

Response to Retirement Income Covenant – Positioning Paper

August 2021

About Fidelity

Fidelity International is a leading global investment manager with approximately AU\$1,075 billion under management (at 30 June 2021) and more than 2.5 million clients around the globe. In Australia, we manage more than AU\$19 billion on behalf of our clients.

Fidelity Investments based in the US, manages approximately US\$3,700 billion on behalf of 83 million clients, with the majority of these assets in retirement portfolios. More than \$78 billion of these assets are on behalf of clients who are already in retirement.

Recommendations

Summarising the main recommendations discussed in this submission:

- 1 Trustees should separately consider the investment needs of accumulation savers and retired members. It may be appropriate for superannuation funds to separate the assets of accumulators and retirees.
- 2 Trustees should measure the success of retirement products in relation to the outcome they deliver, such as risk adjusted return. Some more traditional measures of performance, such as performance vs a conventional market benchmark index or vs peers, are not appropriate for this purpose.
- 3 Trustees should consider the use of asset allocation approaches that help manage and mitigate the main investment risks to which retirees are exposed. Such approaches may include bucketing and defensive asset allocation.
- 4 The investment needs of retirees have been shown by the Retirement Income Review to be highly diverse. For this reason, default products are unlikely to be suitable. We therefore recommend the use of a building block approach where fit-for-purpose building blocks are blended in appropriate proportions for each member cohort.
- 5 Fit-for-purpose investment building blocks should be those designed for retirement decumulation and they should help manage and mitigate the principal investment risks that members in retirement are exposed to. An example of a fit-for-purpose investment building block for investment growth is defensive or low volatility equity.
- 6 Simplicity is an important consideration in the design of retirement offerings. Simpler products are more likely to be understood and accepted by members.

Response

Fidelity International is pleased to submit a response to this important positioning paper.

We support the broad aims of the proposed Covenant, namely that Trustees of superannuation funds need to provide retirement solutions that seek to:

- 1 Maximise retirement income
- 2 Manage risks to the sustainability and stability of that income
- 3 Allow flexibility for members to access capital at any time

There are some important implications of these aims to consider:

- Aiming to maximise income will inevitably entail some degree of risk-taking by members with their investment portfolios which is in conflict with the aim to keep income sustainable and stable. Therefore it is critical that the appropriate balance between risk and income level is struck
- As reported in the recently published Retirement Income Review¹, retirees have diverse needs at retirement, so the products or solutions available to them need to be flexible, allow for change or adjustment during the course of retirement and also allow access to the capital supporting the product when required
- The right balance between risk level and targeted outcomes will vary by individual.

This submission will address only the investment considerations as they relate to the characteristics of investment approaches, products and solutions that are appropriate for members in the retirement phase.

Member outcomes

In 2018 the prudential regulator APRA introduced SPG516 – Outcomes Assessment². This SPG sets out a framework for Trustees in assessing member outcomes. Of relevance to this discussion for retirement, the Prudent Practice Guide SPG516 sets out that due consideration should be given to the financial outcome members can expect in retirement. It also specifies that outcomes should be assessed in relation to their success in delivering targeted outcomes, such as income in retirement. And success should be measured with appropriate risk measures, such as risk adjusted return over appropriate time periods.

The Trustees of a superannuation fund need to incorporate in the design of their retirement income products with those characteristics that will more likely improve outcomes for members – this is consistent with the aims of this Positioning Paper.

Investment needs in retirement

As a starting point we should consider the range of investment needs that retirees drawing down on their superannuation in retirement are likely to have. One outcome of the Retirement Income Review was that retirees are highly heterogeneous in the range of their needs and aspirations in retirement. Nevertheless, there are likely to be some common denominators, as set out below:

- Sufficient income to maintain quality of life
- Steady income, that does not vary excessively
- Income that lasts, is sustainable
- Real returns on the investment portfolio
 - for maintaining spending power over time as the members age
 - to sufficiently maintain the capital base from which income is drawn
- Smooth, or reasonably smooth, path of returns to
 - improve member confidence and certainty
- Some degree of insulation from market volatility
 - this helps with the stability of income
 - to improve member confidence and certainty

Investment product design

We would advocate that investment products and solutions to be used for retirement decumulation should have the following characteristics:

- **Fit-for-purpose.** That is, their investment characteristics should be well aligned to the investment needs of retirees. This will include helping to mitigate the main investment risks (set out below).
- **Outcomes focused.** Products should focus on the outcomes they are designed to deliver. This is a critical element.
 - This means that in measuring the success of these products, they should be measured on the outcome they deliver and not on market-driven measures.
- **Building blocks.** It makes sense to have a range of suitable investment building blocks which can be blended in different proportions depending on the needs of the different cohorts of members that each superannuation fund will have.
 - Each building block should have investment characteristics that are fit-for-purpose so that they improve the likelihood of delivering outcomes consistent with the investment needs of retirees.

1. Retirement Income Review published by Treasury 20 November 2020.
2. APRA Prudential Practice Guide published December 2018.

Main investment risks

The principal investment risks that a retiree is likely to face are:

- **Sequencing risk.** This risk arises from market volatility that can impact retiree portfolios adversely, the risk is most acute around retirement age and beyond when balances are usually at their largest. Market events that occur in a certain sequence or at certain times may disadvantage some member cohorts more than others.
- **Inflation risk.** This is the risk that a retiree's portfolio (the income and the capital base supporting the income) progressively loses purchasing power over time due to inflation of the goods and services that are consumed by the retiree.
- **Longevity risk.** The risk of outliving savings if a retiree lives longer than they expect or have budgeted for. This risk will play out over longer periods, later in retirement.

It will be desirable in the design of retirement-appropriate products and solutions to enable management and mitigation of these risks. The aim of fit-for-purpose products will be to help manage and mitigate these risks to appropriate levels.

Fit-for-purpose building blocks

One of the important elements of almost any retirement portfolio is listed equity. Of the major asset classes, listed equity generally has a high expected return over medium and longer term future horizons. So there is little doubt that most retirement portfolios should contain some proportion of listed equity exposure, although the appropriate proportion in the portfolio mix will vary.

However, conventional listed equity portfolios are not necessarily best suited to the needs of retirees – the impact of volatile markets on the portfolio when an income is being drawn can be damaging to the longer-term sustainability of the portfolio. The characteristics of 'defensive' or 'low volatility' equity portfolios are effective in mitigating the market volatility usually experienced with listed equity and yet still providing exposure to the underlying 'equity risk premium' that is required by investors. This therefore can help portfolios to be more sustainable over the longer term.

There is a convincing argument that some form of more defensive equity or low volatility equity exposure is much better suited to the needs of retirees than using more conventional equity exposure. The rationale for this statement comes from the impact of compounding, or dollar cost averaging, which is explained below.

Dollar cost averaging in retirement

This is an important concept for Trustees to understand.

The concept of dollar cost averaging is quite well understood when saving for retirement. A regular saving into a retirement savings pool over an extended period (such as regular super contributions) will mean that some of these contributions will be invested when prices have fallen (i.e. markets have been volatile); these contributions will benefit most when markets recover. This regular compounding effect is hugely beneficial to savers over an extended period and is one of the key characteristics of regular savings that constitutes the Australian superannuation system. This is known as dollar cost averaging.

However, what is less well understood by many savers and by Trustees is that this concept of dollar cost averaging works **against** investors when they are drawing a regular income from their savings. Drawing a regular income, which members in the retirement phase are obliged to do, when markets are depressed represents a permanent loss of capital. The government has recognised that this problem exists and has reduced the compulsory minimum drawdown rates from super during periods of extreme market volatility (such as 2008/09) and 2020/21). Nevertheless, this problem is less well understood generally and needs to be considered more widely than just during the most extreme market volatility.

The problem of market volatility of retirement portfolios can be mitigated in a number of ways:

- By asset allocation
- By the use of investments that mitigate the impact of volatile markets.

Asset allocation approaches can be effective in managing overall volatility of retirees' portfolios. This could be via the use of a bucketing strategy (referred to in the Positioning Paper) or the use of a more defensive portfolio, or some other means.

Whilst asset allocation is effective in mitigating unwelcome market volatility Trustees should be careful not to be overly cautious with asset allocation. Asset allocation approaches used in combination with a permanent (or strategic) allocation to growth assets, such as listed equity, are more likely to deliver good outcomes for members over medium and longer term time horizons.

Therefore, we believe it is appropriate to mitigate the problem of market volatility, as demonstrated by dollar cost averaging in decumulation, by the use of **both** some form of appropriate asset allocation framework and the use of investments that themselves mitigate market volatility.

Defensive equity building block

Defensive or low volatility equity is an appropriate form of growth exposure for portfolios that are in a state of income drawdown.

However, these types of strategies can perform and behave very differently from conventional listed equity benchmarks. These types of portfolios have been available in Australia for some years but have so far not been adopted widely by superannuation funds. The main reason for this appears to be that superannuation funds have been concerned about introducing strategies that can sometimes perform quite differently to the market – traditionally the measurement of success that has been used by superannuation funds has been performance relative to conventional market indices, or performance relative to peers, and not on whether the investments have delivered good outcomes for members.

Another consideration is that many superannuation funds have commingled their pension assets with their accumulation assets so that both sets of members have their assets managed in the same way. The dominant portion in almost all superannuation funds in Australia being held for accumulation savers, not those members in the pension phase. And so it is probable that the different investment needs of accumulation savers and retirees have not been able to be fully allowed for in investment product design.

To illustrate the benefits of a defensive or low volatility equity exposure in retirement product design the chart in **Appendix 1** shows an example of how this kind of exposure works in practice. Whilst the example is stylised, it does illustrate that performance success measured in terms of outcomes received are more representative of successful outcomes for members.

Review of performance

It will be incumbent on Trustees to monitor performance of the options offered for retirement. However, it will be important to measure performance in the most appropriate way. Some performance measures do not capture the success with which the investments deliver outcomes for members including how much risk has been taken or how these options performed from the perspective of members' actual experience.

This important point is raised in the SPG516 where appropriate measures of performance success are suggested.

It is our recommendation that appropriate means of measuring performance of post-retirement options should be considered. Some examples of potentially suitable measures are one or a combination of:

- Risk adjusted performance
 - such as Sharpe ratio*
- Success in delivering outcomes for members

i.e. income level, income stability, sustainability of the capital base supporting income

- Extent of smoothing of investment outcomes in the face of market volatility
 - measures such as downside capture* and upside capture* are appropriate here.
- Money-weighted rate of return* (or internal rate of return*) measures.

These measure the actual experience of dollar portfolios rather than time weighted rate of return* measures, which are more commonly used but do not reflect actual experiences.

We recommend that the measurement of the success of a post-retirement strategy should be on the outcomes delivered to clients rather than shorter term comparison to market benchmarks.

Longevity risk

One of the key risks that members will face later in retirement is the risk of outliving their retirement savings – this is longevity risk. This risk is a threat to the sustainability of retirement income. To combat this risk there are products available in the market, such as annuities. Other longevity products are also available.

Whilst these types of products can be effective at reducing the impact of longevity risk they can suffer from perceptions of:

- high cost (especially in current financial conditions)
- a lack of flexibility if individuals' circumstances or requirements change over time
- inability to access the capital underlying, or redeem early from, these products once the initial investment has been made

Therefore, we believe it would make sense to encourage product innovation with solutions that can operate in the Account Based Pension environment and overcome some of these perceived shortcomings.

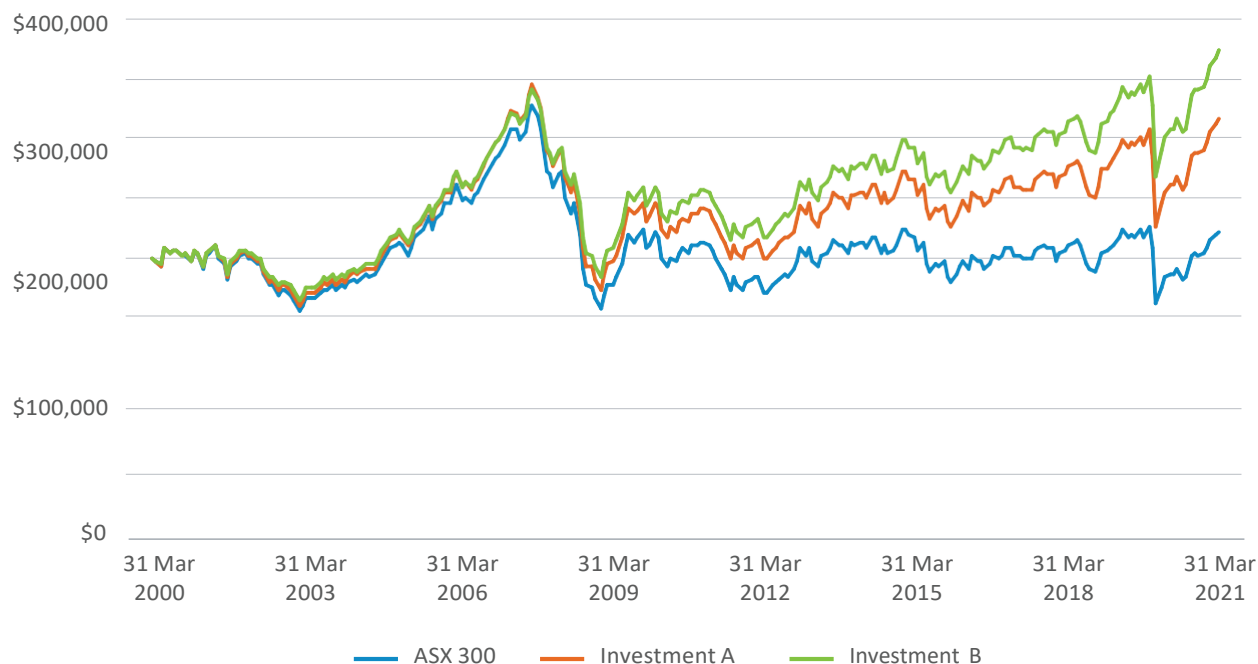
It is therefore our recommendation that Trustees should be encouraged to consider innovations in the Account Based Pension environment that could potentially provide a bridge to longevity protection products later in retirement when the protection they provide will be most needed.

Complexity and member engagement

An important consideration is complexity and ease of member engagement. There is little doubt that products that are complex will be difficult for members, and perhaps advisers, to properly understand. Where products are difficult to understand the level of trust in them, and the level of appreciation for the benefits they can bring, will likely not be fully considered by members. Therefore, we would urge that products should retain as much simplicity in their design and structure as possible.

*See **Appendix 2** for definition of these terms.

Appendix 1 – Chart illustrating impact of dollar cost averaging in decumulation



Source: eVestment, Fidelity.

Initial balance	Monthly withdrawal
\$200,000	\$1,300

	Downside capture	Upside capture
ASX 300	100%	100%
Investment A	95%	100%
Investment B	85%	95%

Summary of market behaviour since 31 March 2000

	Proportion	Average size
% Up-markets	64%	3.0%
% Down-markets	36%	-

Notes:

This chart is included for the purposes of illustration only. There is no guarantee with respect to return, capital preservation or volatility.

This chart illustrates three hypothetical investments: one in the ASX 300 and two others in investments over 21 years (the longest period past data is available for) – 31 March 2000 to 30 June 2021.

It shows an actual dollar outcome (internal rate of return) for an actual portfolio as opposed to the usually-presented time-weighted rate of return outcome which is the industry standard.

It shows three alternative investments – the ASX 300 as an index investment and two other investments which behave differently in up-markets and down-markets.

ASX 300 represents an investment in an ASX 300 index tracker (ignoring fees).

The portfolio started at \$200,000, was invested in these three investments, and was subjected to a monthly income drawdown of \$1,300.

Investment B illustrates a hypothetical defensive equity fund. It performs better than the market in down-markets (it moves 85% as far as the market in down markets) but lags the market in up-markets (it moves up 95% as far as the market when the market is up).

The table 'Summary of market behaviour since 31 March 2000' shows that over the 21-year period, the ASX 300 market is up 64% of the time (monthly data) with an average monthly move of 3.0%.

Although the market has increased over time, average down-markets at -3.3% are generally larger in size than up-markets at 3.0%.

The concept being illustrated in this chart is that a defensive investment (Investment B) performs best in this example because, despite underperforming the market in up-markets, it provides a degree of protection in down-markets (which tend to be larger than up-markets) and so performs better over time for a member drawing an income from their capital.

Appendix 2 – Definitions

Sharpe Ratio. This is a commonly used risk-adjusted investment performance metric. It measures the absolute performance of an investment relative to a risk-free rate per unit of market volatility. It is very helpful for comparing investments allowing for the amount of volatility that each investment displays. Note that market volatility is usually defined as the standard deviation of absolute performance returns.

Upside Capture. This is defined as the proportionate move in upwards markets of an investment. A ratio of 100% means an investment moves exactly in line with a market in upward markets.

Downside Capture. This is defined as the proportionate move in downwards markets of an investment. A ratio of 50% means an investment moves down half as much as the market in downward markets.

Money Weighted Rate of Return. This is a standard performance measurement metric that allows for the actual cashflows into or out of a portfolio of investments. This measure represents that actual experience of an investment. Also known as the Internal Rate of Return.

Time Weighted Rate of Return. This is the most commonly used performance measure that is industry standard for most classes of investment. The calculation eliminates the effect of cashflows to or from an investment and so does not reflect the actual investment experience of the individual.

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