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Capital shortfall options

Many retirees face the prospect of their capital running out, but there are options, writes **Bina Brown**.

Retirees faced with the real possibility that their invested capital may not be sufficient to meet their income needs for the rest of their lives must make some serious decisions about what to do with their remaining capital. The choices available will vary depending on a number of circumstances including an individual's age and health, spending needs, tolerance of risk and existing investments.

Among the options are to move some or all of the capital into one of the new pension products with a built-in lifetime guarantee. Another is to reduce the draw down rate from the pension or revert to the accumulation stage to help preserve and rebuild capital.

Most of these options will incur additional costs. Any type of capital guaranteed product will come with additional fees, while moving from retirement to accumulation phase may have Centrelink implications for welfare payments.

The hardest thing for many to grasp is that many decisions they have to make will be based on conventional wisdom rather than any sure fire answers to what they might do to preserve the capital they have left.

"Conventional wisdom is growth equities will outperform cash in the long term. Another is you can't time the market," says Macquarie Advisor Services executive director David Shirlow.

"So if selling growth assets was the only option then there is a real risk that by stepping out of the market you will miss out on a market upturn. That is not to say that staying there will produce

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the best result," says Shirlow.

Much will depend on the underlying investments. In the case of a direct share portfolio it will depend on the companies in it. For a managed funds portfolio it will be up to the managers to perform.

Macquarie has crunched the numbers for Smart Money showing what happens when a retiree switches from a growth portfolio to a conservative portfolio of cash investments.

Based on a number of assumptions, sticking with the growth portfolio produces a superior result in the longer term.

Another option may be to stop an account-based pension to allow a superannuation account balance to build up without draw down.

Based on Macquarie figures, a retiree who has begun a pension and is drawing down the minimum is better off continuing that strategy rather than reverting to accumulation phase.

The idea is retirees who are taking a pension but don't need the money can invest it outside superannuation without any adverse tax consequences.

Shirlow says arrangements aimed at protecting pensioners from market downturns are another alternative.

"For some this may mean exploring hedging strategies over particular assets or groups of assets," he says. For others it may mean contemplating a completely different income stream arrangement, such as one of the new "hybrid" pension arrangements offered by some financial institutions, he says.

"Entering an arrangement which passes risk to another party will always come at a cost, since the other party is typically going to want to be compensated for taking on the risk," says Shirlow. "So, in deciding whether to enter an arrangement that offers investment or other protection, it is a matter of weighing up the value attributed to the protection against its cost."

Michael Loizou, managing director of financial planner Capital Results, says his firm continually reviews all client model portfolios and, after the global financial crisis, takes a closer look at how they are structured.

Macquarie's David Shirlow. Photo Jim Rice

The focus of the initial review is on making sure each portfolio is properly diversified and in line with the client's chosen risk profile. The aim is to have an allocation to cash within portfolios that will then be used to draw down any income.

"We use platforms where there is a cash account that collects the distributions and dividends, rather than reinvesting," says Loizou.

"A few years of the pension is kept in cash. The theory is that in

Client interest in fund manager performance has risen since the crisis and advisers are paying closer attention to decisions.

the years where there is a downturn in the equity markets you use the cash that will be replenished while waiting for the markets to recover."

But even this is not perfect. "The issue is some of the distributions have been lower in the past 12 months, which has impacted some people's cash reserves," he says.

Loizou says some retirees were able to take advantage of the 50 per cent reduction in the minimum pension payment for 2008-09, 2009-10 and 2010-11.

Client interest in fund manager performance has risen since the financial crisis and advisers are paying closer attention to fund manager decisions. "We are making changes between fund managers more than we did previously. We are also making tactical changes to asset allocation," he says.

Costs involved in switching funds or changing asset allocations will vary depending on how a person's investments are structured and how an adviser charges. In the case of an investment platform, most switches between funds are free. There will probably be a buy/sell spread that is the difference between the price of the units bought and those sold or in the case of shares the brokerage costs of buying one and selling another.

Loizou says retirees keen to move their investments to cash as a way to preserve capital need to consider the risks. "When things do recover they will miss out," says Loizou.

Therein lies the fundamental problem all investors face. Do you rely on history and assume markets will recover, or take the view that any further volatility will be too much and so invest conservatively but safely?