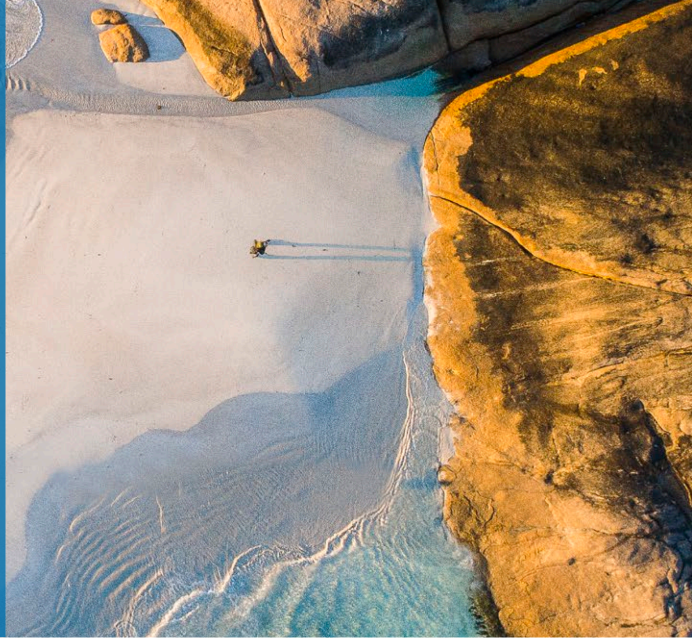
Allianz Retire+ Retirement Insights

Controllable factors and uncontrollable risks in retirement



Australians are experiencing a major societal transformation. We are living longer than ever, and our population of retirees is expected to increase from 7.4 million in 2022 to 10 million by 2041[1].

Often described as a 'grey tsunami', this growing cohort of retired Australians is repeatedly positioned as a challenge, or even a burden. For those looking toward 25 years plus in retirement there's a mix of excitement and fear; the opportunity to realise dreams overlaid with concern that their savings simply won't last.

The retirement landscape

Thanks to improved nutrition, medical advancements and a better standard of living, life expectancy today is substantially longer than that experienced by previous generations. Rather than celebrating the extra years of life, policy makers and retirees are fearful – how will these extra years of life be funded?

While much is published about inadequate retirement savings, research[2] found 87 percent of retirees, or those soon to be retired, have all their basic needs met (being able to afford food, clothes, energy, medical). Further, 70 percent have their psychological needs met (friendships, hobbies, freedom). The question, therefore, should be less about how much each person takes into retirement and more focused on creating certainty and meeting needs from what they have.

Longer lives mean retirement savings need to last an average of 25-30 years post retirement. It's anticipated that retiring Australians will move $2 trillion from the accumulation phase to decumulation[3] over the next 15 years, and Treasury projections indicate the median super balance at retirement will grow to $460,000 by 2060-61 as the system matures[4].

The Retirement Income Covenant identifies the goals of retirement investing as:

1. To maximise retirement income
2. To manage the risks to the sustainability of that income
3. To have some flexible access to savings during retirement

To achieve these goals, it's important to understand the risks that can impact the quantum of funding available for retirement, as well as each client's standard of living. Given the expanded timeframe over which retirement income may be required, it's important that both advisers and investors understand and plan for those risks that can impact retirement savings.

1 Australian Bureau of Statistics, Population Projections, Australia, 2017 (base)-2066 (Latest Release, 2018, Medium Series)
2 Allianz Retire+, Project McFerrin, July 2021
3 Allianz Retire+, Retirement: Opportunity for financial advisers has never been greater; portfolio construction has never been tougher, 22 October 2021
4 Australian Treasury, 2021 Intergenerational Report, 28 June 2021

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Risk in retirement

As your clients approach retirement age, it's important they understand the risks they will be exposed to, both those that can be influenced by them (or you) and those less able to be controlled.

As clients transition from accumulation to decumulation, their investment objectives change from amassing wealth to generating a level of retirement income to meet their lifestyle goals. As such, the risk-return landscape transitions from 'maximising returns for a given risk tolerance' to 'creating greater certainty of income'. This greater focus on using accumulated wealth to sustain a level of income throughout retirement requires careful planning and a meticulous focus on portfolio construction to generate a sustainable level of income to meet desired living standards and also manages risks.

'Controllable' risks

There are several retirement risks that are often described as 'controllable', although that might not always be the case. Unforeseen circumstances can derail the best of plans, although ideally, personal insurance will provide a safety net, particularly for those forced to retire due to ill health or an accident.

Take the timing of retirement. In an ideal world, your client will identify their preferred retirement age and as guided by you, commence the transition to retirement at the appropriate time. However, 43 percent[5] of Australians surveyed in 2021 were unexpectedly forced into early retirement due to ill health, accidents, carer responsibilities, job loss or business failure.

Key Takeout

This statistic highlights the importance of early retirement planning; unforeseen circumstances can bring a client's retirement date forward and see them less prepared to meet their longer-term needs.

A second controllable risk relates to the quantum of retirement savings and suggests that increasing contributions can mitigate the risk of insufficient savings. While the strategy is sound, it's not always possible for a client to increase contributions. There's an increasing number of retirees taking mortgage debt into retirement or drawing on their savings to be the 'bank of mum and dad'. The factors that can impact retirement timing can also limit the ability to make additional contributions.

Key Takeout

Retirement planning should consider strategies to increase contributions to retirement savings as early as possible; even a small increase in contribution can have positive long term impacts.

A third controllable risk is the rate of withdrawal. The higher the rate of capital drawdown, the faster retirement savings will be consumed. This will impact the client's ability to meet their basic and psychological needs, as well as their lifestyle and wellbeing. However, there are minimum drawdown requirements to be met and personal circumstances can change, both of which can impact retirement planning and the longevity of savings.

Key Takeout

A guaranteed income product with a regular rate of income helps forward planning and may reduce a client's need to draw additional capital, thereby preserving capital for a longer period.

5 Allianz Retire+, Project McFerrin, July 2021

Source of the problem: How can uncontrollable risks effect your client's retirement?

Uncontrollable risks are often interrelated and can result in retirees questioning how long their money will last or whether they can afford the lifestyle they want. This may have longer term ramifications for your clients: it could impact their investment risk tolerance, see them reduce spending or cause them to make unwanted lifestyle adjustments.

Longevity Risk

Quite simply, longevity risk is the risk of your client outliving their retirement savings.

Since the advent of compulsory savings, life expectancy has increased and with it, the number of years retirement savings need to fund. It's an issue of concern to a number of Australians. A survey of pre-retirement age Australians in 2022[6] found that while less than 50 percent expected to outlive their super, most respondents didn't expect to reach their desired level of retirement income.

With greater life expectancy, how do you determine how much a retired client can afford to draw down each year? For many retirees, it's a dire choice: live more frugally or risk running out of money.

Key Takeout

The key to mitigating longevity risk is adequate capital; this requires an exposure to growth assets, which needs to be balanced against the associated risk/s. A protected product may help to mitigate this risk along with securing a guaranteed lifetime income solution.

Market risk

The risk of a large decrease in portfolio value and expected income arising from a market shock is known as market risk. The prevailing market conditions prior to and during retirement can affect the longevity of retirement capital and the level of income generated.

A significant capital loss requires a significant gain to get back to the same point. As illustrated in figure one, there is a nonlinear relationship between gains and losses; as the loss grows, the gain required to restore the loss escalates.

Figure one: The math of recovery from portfolio loss

Percentage loss	Gain needed to restore loss
10%	11.1%
20%	25.0%
30%	42.9%
50%	100%

Source: Craig Israelsen, Ph.D.

A fall in market value can exacerbate longevity risk and increase loss aversion. While clients in the accumulation phase generally have the advantage of time and future contributions to recover losses, retirees in the decumulation phase generally don't have this opportunity.

Key Takeout

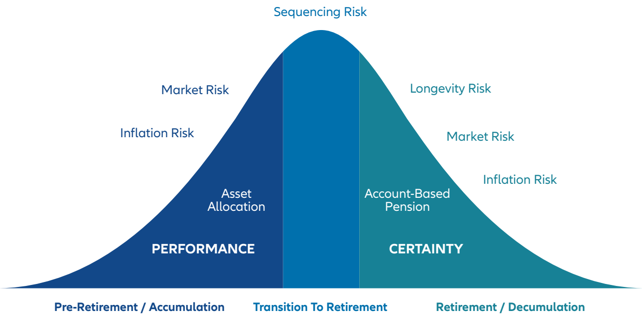
Consider products with some form of downside protection and income certainty to manage market risk.

6 Investment Trends, 2022 Retirement Income Report, October 2022

Sequencing Risk

Closely related to market risk, sequencing risk occurs where the order of years with positive or negative returns and the timing of your client's retirement is unfavourable.

Figure two: Sequencing risk



Source: Allianz Retire+

Market returns in the years during the transition to retirement can make a huge difference to how long retirement savings last. If a client retires during a period of positive returns, their income drawdowns will be fully or partially offset by positive investment returns.

However, if retirement coincides with a period of negative returns, retirees will be drawing down on a diminishing capital base. With less time to recover, falling asset prices and income drawdowns can magnify the scale of capital losses and erode retirement savings at an accelerated rate. Ultimately, any losses will diminish the total value of the remaining assets.

Key Takeout

Products with protection and income certainty purchased prior to or during the transition to retirement can help manage sequencing risk.

Behavioural Risk

Also referred to as 'loss aversion', behavioural risk can impact how a retiree invests, how much income they draw and can even impact their lifestyle. A range of behavioural studies have illustrated traits and biases that can impede your clients from making reasonable decisions about their retirement savings.

These biases might stem from others' experiences, the fear of outliving their savings or the fear of losing capital. Investment Trends identified three retirement fears (figure three) pertinent in the current environment.

Figure three: Retirement fears and concerns

Expect to outlive their super	47%
Concerned about medical costs	43%
Concerned about inflation & rising costs	42%

Source: Investment Trends, 2022 Retirement Income Report, October 2022

While loss aversion is a major factor influencing investor behaviour, particularly in retirement when it's difficult to recoup losses, understanding other biases and fears that can negatively impact clients' decision making is an essential part of retirement planning.

Key Takeout

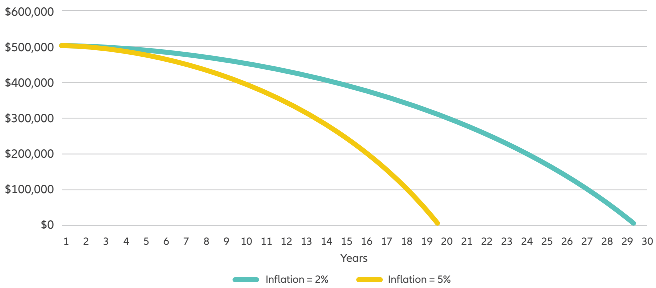
Education is the best way to mitigate this risk; retirees need to understand the potential long-term ramifications of reducing exposure to growth assets. Offering products with downside protection or guaranteed income can help manage loss aversion.

Inflation Risk

Inflation risk is once again top of mind as Australia's cost of living spirals. Higher inflation reduces purchasing power; it may exacerbate the fear of running out of money and increase loss aversion.

The compounding impact of inflation over time can erode retirement savings. Figure four uses the example of a retiree with $500,000. An annual inflation rate of 5% would result in their savings running out 10 years sooner than if inflation stayed at 2%. Concerns about inflation and rising costs are top of mind for many pre-retirees; for those already living on a fixed income, the figure is likely to be much greater.

Figure four: The impact of inflation



Source: Allianz Retire+, March 2022. For illustrative purposes only. Assumes a fixed rate of inflation applied to the withdrawal amount for the entire investment period. Fixed rate of investment return for the entire investment period. Not reflective of historical or expected capital market outcomes.

Key Takeout

Consider an allocation to products designed to prosper in an inflationary environment, such as inflation-linked bonds, private credit or securing a guaranteed lifetime income that has the potential to rise over time.

Retirement risks are interrelated. Volatile financial markets lead to market risk and sequencing risk, while inflation can be the catalyst for both. Inflation can increase longevity risk and impact a retiree's behaviour, making them more loss averse or leading them to live more frugally. While some of these risks can be managed by educating your clients, they can also be managed – wholly or in part – by careful portfolio construction.

Conclusion

Uncontrollable risks can have a significant impact on your client's retirement savings plan

Constructing a retirement portfolio can be complex – retirees need capital, income and flexibility as their circumstances change. One approach is to incorporate both protected and guaranteed income products. Products with downside protection can help safeguard against market risk, preserve capital and often provide a reliable source of income. Guaranteed income products can also provide a steady income stream throughout retirement. By combining such products, you can create a diversified portfolio that balances risk and reward, helping to ensure a comfortable and secure retirement for your clients.

About Allianz Retire+

We are an Australian company dedicated to developing retirement products to meet the unique needs of Australian retirees.

We have brought together Allianz' world-class insurance know-how with PIMCO's unrivalled investment expertise to deliver security and stability throughout retirement.

Our combined heritage, long-standing stability and global reach ensures that our retirement products can last a lifetime and evolve with the ups and downs of the market and the changing needs of our clients.

More Information

Get in touch

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Diagrams and examples in this document are not exhaustive. The data, assumptions and outcomes shown are hypothetical and designed to illustrate the product concept. They are not reflective of real life examples and should not be relied on as indicative of any actual product performance, capital or income return.