Smart investing

A retirement income rethink

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Robin Bowerman, Head of Corporate Affairs at Vanguard Australia, shares investment and personal finance insights gained from over two decades in the finance industry as writer, commentator and editor.

Robin Bowerman

What are your plans for your retirement years?

Are you, like most, working towards financial independence, when you can shed the responsibilities of work with an income to continue to live your life, the flexibility to go on that trip, and to pursue those hobbies...

In many ways, todays aging population of Australians are facing a more complex course to attaining this idyll. The combination of low yields and lower return expectations arguably creates the worst headache for those approaching or already in their draw down years. The old reliable income from term deposits and dividend yields is increasingly under pressure with interest rates at record lows and an increasing number of companies reduce or defer their dividends.

Many retirees and advisers use the 4 per cent rule of thumb when considering an appropriate level of income to draw from their savings when they retire. That is, drawing 4 per cent of the portfolio value out each year as income, without a substantial risk of running out of money too soon, assuming the portfolio was yielding at least 4 per cent.

If we look back, in 2013 an investor following this 4 per cent rule could have used a balanced, diversified portfolio of 50 per cent Australian shares, 25 per cent Australian bonds and 25 per cent term deposits to get that 4 per cent yield. Not taking on too much risk, including downside protection of bonds and the peace of mind that term deposits provide to many.

But given the current investment outlook, income focused retirees now need to rethink how to earn enough income to meet their spending goals. To maintain the same level of income may involve taking on higher levels of risk, often to the detriment of that protection and peace of mind.

There are three main ways that tend to be considered on this front – you could invest in higher yielding bonds, increase your allocation to equities or introduce higher yielding equities.

All of these options come with the potential for investors to take on, in some cases, much higher levels of risk than a retiree may otherwise have an appetite for by decreasing the defensive investment choices which balance out portfolios and mitigate equity risk.

For example, that same investor described earlier would today have to shift to a portfolio of 100 per cent equities to get the same 4 per cent yield. Shifting the portfolio that dramatically almost doubles the risk built into the portfolio versus the

2013 example, removing the benefits and protection provided by portfolio diversification through investing in other asset classes such as fixed income.

But there is a different way to plan for the draw down years which takes a broader view than just concentrating on income yield.

If your starting point focuses instead on the total return (all sources of return) of your portfolio versus just the income or dividend yield, and you introduce a prudent spending strategy, you can keep control over both the risk level within your portfolio and how much income you draw out each year.

Unlike an income-oriented strategy which generally uses interest/dividends as income and preserves capital, the total return approach accepts that in some years the drawdown of capital may be necessary. This for some will require a significant shift in thinking, as for many the income approach appeals because the underlying nest egg isn't drawn on. However, a dramatic shift in investing environment and outlook is demanding investors rethink the costs – and risks - of maintaining an income-oriented approach in the future.

To implement the total returns approach, goals and risk tolerance should first be considered. This informs an appropriate asset allocation at a level that can sustainably support the spending required to meet those goals, with the use of capital returns when necessary.

For example, during periods where the income yield of a portfolio falls below your spending needs, the capital value of the portfolio can be spent to make up the shortfall. As long as the total amount drawn from your portfolio doesn't exceed the sustainable spending rate over the long term, this approach utilises both income and capital growth elements of the portfolio during the volatile periods for markets which inevitably occur.

It will require the discipline to reinvest a portion of the income yield during periods where the income generated by the portfolio is higher than what is required for living expenses.

The total return approach allows you to separate your spending strategy from your portfolio strategy which can ensure the risks don't creep up to a level out of step with your risk tolerance.

In addition to the benefit of smoothing the source of drawdowns between income and capital growth throughout retirement, it can also allow for better diversification of risk across countries, sectors and securities, and can be useful when considering how to incorporate other income, such as the age pension, into your plan.

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