

WEEKLY REPORT FEBRUARY 2021



Private Asset Management Ltd

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LIVING ON YOUR NESTEGG – WHAT COULD GO WRONG?

Two weeks ago we looked at the decumulation phase of a retirement savings plan – the period after retirement when you and the financial sector live off your savings. The example was of a couple who, having reached age 65, had saved \$500,000 and wanted to know the maximum amount they could safely spend each year, assuming they lived to 90, at which time both their bodies and their savings would be exhausted. Given a balanced portfolio and typical fee structures that number was \$22,500 per year, increasing at inflation of 1.5% pa.

That is the base case position. But the future is uncertain so today we will look at various risks to the most likely outcome. First off though let's review a paper on the topic written in 2016 (and updated in November 2020) by The NZ Society of Actuaries. Entitled "Decumulation Options In The NZ Market: How Rules Of Thumb Can Help", the paper makes the case for various principles which are generally reliable in the absence of full advice. One of these was that an individual retiring at age 65 can safely take around 4% of the starting value of his/her retirement savings and increase that amount in line with inflation. Coincidentally the \$22,500 we arrived at is 4.5% of \$500,000 although the actuary's modelling forecast that there would be some funds left over at age 90. The reason for the different outcomes is that the study assumes a 1.6% return for bonds after tax and fees and 5.1% for shares also after tax and fees.

Part of the reason for the higher returns used in the actuaries report is that, whilst the report is written for retail investors, the study assumes low, institutional level fee structures, much lower than the typical KiwiSaver balanced fund. Also the modelling assumptions included the following "investment management expenses are not explicitly allowed for. Instead we assume that they are either small (passive management) or that they are off-set by value added from active management". My view is that those are a couple of pretty heroic assumptions, particularly given the level of non-institutional active fees typically charged in NZ, eg KiwiSaver, and is in contrast with all the data from the likes of S&P Indices versus Active (SPIVA) which shows that active management after fees consistently underperforms. However one of the authors of the Decumulation Options report made the point that the future is uncertain and current yields are not a particularly good indication of future returns. The actuary also stressed the fact that his report assumes rational behavior from investors ie that, if they could not find low cost, active management that added value, investors would opt for low cost, passive alternatives. He was also very much of the view that my forecast of a 1% return from bonds was too conservative as it ignored significant possible components of future return including credit premia, forward yield uplift on future reinvestment and possible future hedging premia. Forecasting interest rates for 30 years is obviously problematic – the average maturity of a typical bond portfolio is well below 10 years so the bond holdings will be rolled over a number of times in the decumulation phase. However the relatively low level of long term interest rates on very long dated local and overseas bonds suggests that the market thinks the possibility of a large rise in interest rates over the investment horizon is unlikely. BCA Research, in a report written in late 2019, forecast 1.7% pa for global bonds and 5.9% pa for global equities, pre-tax, pre-fees. Most asset classes and in particular bonds have grown more expensive in 2020 and if one just deducted FIF tax from BCA's 5.9% pa the post-tax return falls to 4.5%.

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Let's look at some sensitivities, particularly those on the downside. Probably the biggest financial worry for the newly retired is running out of money. Consequently many retirees don't spend as much as they could in retirement and leave large amounts to their children. If, as in our example, a retiree's nest egg is invested in a balanced portfolio then the big worry is a deflationary bust and concomitant share market crash. All crashes are not equal however – if the crash occurs when you are aged 89 this probably won't be a big deal but if it happens when you are 65 it could materially impact the safe withdrawal rate. The timing of an equity market downturn is known as "sequence risk" (SR). In the paper "Measuring Sequence Risk" the authors define SR as "the risk that a bad return occurs at a particularly unfortunate time, such as around the point of maximum accumulation or the start of decumulation. This concept is particularly relevant in the context of retirement savings where the implications for withdrawal rates of a bad return can be particularly severe." So our first "what if" scenario is "what if stock markets fall by 20% immediately after you retire, go nowhere for two years then return to trend growth of 6% pa?" The computer says this would reduce the withdrawal rate by 18% to \$18,500 pa. That is quite a hit and reflects the relatively high weighting in shares in a balanced portfolio.

The next scenario is "What if we just leave the money in the bank at 1%?" The result of the lower return on a cash investment – estimated at 1% pa pre-tax, post fees is that the withdrawal rate falls to \$18,000 pa. Another risk with this strategy is that interest rates could fall further although if they did it is likely, but not certain, that inflation would also be lower.

The base case scenario assumes the use of a higher cost financial planning service and the associated fee structure – totaling 1.6% pa. Lower cost options exist so the next scenario considered is where annual fees are limited to 0.5% pa. Under this option the safe withdrawal rate rises from \$22,500 per year to \$24,000, an increase of 7%.

The last scenario we will consider acknowledges the fact that the 1% return we forecast for bonds could be too low over the next 25 years so "what if interest rates average 2%?" This moves the withdrawal rate up to around \$23,000 pa.

Lastly, whilst the decline in interest rates and rise in stock markets is pretty depressing for an individual in NZ contemplating retirement, things are very much worse in other countries, notably in Europe and Japan. S&P Dow Jones Indices produces a quarterly Cost of Retirement Income report and in the December 31 issue they highlighted that the present value of hypothetical, inflation-adjusted retirement cashflows - equal to USD 1 per year, beginning at various retirement dates (vintages) and lasting for 25 years thereafter - rose for almost all vintages in 2020, with many annual increases exceeding 20%. These annual increases were typically larger than the equity market gains after Q1 2020 and so highlighted potential challenges for investors looking to translate retirement savings into inflation-adjusted retirement income. For example, hypothetical monthly retirement distributions for the S&P STRIDE 2020 index accounted for 2.78% of the index value at the end of last year.

Brent Sheather is an Authorised Financial Adviser. A disclosure statement is available upon request. Brent Sheather may have an interest in the companies discussed.