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Retirees stuck in tug of war: balancing high risk v safe long-term returns is an ongoing problem

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IN many ways superannuation is like playing a lifelong tug of war.

In our working years we are constantly being exhorted to save more to avoid the ignominy of being unable to fund our own retirement.

But escalating costs for mortgages, food, utilities, cars, holidays and an entertaining night out are all tugging in the opposite direction.

Human behaviour being what it is, short-term gratification generally takes the honours over a reward that is a long, long way down the track.

You might think that when retirement finally arrives, the tug of war is over. Time to let the rope go.

But in reality you have just started a new game, one with arguably a higher level of risk now that the regular pay cheque has stopped.

Our mandatory super system has much to commend it but there is one thing there is no escape from: the risk is all borne by the fund member and that doesn't change the day you retire.

One of the key questions we have to answer when setting our retirement savings goals is how much will we need in retirement to be able to afford the with which lifestyle we are comfortable.

For most people their super fund balance at the time of retirement is likely to be the largest lump sum of money they will be responsible for. The challenge is to convert it into an annual income that is sustainable across the expected retirement years.

If you are in good health and take a conservative approach, that means planning to make it last for 30 years.

That is a challenge on many levels.

For a start, the average Australian will not have saved enough in super to be able to live off interest alone.

That means some level of exposure to growth assets such as shares is going to be necessary to keep the portfolio growing during the long term while it is in drawdown mode.

This month the Association of Superannuation Funds of Australia released its latest figures for the ASFA Retirement Standard, which shows a couple looking to achieve a comfortable retirement will need about $54,000 a year to live on.

By comparison, a recent survey into retirement incomes by research group Investment Trends uncovered some interesting differences in attitudes among people nearing retirement as against those in retirement.

The research segmented people into groups based on whether they were less than three years from retirement up to people more than 11 years away from retiring.

On average people said they needed $56,000 a year to lead the lifestyle they wanted and also felt that was achievable.

Investment Trends then asked a group of retirees again ranging from less than three years since they retired up to people who had retired more than 11 years ago.

The result, and this is good news for people perhaps struggling to get their portfolio up to the level they aspire to, is that retirees actually spend $36,000 a year, significantly less than what our accumulator group thought would be necessary.

There is a range of possible explanations here.

It could be that people find they can simply live more cheaply than they thought possible once work and time demands are out of the picture.

Or it could be that people are being frugal and conservative, particularly after just living through a global financial crisis, to preserve or rebuild capital.

Whatever the answer, it is interesting to consider the various ways people set spending levels from their super accounts.

It is not uncommon for people to simply base withdrawals on the amount needed to cover living expenses.

Another is to set a specific dollar amount or withdraw just the investment income, with direct shares paying fully franked dividends having special appeal among direct share investors using a self-managed super fund. Financial planners often favour a set percentage of the portfolio value as the withdrawal level.

In reality most people will probably use a combination of spending strategies as things affect them: a new car is needed, for example, or markets rise or fall significantly, prompting a review of the drawdown strategy.

As with many things to do with superannuation or investment, it can be as complex or as simple as you want to make it.

The problem is that you are balancing the competing needs of short-term liquidity against longevity risk, the risk you will run out of money too soon.

A simple way to think of it is that you need two investment buckets: one to cover liquidity and the other to manage longevity risk.

Some financial planners apply that literally, recommending you have two to three years of income needs in cash or short-term defensive assets and a second bucket invested in growth assets for the longer term.

From an investment portfolio perspective a key question as you near retirement is whether you should significantly alter your asset allocation towards more defensive assets.

The asset allocation decision is central in terms of how a portfolio performs and a typical growth portfolio in the run-up to retirement often invests about 70 per cent in growth assets such as domestic and international shares.

With an investment horizon of 20-plus years a strong argument can be made that you do not need to adjust it, at least for the early years of retirement.

But the reality is that sharemarkets can wipe off value quickly and, once retired, your ability to rebuild capital is usually limited. Ask anyone who retired just before the GFC.

So it comes down to a trade off between risk and potential return.

By shifting the portfolio into more defensive assets you lower the risk of depleting the portfolio before you plan to. But you are giving up potential market growth.

Welcome to the retiree's tug of war.

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