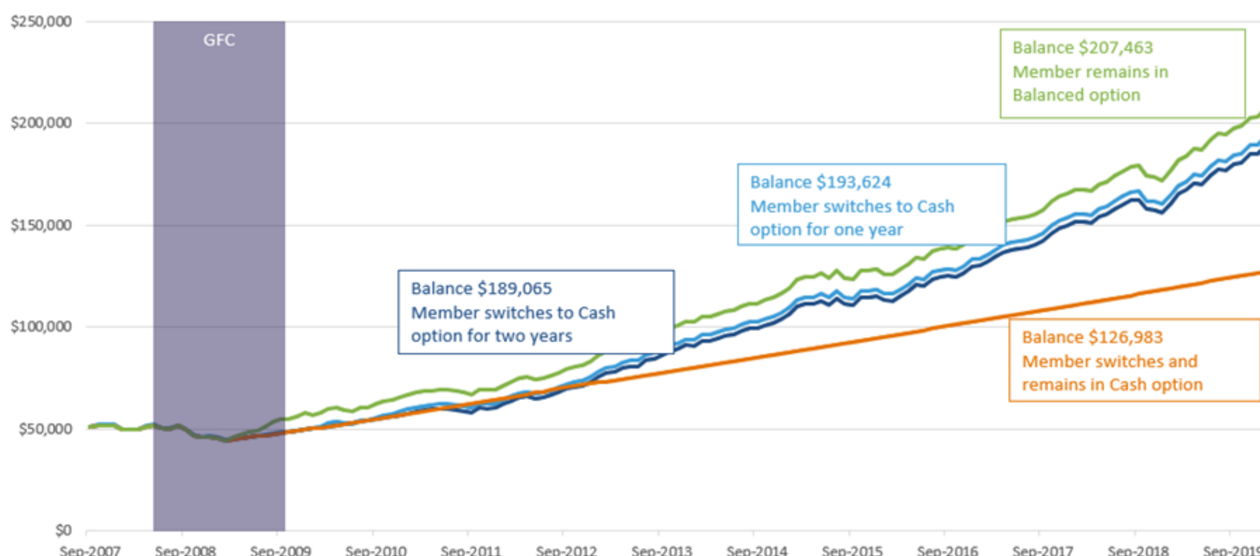
We saw a similar situation around the GFC, when 5-7% of super members switched to safer assets such as cash in the wake of the crisis, according to a study by the Centre for Retirement Incomes and Financial Education Research[2].

As the share market sank by about 50% in the months leading to March 2009, there was a surge in activity among members switching to lower-risk options such as cash. They stayed in those options, missing out on the subsequent market rebound.

The chart below shows what would have happened to a sample member's super following different decisions they might have made during the GFC. Changing their investments away from more volatile investments, like shares, after the value had gone down, and missing the benefit of that value going back up cost thousands of dollars which can never be recovered.

For most people who are not likely to access their super for many years the best thing to do, is to decide to do nothing. That might sound like they are ignoring the problem because at a time like this many of us feel like we need to take action. But when investment markets fall people often lose more money by making decisions at the wrong time.

Chart 1: The impact of switching during the GFC



Source: Frontier Advisors, SuperRatings. The analysis is based on the returns during and after the GFC and assumes an average member with a starting balance of $50,000 and SG contributions invested in the median balanced/cash fund.

2. Member Investment Choice Response to the Global Financial Crisis. Report prepared for The Australian Institute of Superannuation Trustees by Paul Gerrans, Centre for Retirement Incomes and Financial Education Research Edith Cowan University, September 2009

Retirees

While balanced funds recovered and then climbed to new highs following the GFC, many older members were collateral damage.

Older members face significantly higher investment risk due to their greater accrued savings, which can completely derail their retirement plans. Sequencing risk describes how the order and timing of investment returns can quickly erode retirement savings. The impact on those who retire in (or because of) a downturn, when their balance reaches its peak and they start drawing down, can be enormous.

Younger members invested in balanced investment options do not face this same level of risk. They have a longer investment timeframe to ride out downturns and are still investing – and so buying assets cheaply – rather than withdrawing funds when the market is low.

Few default balanced investment options are designed to protect older members against sequencing risk. Even in retirement, most funds' allocated pension products replicate the default balanced fund.

This risk can be seen by analysing the returns of three hypothetical retirees with a starting balance of $250,000 just prior to the GFC. They draw a pension at the minimum rate and transfer their accumulation balance into either the Balanced, Conservative, or Cash option. This example ignores the higher returns they will have earned in a Balanced option prior to retirement.

In the five years following the GFC, the retiree invested in Cash was more than $40,000 better off than the retiree invested in the Balanced option.

Balanced	Conservative	Cash
• Invests in the balanced option • Balance after five years: $194,711	• Invests in the capital stable option • Balance after five years: $225,415	• Invests in the capital stable option • Balance after five years: $239,748

However, as the market rose strongly in the following years, the Cash investor's savings fell more than $35,000 behind the Balanced investor by March 2020.

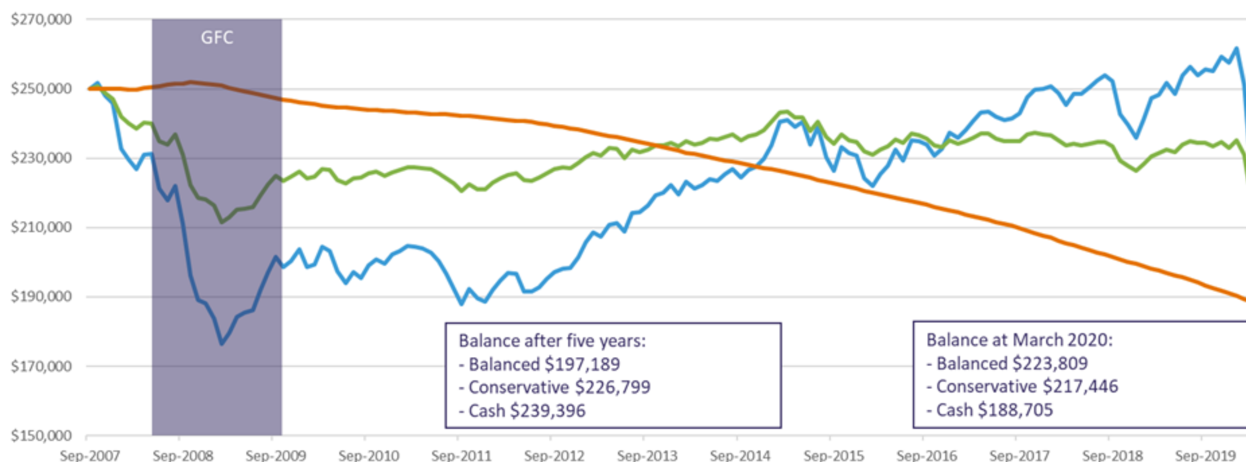
The retiree invested in the Conservative option was better off than the retiree invested in the Balanced option for about nine years following the GFC. While the Balanced investor made stronger gains in recent years, most of those gains were given back in February and March 2020 as the coronavirus pandemic dragged share markets down by about one-third.

This is sequencing risk in action.

Traditional advice to stay invested for the long term is generally sound, but it does not address the heightened risks faced by older members.

Unfortunately, many older members are most vulnerable to switching investment options after a downturn because they suffer from loss aversion. Advising them not to switch can only prevent so much of this damaging behaviour. They need specific tailored investment solutions that address their unique needs.

Chart 2: The impact in retirees after the GFC



Source: Frontier Advisors, SuperRatings. The analysis is based on the returns during and after the GFC and assumes an average member with a starting balance of $50,000 and SG contributions invested in the median balanced/cash fund.

Tailoring better investment options for retirees

Lifecycle funds have attempted to better manage the risks faced by older members by automatically derisking members as they approach retirement. Adopting a lifecycle strategy provides an element of protection against sequencing risk in the years approaching retirement but this protection comes at a cost of a likely lower balance at retirement.

However, many lifecycle strategies often only address the accumulation stage. In addition, most make assumptions based on just one factor: age. Members nearing retirement may have a mortgage to pay off or alternatively significant savings outside of super or a wealthy spouse – factors which can all change their relationship to investment risk.

While funds currently lack this type of broader information, the onus is now on them to explore how to fill in the gaps. We discussed some potential improvements to lifecycle strategies in an earlier Frontier Line.

Bucketing approaches can help, with near-term income needs are invested in a cash bucket and with the remainder invested in more growth assets. The cash bucket provides the retiree with the comfort that they can follow a higher risk strategy for the remainder of their money. But again, there is little tailoring to the specific needs of the individual retiree.

Good quality personal advice can be the solution for retirees with large balances but is too costly for the typical retiree. Technology can help funds make more intelligent assumptions about their members.

In time, a member could give permission to their fund, or a third-party fintech, to analyse their lifestyle with far more precision using data from their bank accounts, home or investment loans, and super, which could be used to forecast their eligibility for the Age Pension. This would support solutions that reflect the three pillars of retirement: superannuation, the Age Pension, and private savings (particularly home ownership).

The final word..

Super funds have served the bulk of members extremely well, but merely adopting the same investment strategy as the accumulation stage may not serve the needs of their growing numbers of retirees.

While younger investors can ride out extended market downturns, such underperformance has more severe implications for older investors unlucky enough to retire at the 'wrong' time.

With the Australian economy likely to experience its biggest economic contraction since the 1930s, and with COVID-19 outbreaks flaring up again in Australia and overseas, uncertain times lie ahead.

Funds need to take active steps to ensure that a member’s retirement date no longer plays such a strong role in the retirement outcomes of older members. That includes using data to pinpoint those members who can’t bear excessive investment risk and creating more tailored investment strategies to protect their savings.

Retirees are a diverse group with individual goals. However, they share a heightened risk that threatens to derail their lifestyle after leaving the workforce. The need for the industry to respond to this challenge has never been more pressing as our population ages. The alternative will be felt for decades to come.

25 years

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