Investing through Retirement

Tom McLoughlin, Russell Investments

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ARF background

Since 2011, DC members now have the option of purchasing an ARF (and/or AMRF) at retirement instead of purchasing an annuity (priced on Fixed Income)

ARF structural benefits;

1. Disappointment with Annuity, Primarily an alternative, hopefully (better than) an Annuity
2. Legal ownership with preservation of pension capital for passing on inheritance to partner/dependants on death.
3. Tax –
    1. 25% of Fund v the salary and service rule – Potential advantage where 25% rule yields a higher lump sum (at max 1.5 times Salary clear advantage if fund > 6 times salary)
    2. ARF holders are driven by Revenue rules to draw down 4-5% (6% if €2m) of the value of the ARF each year
4. Flexibility
    1. Staged retirement
    2. Draw varying benefit levels (Revenue minimum) depending on needs, Rapid encashment allowed, as quickly as tax efficiency permits
    3. Deferral of annuity purchase
5. Post retirement fund with (theoretically) unlimited investment options (vs Annuity fixed income)

Perceived drawbacks of ARFs

- ***<u>Investment risk</u>****;*
  - *Individual retains investment risk beyond retirement.*
  - *Retail funds & retail charges*

– ***<u>Longevity risk</u>*** is not covered by ARF;

- Risk that Members may exhaust their fund by living longer than anticipated
- Potential (in future) to mitigate through use of deferred annuities or phased purchase of annuities to cover a certain level of minimum income?

– **<u>Post retirement uncertainty</u>** - ARF Investment pot

- will not provide steady stream of predictable annual income,
- But will hopefully generate at least equivalent income.
- Human behaviour –
  - May prompt conservative drawdown behaviour by retirees
  - Also too conservative investments may dilute returns (limited information to date suggests this occurs)

Behavioural aspects

- ARFs used for :
  - Long term growth
  - Alternative and more flexible source of income to an annuity
  - Preservation of pension capital for inheritance
  - Deferral of annuity purchase
- Segmenting membership;
  - Individuals with a core existing predictable income (.eg, legacy DB pension, other retirement income etc) more likely to use ARF for “excess”
  - Higher Income members more likely to use
  - Member comfort with nature of ARF risk ,e.g, Investment, Longevity, less predictable income stream

Investment returns matter

- DC provision dependant on both reasonable returns & affordable conversion (Annuity) rates,
- Pre Retirement - Proportion of Pension Pot at retirement, based on 40 years working

Varying Investment return levels	4%	5%	6%	7%	8%
Portion met by Funding	40%	32%	24%	19%	14%
Liability met by Investment	60%	68%	76%	81%	86%

- ARF potential impact;
  1. Lifestyling up to Retirement - average investment return could typically be increased by 2% pa if DC funds were not targeting annuity conversion.
  2. Post retirement ARF - each 1% increase in ROA can add 8% to the annual retirement income/wealth.
  3. Combined this could increase members annual retirement “income” by up to 100% (with some associated risks)

Investing through retirement can help reduce Risk

- Risk Categories;
  1. Inadequate Pension Provision major risk;
     1. Reduced investment return, also relative to Inflation post retirement.
     2. Increasing costs of annuities
  2. Investment Risk
     1. Permanent loss of capital,
     2. Temporary/short term mark to market volatility without permanent loss,
     3. Strong argument that extending your Investment period horizon is one of the key risk reducers, while also helping Investment returns
  3. Conversion from DC to Annuities a large single event Risk
     1. Purchase of Annuity at a single point in time
     2. Mitigated partially by Staged Glidepath but often at single points each year
     3. Typical Lifestyle process has significant Duration mismatch and includes minimal inflation protection

CONCLUSION

Current Lifestyle process contains material risks,

Investing through retirement can help.

Linking Trustee & ARFs

Before retirement
TRUSTEES decision

- Trustees make investment decisions
- Assets held in the Plan
- Focus on accumulation
- Institutional funds

After retirement
MEMBER Decision (with IFA)

- Individuals make investment decisions
- Assets held under contract with ARF provider
- Focus on decumulation
- Retail funds (

- Work/retirement patterns are not so cleanly separated (especially in the future)
- Reality is that the Investment Fund pre & post retirement investing is interlinked
  - Investment horizon crucial factor for Trustees
  - Individual members at Lifestyle stage have an Investment horizon through retirement
  - Lifestyle stage of Trust has to be framed differently for Annuity or ARF
  - The two investment strategies should be inter dependant (especially at Lifestyle Stage)
  - DC Funds are nearing their peak at Lifestyle stage, and crucial decisions need to be made.

Role of Trustees

1. Decision on ARF V Annuity at start of Lifestyle.
    - Trustees need a Programme to communicate this issue (& related information) to members so that members will make an informed decision
    - If the member does not make a decision, will the Trustees have to do so for them?
2. Lifestyling –
    1. Whether to Fixed Income or remaining in Growth Assets (at a period when member funds are peaking)
    2. What type of Lifestyle options or fund is appropriate for members transferring to ARF
3. Transition from Trust to ARF – Trustees can help members?

Information & Communication

To date, members uncomfortable making Investment decisions. The complexity of ARF/Annuity decision needs greater member engagement

- IFA engaged (by whom) to complete Member Financial Fact Find
  - Other Pensions
  - Other sources of Wealth & financial needs
  - understanding/attitude to various Risks
  - How the Trustee Lifestyle approach fits in

- Member communication (in association with IFA, 1:1)
  - BEFORE Lifestyle
  - Throughout Lifestyle
  - At Retirement (& obviously beyond)

- Segmenting the approach
  - At different income levels?
  - At different service lengths/other Pensions etc

Lifestyle and ARF.

Objective to achieve level of continuity of Lifestyling between the DC scheme & the ARF Fund

Member choice or Default Fund implications?

1. Hopefully member decision on ARF V Annuity
2. If ARF do Trustees have to provide appropriate 2nd Lifestyle Fund or leave to member

1.Investment choices – as wide as possible

1. Allow member in association with IFA to construct investment strategy aimed at continuity with range of ARF fund options
2. Wide range of Asset Classes as building blocks
3. Bundled Target Return Funds also an option

2.Lifestyle Default Fund,

1. Currently Default option is an Annuity Lifestyle
2. Case for clear 2nd option of ARF Lifestyle, if this helps members?

ARF Default Fund

Desired features

1. Trustees Investment strategy now recognise that the member's investment horizon is moving beyond retirement age,
2. Prudent investment principles remain
3. Reasonable Growth return target over medium/long term, to achieve specific returns/pension levels
4. Conservative Volatility/max drawdown targets
5. Clear message to members of these principles

Target Return Funds may contain many of these features

1. Specific target return (also useful basis for members to decide on which option)
2. Volatility/max drawdown targets to reduce risk
3. Diverse range of asset classes and Manager changes Asset Allocation in response to market risk

Trustee role on Transition

- Investment Fund issues
  - Facilitate best of breed Funds for members
  - By facilitating best of breed IFA,
- Minimise transition costs
  - Commissions of IFA at transition
    - Trustee role to check what rates are being charged
    - Pool of IFAs to encourage competitive rates
  - Fund transition management costs can typically be 1%
- Ongoing ARF Fund charges
  - Role for Trustees in facilitating Group rates

Where to next?

- ARF a relatively new product, some clear advantages and some issues.
- Likelihood of future Low interest rates mean annuities remain “expensive”
- Market & member responses still evolving
- Critical decision for members but Trustee also involved
  - DC Fund values increasing
  - 1^{ST} Wave of DC retirees upon us
- Communication effort needed by all parties, who have clear aligned interests (Member, IFA, Trustee, Fund managers, Employer)
- Start of ongoing focus item by IAPF

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THANK YOU

Tom McLoughlin, Russell Investments