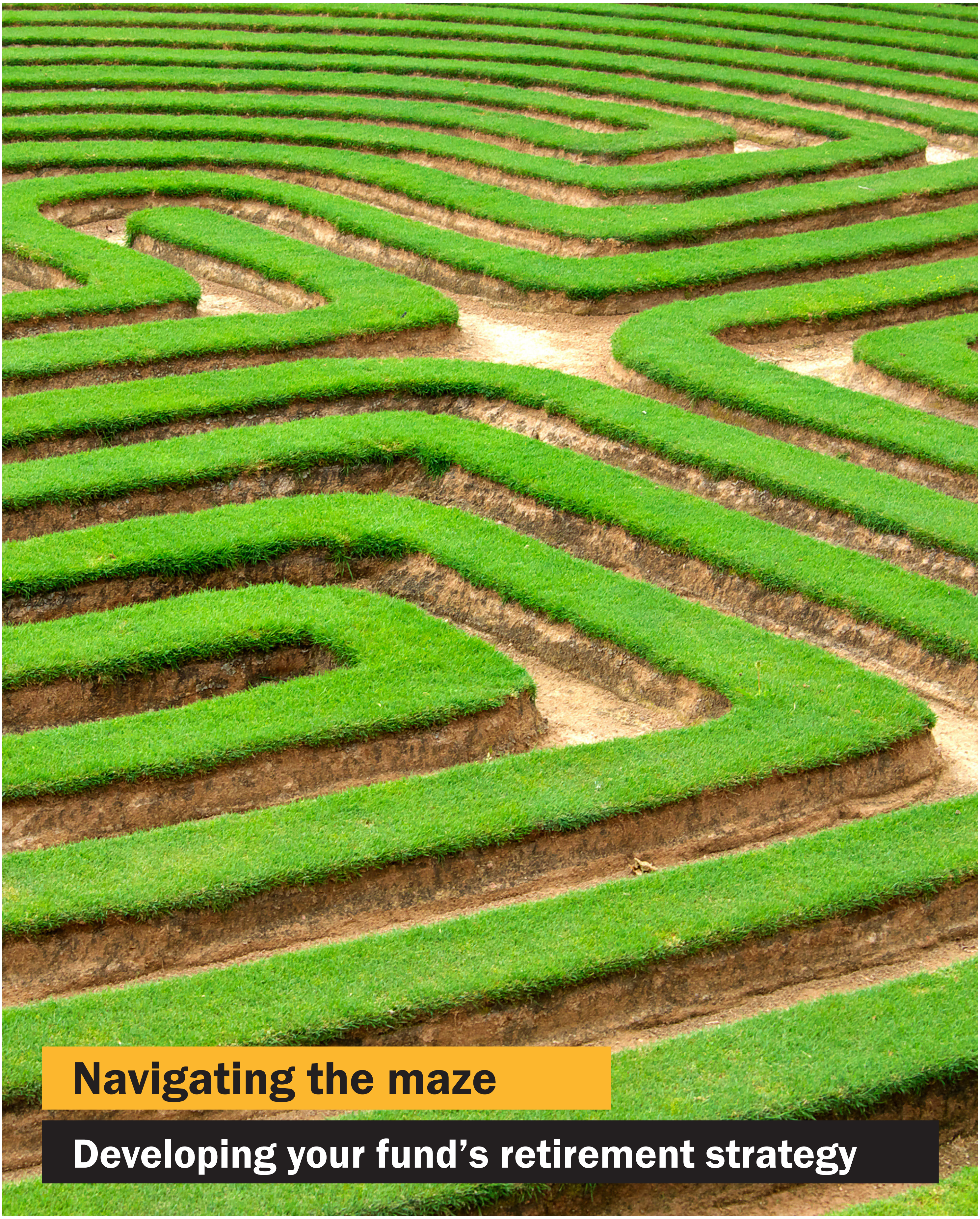


Navigating the maze

Developing your fund’s retirement strategy

TOWERS WATSON

> "It is little surprise that no universal solution presents itself. The oft-stated mantra 'there is no silver bullet' for retirement strategy remains apt."

Navigating the options for members' retirement phase is a key challenge for superannuation fund trustees. Towers Watson Australia head of retirement income solutions NICK CALLIL discusses how Towers Watson's Retirement Strategy Appraisal (RSA) framework can be used to assess and compare strategies, and provide deeper insights among key stakeholders into your fund's retirement product options.

As the focus on providing sustainable retirement incomes for fund members reaching retirement intensifies, superannuation funds continue to face the challenge of developing retirement offerings which meet the key concerns of their members.

This is no simple task. Given the range of retirement products and strategies available, the multitude of different risks and preferences that matter to retirees, and complex implementation issues, it is little surprise that no universal solution presents itself. The often-stated mantra 'there is no silver bullet' for retirement strategy remains apt.

While it is tempting to rely on existing solutions which are in place and are known and understood by members, innovation continues to occur in the product marketplace, and funds must consider whether any of the new breed of products can better meet retirees' needs. Further, as funds develop greater internal resources, there are a number of strategies which can be developed by funds themselves and offered without the need for a third party provider, which may also warrant close consideration.

Many funds will have devoted considerable time and resources towards ensuring that their internal team has a good awareness and understanding of the range of retirement products and strategies available, and the key design features of each. While this is an important step in the process, it often leads to the question: what next? Or, more specifically, how does knowing more about the various products and strategies help Board and management assess what is right for their fund's retirees? Ultimately, developing a fund's retirement strategy requires not just familiarity with the design features of the various products, but a rigorous assessment of the outcomes generated by each, and a quantitative comparison of these outcomes across different product types.

A key obstacle to undertaking this assessment has been the complexity of comparing retirees' outcomes from products with diverse features, return drivers and payoff profiles, under differing prospective market return scenarios. In this article, we outline Towers Watson's approach to help funds develop their retirement strategy, including specific tools for comparing different retirement products.

Retirement products: a growing market

The range of retirement products able to be offered by funds for their members in retirement has grown well beyond the standard account-based pension. We can classify such products according to whether they can be offered directly by the funds themselves, or whether an external party (such as a specialist fund manager or insurer) is generally involved due to the specific product features. Figure 1 illustrates the retirement products we currently see in this market.

The list of products has expanded in a relatively short time frame through internal innovation by funds and product development by insurers, fund managers and other providers, and can be expected to expand further in the coming years through continued innovation and regulatory encouragement. For example, we expect to see deferred annuities soon become part of the retirement product landscape, assuming that currently anticipated regulatory changes eventuate. The range of options available to funds is actually much wider than figure 1 might suggest – within each product category, there is a range of design variations possible, and of course a fund may combine two or more products (for example, an 'in house' strategy in tandem with an external product) to produce its own strategy.

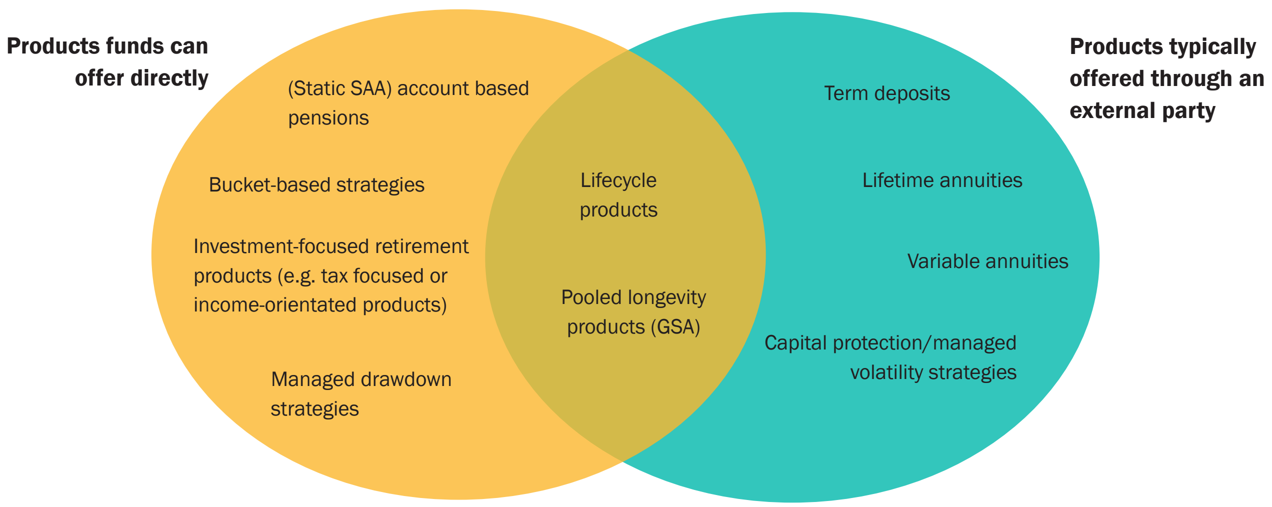
The challenge faced by funds in comparing retirement products and strategies arises from the diversity of the design features among the products available in the market place. Ultimately this variation arises from the fundamentally different ways in which products and strategies seek to deliver improved outcomes for retirees, relative to a conventional static asset allocation account-based pension. We can identify the broad approaches which underpin retirement products as follows:

- Strategies which rely on investment market returns but which aim to tilt or shape the underlying distribution of returns in a way which produces outcomes considered to be advantageous for retirees. This category includes tax focused, managed volatility and other investment-focused products.
- Strategies which rely on the pooling of mortality of lives and effectively redistribute wealth towards retirees who live longer than average, either on a guaranteed or pooled basis. This category includes immediate and deferred lifetime annuities, and pooled longevity or group self annuitisation (GSA) products.
- Strategies which rely on either shifting wealth between asset classes, or managing the source of the amounts drawn down (that is, spent) among various asset classes, in such a way that aims to improve retiree outcomes. This category includes lifecycle and bucket-based strategies.

Each of these approaches may be argued by proponents as addressing a key priority for, or risk to, retirees. However, the fundamental difference of the underlying approaches means that products can have completely different payoff structures and sensitivities to factors such as market returns, inflation, drawdown strategy and lifespans experienced by an individual over their retirement. For example, a tax-aware investment fund, a lifecycle strategy and an immediate lifetime annuity will each respond differently to poor market returns, higher than anticipated inflation, and a longer than expected lifespan, and hence the level of protection provided by each against such events will also differ.

Given this diversity of 'value drivers' underlying retirement products, how can a fund assess the retirement outcomes they deliver, taking into account all of these variables, and thereby determine an appropriate product strategy for its retirees?

Figure 1 — The retirement product universe



Source: Towers Watson

A structured approach to retirement strategy

Rather than beginning with a comparison of different retirement products, we propose a structured process to developing a fund's retirement strategy, illustrated in figure 2. The key early stages of the process include a detailed investigation into the profile of the funds' membership in and approaching retirement, considering not only account size but other influencing factors such as age at retirement, gender, and degree of dependency on the age pension. As the retirement strategy is being developed for future retirees, it is important to conduct appropriate projections to identify the demographics and wealth profile of the fund's future retirees.

Developing a clear overall profile of the fund's prospective retirees allows us to then develop a manageable number of hypothetical, or model, retirees as illustrated in figure 3, which can then be used to simplify the assessment of the retirement products and strategies under consideration.

Towers Watson's Retirement Strategy Appraisal (RSA) framework

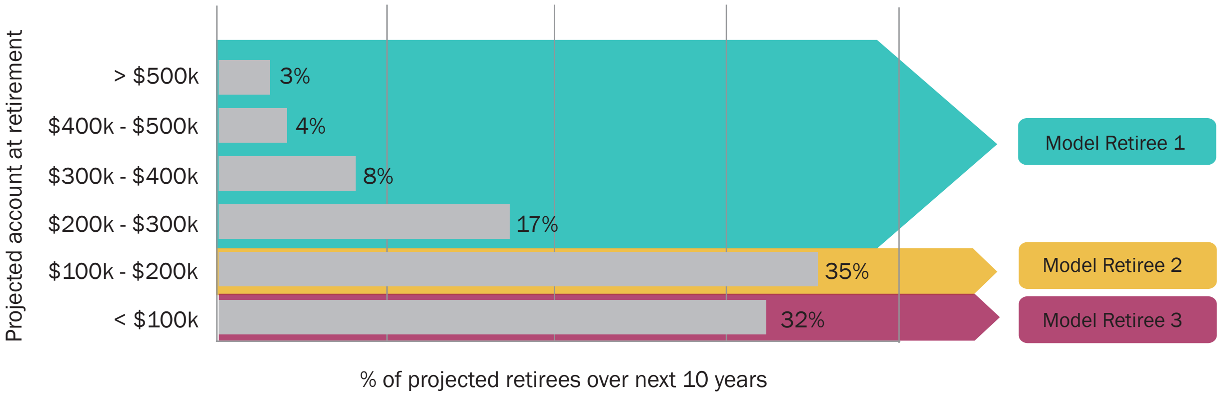
Many funds will be familiar with the modelling framework Towers Watson has used for many years to help formulate our strategic advice on investment strategy and retirement outcomes. Underpinning this advice is our economic scenario model (known as the Global Asset Model), which generates asset class returns and other economic variables for stochastic modeling, and our Retirement Planner, which projects retirement wealth and income for individuals based on a given starting position and retirement product strategy, allowing for the means-tested government age pension.

Together, these tools can be used to evaluate retirement strategies, allowing for uncertain market conditions (for example, asset class returns, inflation), retiree behaviour (such as higher or lower spending rates) and lifespans.

Figure 2 — Developing retirement strategy

Source: Towers Watson

Figure 3 — Demographic/wealth analysis and model retirees



Source: Towers Watson

> "Together, these tools can be used to evaluate retirement strategies, allowing for uncertain market conditions, retiree behaviour and lifespans."

However, given the fundamental differences in value drivers among the various retirement strategies, as described above, we need to consider carefully the measures used to assess and compare the prospective performance of such strategies. To begin with, we note that we need to move beyond a 'tick or cross' type assessment of products – the degree to which stated objectives or risk protection is met, and under what conditions, is clearly important and requires more robust, quantitative evaluation. Further, labels or design features may in fact provide only a partial clue to how well a product meets its claimed objectives. Longevity risk, for example, may be adequately addressed (for certain retiree profiles) by products without explicit longevity protection.

Finally, individual objectives or desired product attributes – such as 'access to market returns', 'longevity protection' or 'inflation protection' – cannot be considered in isolation. A process for combining measures is required, as different products may perform well on specific attributes, but fail to deliver on the overall goal of delivering acceptable outcomes to retirees.

Objectives and metrics

The Towers Watson Retirement Strategy Appraisal (RSA) framework, therefore, initially condenses the possible objectives that retirees may have for a retirement product or strategy into three – a manageable number which makes the next step of assessment workable.

The objectives are set out in figure 4. These effectively cover the wide range of preferences or priorities that retirees may have for their retirement. For example, a desire for longevity protection is effectively reflected in the objective 'delivery of income throughout retirement', as is a desire for protection against inflation. Protection against a 'sequencing risk' event is captured by both the first and second objectives (as any such event will impair the income received over retirement, and will also produce unwanted journey volatility). A preference for adequate liquidity during retirement, or a bequest motive, is clearly met by the third objective. Hence, taken together, this set of retirement objectives form a complete and workable basis on which to assess retirement strategies for a fund's retirees.

However, identifying objectives is only part of the assessment story. Unless clear measurement tools or metrics are in place, it is difficult to make meaningful comparisons of the performance of different strategies.

For each objective identified above, we have developed (based on our stochastic modelling framework described above) a metric which gauges how well the outcomes produced by a given product or strategy meets that objective. We note that conventional metrics used for investment analysis (such as expected outcome, standard deviation or Sharpe ratio) are not able to fully capture the objectives identified above, in particular for products with longevity or capital protection features. Hence, Towers Watson has developed proprietary metrics, such as the Goodness of Fit Index (GOFI), for this purpose. These metrics accommodate retirement products across the spectrum of approaches identified above. They also allow for the changing levels of account size over time and assume an appropriate level of risk aversion of retirees, so that certainty of income is preferred to a more variable income pattern.

This framework allows us to compare and assess widely diverse products – say, an annuity, a bucket-based product and a GSA – on an equal footing, based on the outcomes they produce for retirees, rather than the product features or the method used to produce those outcomes. Results can be compared using the formats illustrated in figure 5, which allow us to clearly consider the trade-offs involved in the decision process. For example, chart 5a shows that higher/more reliable incomes (GOFI) correspond to higher (that is, less favourable) levels of Journey Risk, while chart 5b illustrates that Capital Access can present a more mixed picture – that is, strategies 4 and 5 deliver better access to capital (liquidity) over retirement, despite providing potentially lower or less reliable levels of income.

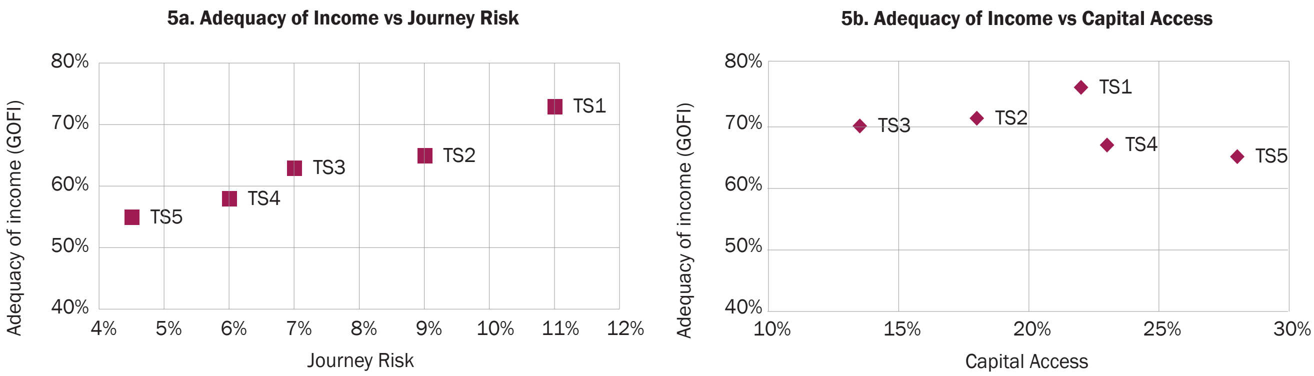
Figure 4 — Retiree objectives and comparison metrics

Retiree objective	Metric	Description
Delivery of income throughout retirement	**Goodness of Fit Index (GOFI)**	Measures how well (0% to 100%) the income generated by a strategy matches the retiree's desired income
Limit on variability of retirement account	**Journey Risk**	Measures the variability of the retirement wealth experienced by the retiree over retirement
Access to capital during retirement	**Capital Access**	Measures the extent to which the retiree has access to capital during retirement or a bequest upon death

Source: Towers Watson

While the modelling results form the core of the comparison between strategies, we have found that the process is as important to a successful outcome as the modelling results themselves. That is, the process of working with a fund's steering group (Board or executives) to analyse the wealth and demographic profile of prospective retirees, develop straw retirees, form views about the relative preferences of those retirees, and qualitatively assess various product options generates important learnings and alignment of views among the steering group that are essential to formulating a successful retirement product strategy. As initial results are built upon with further variations to model retirees, product strategies and assumed market scenarios, insights are developed into the behaviour of various products and how well they meet the preferences of different cohorts of retirees.

Figure 5 — Sample RSA modelling results



TS1 - TS5 represent 5 'test' retirement strategies for a model retiree

Source: Towers Watson

The bottom line

The Towers Watson Retirement Strategy Appraisal (RSA) framework (summarised in figure 6) helps funds cut through the complexity of the retirement product landscape, and focus on the measure that really counts – which product strategy best delivers the outcomes that matter to retirees.

Figure 6 — Towers Watson's Retirement Strategy Appraisal (RSA) framework

RSA can assess all retirement products available on the market, or able to be developed directly by funds, and will extend to future product development.

RSA allows direct comparison of different retirement products/ strategies on a consistent basis, using a small number of metrics which capture the wide range of retiree preferences.

The Goodness of Fit Index (GOFI) measure combines level of income, risks to that income (such as sequencing and inflation risk events) and sustainability over lifetime, to produce a comprehensive measure of income adequacy.

RSA ensures that the trustee's beliefs regarding the relative importance of the various objectives for retirement of its fund members are appropriately weighted.

Source: Towers Watson

Further information

For further information please contact:

Nick Callil
Head of Retirement Income Solutions, Australia
+613 9655 5163
nick.callil@towerswatson.com

or your Towers Watson consultant:

Melbourne	03 9655 5222
Sydney	02 9253 3333

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Towers Watson Australia Pty Ltd
(ABN 45 002 415 349, AFSL 229921)

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