DC Pensions

A Better Retirement Portfolio For Members In The Default Strategy

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EXECUTIVE SUMMARY

- Most defined contribution (DC) plan members typically end up in in the plan's investment default, so it is critically important that this is the best default possible.
- Incorporating an evolving strategy within the investment default is crucial to achieving this.
- One approach is to use lifestyle strategies, which have become the dominant form of investment default for Irish DC plans. Another is to use target date funds, which are the established norm in more mature markets such as the US.
- The DC market is evolving quickly, and investment defaults need to evolve with it. In particular, the retirement portfolio (the end point of the derisking process) in many DC plans needs an overhaul.
- It has become standard among Irish DC plans for investment defaults to derisk to 75% bonds and 25% cash at retirement or something similar, yet this type of retirement portfolio has become:
  - Inconsistent with the benefits available and the options being chosen by members at retirement;
  - Highly exposed to an increase in bond yields;
  - Potentially too conservative.
- Trustees of DC plans should review their investment defaults, especially the retirement portfolio component.

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BACKGROUND

Members often find themselves confused or even overwhelmed by the language used to describe their plan's investment range and the choices available, despite the best efforts of trustees and employers. These obstacles can appear so daunting that, typically, most members either opt for their plan's investment default or, by making no choice, end up in it.

At retirement, another set of difficult choices appears. Apart from the tax-free lump sum, which has universal appeal, the member now must choose from the following:

•An annuity;

•An Approved Retirement Fund (ARF);

•An Approved Minimum Retirement Fund (AMRF);

•A taxed cash lump sum.

Although the decisions facing members entering retirement are just as difficult as those facing members saving for retirement, no investment default is available for the retired member who is considering an ARF. Further, the trustees who provided an investment default during the saving phase are no longer available to help during decumulation. The members are on their own.

Trustees can help retiring DC members with these decisions by ensuring that the investment default for their plan contains a suitable retirement portfolio. Trustees are not responsible for the investment choices made post-retirement, but they can at least ensure that the starting position is appropriate.

WHY ARE THE YEARS AROUND RETIREMENT SO IMPORTANT?

For DC members, the years leading to and just after retirement are critical. The retirement account is typically at its highest value just before retirement. Years of contributions and investment return have combined to build the nest egg. For many members, the DC retirement account may be their single biggest asset, or possibly their second biggest asset after the family home.

At this point, investment return is a far bigger determinant of comfort than contributions. In fact, an extra 1% investment return in the final year of work can add as much to the nest egg as a year's worth of contributions at the start of the member's career.

So, it is important to maximise the return in these critical years, with an acceptable degree of risk.

The years immediately after retirement are equally important because:

(a) Spending in the active phase of retirement is high; and

(b) The nest egg is still at its peak, which means that an extra 1% investment return has far greater impact than in later years.

THE 1:2:3 RULE OF STAYING INVESTED IN RETIREMENT

For every euro of income that is withdrawn in retirement:

- 1/6 comes from contributions made during the member's working life
- 2/6 comes from investment return generated before retirement
- 3/6 comes from investment returns generated after retirement.

WHY TODAY'S MARKET IS PARTICULARLY RISKY

In the traditional investment default, the member's account is derisked over a number of years leading to retirement. This process is called the "glide path" and, in Ireland, has typically involved a gradual move away from a growth portfolio to long-dated high-quality sovereign bonds and cash. The aim is to reduce risk in the move to retirement.

Clearly, there is an opportunity cost involved in any move from a growth portfolio to long-dated high-quality sovereign bonds and cash. A well-diversified growth portfolio is expected to outperform a 75/25 bond/cash portfolio over any meaningful investment horizon.

In the current market, in which expected returns from long-dated bonds are at historic lows and cash returns net of fees are extremely low or even negative, the opportunity cost is even higher than usual. This cost could be 3% per annum or more in today's market.

In addition, bond yields may increase, exposing the close-to-retirement member who subsequently does not buy an annuity to a potentially significant capital loss.

OPTIONS AT RETIREMENT

Retirement portfolios should reflect the benefits that a member is expected to buy at retirement. Traditionally, the member had very little choice in this area: after the tax-free retirement lump sum was taken, the balance of the member's account was typically spent on an annuity. This resulted in the typical 75/25 bond/cash portfolio at retirement. However, things have moved on and, since 2011, it is no longer compulsory to buy an annuity.

To use an ARF, the retiring member must also have approximately €12,700 per annum of guaranteed income for life. For many individuals, the state pension will provide most of this. For some, income from a defined benefit pension scheme is also available.

Individuals who do not have that level of income must place up to €63,500 in an AMRF before they can buy an ARF. An AMRF works in a similar manner to an ARF, with the exception that no income can be drawn from the initial AMRF investment until age 75.

It is not easy to predict what members will do, but some lessons may be learned from mature DC markets overseas. For example, in the US, where annuities are available but there is no requirement to buy one, fewer than 10% of retirees buy annuities. In Australia, where there is no requirement to buy an annuity and members can simply cash out their benefits, members do not typically fully withdraw their funds at retirement. Members in Australia have a great deal of flexibility, but the most common action for those with meaningful balances is to invest through a type of flexible drawdown product. (Drawdown means systematic withdrawals of interest/investment return and capital from the accumulated nest egg).

In the UK earlier this year the Chancellor announced radical changes to the treatment of DC pension schemes. DC members will no longer have to buy an annuity (although they can still do so if they wish). These developments will lead many UK DC plans to review their investment ranges, and in particular the investment default design.

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One can also learn from the experience of the retirees from first generation DC plans here in Ireland. Even for those who have chosen the annuity route, the reality is that a far higher percentage of their fund has been used to secure tax-free cash than 25%; in fact, for many retirees, all of their fund was taken as a tax-free lump sum at retirement.

Either way, DC plans need to reconsider the investment options they offer, and the investment defaults used. If members are using an investment strategy that targets the price of an annuity as they approach retirement but do not actually intend to purchase an annuity at retirement (or a much smaller annuity), many existing default strategies may be inappropriate. Individuals seeking to draw down will need to retain a proportion of growth-seeking investments in their pension plan to offset the impact of inflation and to maintain their income at adequate levels.

A CLOSER LOOK AT VARIABLE INCOME

As noted above, retiring members in Ireland have historically converted their retirement accounts into lifelong income by purchasing an annuity. An alternative approach (which is the norm in other markets) is to take systematic withdrawals from a diversified portfolio during retirement. That approach is now widely available in Ireland, thanks to ARFs. The ARF is likely to prove attractive for many members. There are several reasons why retiring members might choose to use part of their pension to buy an ARF or AMRF, rather than an annuity:

- An ARF or AMRF can continue to provide tax-free investment growth after retirement;
- Income can be drawn from an ARF as needed;
- An ARF or AMRF can be inherited.

A CLOSER LOOK AT SECURED INCOME

The cost to a 60-year-old of buying a pension income for life of €10,000 per annum is €254,000 approximately. The cost to a 65-year old of buying the same pension is €225,000. This is because delaying annuity purchase by five years reduces the expected pay-out period and cost, and this pattern continues to age 70, 75 and 80 (and beyond).

INCOME DRAWDOWN AND ANNUITIES ARE COMPLEMENTARY

You should not view the choice as being a stark, either/or decision. Systematic withdrawals and annuities are complementary. At certain times and for certain people, an annuity will be the mainstay of overall retirement income; at other times and for other people, the emphasis will be on systematic withdrawals from a diversified portfolio.

Annuities, just like diversified portfolios, come in different shapes and sizes. The Irish market has traditionally focused on immediate annuities (that is, annuities that start to pay out immediately rather than in the future), but this is not necessarily how the market will continue. It is worth noting that in The OECD Roadmap for the Good Design of Defined Contribution Pension Plans, 2012, the OECD endorsed the use of deferred life annuities within DC investment defaults, stating: “A combination of programmed withdrawals with a deferred life annuity... could be seen as an appropriate default.” (A deferred annuity can be purchased after retirement, or at retirement but with a delayed pay-out).

A BETTER RETIREMENT PORTFOLIO

It was mentioned that DC retirement portfolios in other markets can be very different from the traditional Irish 75/25 mix, for example in the US and Australia. These are mature DC markets where annuities are not the dominant route to retirement income. Clearly, drawdown portfolios may not be appropriate for everyone in the circumstances of the Irish DC market, nor may they suit the risk

preferences of individual Irish members. However, their objective - to support systematic withdrawals throughout a long retirement - will resonate with very many DC plan members who are close to retirement.

The current standard of targeting an annuity is open to challenge for most DC plans. The DC market now requires a more sophisticated approach that allows for the inclusion of variable income from an ARF.

KEY FEATURES OF THE BETTER RETIREMENT PORTFOLIO

1. Better alignment with likely member benefits
2. Reduced exposure to the risk of bond yields increasing
3. Greater awareness of current (historically low) yields on cash
4. Makes best use of member's retirement account when it is at its largest
5. Flexibility to buy an annuity when rates are more favourable
6. Combination of asset classes consistent with sustainable income withdrawals in retirement

CONCLUSION

As the DC market evolves, investment defaults, especially the retirement portfolio of many plans, need an overhaul.

Although many investment defaults are derisking to a 75/25 bond/cash portfolio at retirement, this arrangement is now seen as inconsistent with the benefits that members could take at retirement and as potentially too conservative. It also exposes members to increases in bond yields.

Retiring members deserve the best start possible in retirement. Trustees of DC plans should review the retirement portfolio component of their investment default as a matter of urgency.

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