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Private Asset Management Ltd

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QUANTIFYING THE LONG-TERM IMPACT OF ASSET MANAGEMENT FEES ON RETIREE INCOME AND INHERITANCES – Part 1

Most moderately wealthy ($500,000 - $2m) retired individuals have two primary investment objectives, as follows:

- Firstly, to have enough money to live on during their retirement.
- And secondly, to leave a lump sum to their children and/or charities.

Obviously, there is some tension between the two objectives and usually the larger the sum to invest the more the latter objective can be prioritized. Having said that, and, as we covered in the NBR story "Dividends What Are They Good For" (published on 9 July 2023), many retirees who have employed a disciplined savings regime over the 40 or so years of their working life find it very difficult to suddenly switch to a strategy of dis-saving. Retired people often like the idea of just living off the income produced by their portfolio, rather than spending their capital. This strategy reinforces their perception that they are acting prudently. In a paper, "Explaining Investors Preference For Cash Dividends", by Shefrin and Statman, the authors provide a simple explanation for income investing. They suggest that, as many individuals are worried that their funds might run out in retirement or they wish to safeguard their wealth against the risk of overspending, they employ a rule to the effect that "thou must only spend dividend and interest income". This rule prohibits spending your capital and thus often sees retirees moving to the next life with more money than they originally retired with.

Besides these behavioral factors there are a number of other important parameters which influence investor outcomes generally rather than the prioritisation of one of these two objectives over the other. These primarily relate to asset allocation, investment performance and fees. In a new paper, "Quantifying the Long Term Impact of Assets Under Management Fees on Retiree Income and Inheritances", published in the Journal of Retirement, James Mahaney, Principle of Mavericus Retirement Services models the impact of AUM fees on retirement income flows and inheritances. Cutting to the chase his results indicate that on average every 1% in annual fees results in a 15% reduction in income and a 23% reduction in the terminal sum i.e. the inheritance amount. Mahaney starts by explaining the reasons for writing his paper: "The shift from defined benefit plans to defined contribution plans has shifted the cost of generating income in retirement from plan sponsors to individuals. As they seek to turn their savings into retirement income individuals invariably use a financial advisor." Arguably the chief advocate for employee financial welfare in the USA is the Department of Labour (DOL) and the DOL is very concerned about the impact on retiring employees wealth of shifting out of a company-sponsored pension plan when they retire to an Individual Retirement Account, known as an IRA. IRA's are typically managed by a financial advisor. The DOL described this move as "the single most important financial decision a plan participant makes over a lifetime of retirement savings." Research by Munnell et al of the Centre for Retirement Research at Boston College, "Investment returns: defined benefit vs. defined contribution plans" found that the rates of return over a long period for IRAs were less than half of those achieved by defined benefit plans.

Whilst KiwiSaver is still in its infancy the same dynamics will likely become apparent in NZ when Kiwsavers retire – they will need to make the decision as to whether they switch their Kiwisaver fund to a portfolio managed by a financial advisor. Based on the US experience there is a risk that the alternative will have higher fees, higher risk and more chance of underperformance relative to the benchmark.

Mahaney writes that "it is possible to look at the impact of fees on both retirement income and legacy values by viewing through the lens of a common financial planning approach. The process will utilize the widely embraced safe withdrawal rate methodology and assume the retiree desires a 95% probability of success using Monty Carlo simulation over a 30 year period of retirement. The initial withdrawal value amount is increased annually for inflation." His analysis determines that, before any fees, a safe withdrawal rate with a 95% probability of success for a $500,000 portfolio is 3.1% pa and the median amount of assets left at death is $663,000. However with a 1% fee the probability of success falls to 85% and the median value of legacy assets falls to just $328,000. He then uses the Monte Carlo model to solve for a 95% probability which necessitates a reduction in the amount that can be safely withdrawn. The result is a safe withdrawal amount of 2.64% pa with a median legacy amount of $508,000. That's a bit complicated but the bottom line is that a 1% annual fee reduces income by 15% and the amount left over for children/charities etc by 23%. If drawings are held at 3.1% the amount left for children/charities etc halves. Clearly even a 1% total annual fee is a big deal for anyone with an interest in the residual assets because, for individuals who aren't on the Rich List, when push comes to shove maintenance of income is likely to be prioritised.

Although only published last month the analysis was based on US interest rates back in January 2022 and a forecast return from equities of 5-6% pa. Because of the massive rise in interest rates since that time the sensitivity of both income and terminal sum to fees will be reduced. Given these changes I thought it would be interesting to update these numbers using a less sophisticated model, for a typical balanced portfolio held by an NZ client of a financial planning firm, using current interest rates and a more optimistic 8% pa long term return for equities. But that is enough for this week – in two week's time we will look at the impact of fees on income and residual capital in an NZ context.