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Approved Retirement Funds

A more sophisticated approach to investment warranted.

It goes without saying that having their fund run out too early ("bomb-out") is the key risk faced by ARF investors. Having a client suffer bomb-out, or make the wrong choice between an ARF and an annuity may rebound on the adviser. Now that the imputed distribution is higher and given the compression of bond yields the risk of bomb-out is much greater.

Projected investment outcomes are central to the advice around ARFs and the choices made by clients. After things go wrong anger is likely to be accompanied by amnesia as regards who made what choices and on what basis – **it is therefore vital that advisers can demonstrate that their return assumptions were reasonable.**

In the first instance comparisons between ARFs and annuities should be based on realistic levels of growth which are broadly consistent with the client's attitude to risk. For example, where a client's attitude to risk is cautious a growth of 5% is unrealistic. In particular, where a substantial proportion of the ARF is invested in bonds, *the yield to maturity on a representative bond index should form a key point of reference for projected growth.*

The leading bond benchmark in use for pension fund investing is the Merrill Lynch EMU Govt >5 Year Index and this has an average yield to maturity of 3.5% (at the time of writing). If Euro government bonds form the bulk of the ARF investment, as will frequently be the case, this effectively sets a ceiling on the assumed net return which can be used.

Once the decision has been made to invest in an ARF the adviser needs to recommend how it might be invested – obviously an assessment based on risk tolerance will be a key starting point. {Incidentally, those using a risk profiling tool should consider its appropriateness given the depletion associated with ARFs.}

Crucial to designing an ARF portfolio (and related projections) is the assumption of what average net investment return it will produce. This is offset against the forecasts of the client's annual income withdrawals, and (assuming the latter is greater), it yields an estimate of how long it takes for the fund to be fully depleted.

That is what needs to be done as a minimum – however it will be good practice and probably advisable to put far more flesh on the bones of this process. In particular, how consistent is the portfolio return assumption with its underlying components? What about the impact of inflation, which might force the client to take ever-rising income withdrawals? How might higher inflation impact investment returns? Portfolios which are heavily invested in conventional bonds are particularly exposed to unanticipated inflation – an ARF client should expect to have this explained to them and be shown a model(s) of the potential impact.

The attached schematic shows how a more sophisticated process might work. For each fund (or other instrument) going into the portfolio, the adviser should specify an assumed gross annual investment return, and then subtract costs and charges to give the assumed net investment return. In a low-return world, **charges have a crucial impact** on investment outcomes, so they must be taken account of with as much precision as possible. Then, using the proposed portfolio weights, the fund-by-fund return assumptions are combined to give the implied portfolio return. Where the ARF is invested in one or more mixed funds, projected returns should be on the basis of a 'look through' to the underlying assets.

The client's net income requirement must also be fed into the model, and in a properly rigorous approach it should escalate annually in line with assumed inflation. Adding in assumed income tax rates (which may also change over time) gives a yearly estimate of gross income withdrawal. An iterative projection of successive year-end fund values can now be constructed, which will show the adviser (and the client) when the point of depletion might arrive.

Of course any such projection is only as good as the assumptions going into it; but this model at least ensures that the projection is consistent with the assumptions. And the more clearly the process articulates the linkage between the input (assumptions) and the output (projections), the better informed the client's decision will be – and the better protected the adviser will be from future recriminations.

There is another major investment issue with ARFs – the typical ARF investor is of an age where most advisers will feel under pressure to steer them towards investing on a cautious basis - the client may prefer such an approach anyway. However with bond yields in a number of leading economies at very low levels (German bond yields were hitting new lows at the time of writing) the scope for growth on cautious funds/portfolios appears very limited.

An ARF invested cautiously is unlikely to produce enough growth to cover the imputed distribution and charges *and so is likely to be declining from the start.* It may be that a cautious investment approach has no realistic chance of lasting as long as the client is likely to need it to; in such cases the client's need for income in retirement may over-ride their risk disposition. The same may be true where the pension 'pot' is simply not big enough to fund the necessary withdrawals unless returns are higher. There is a delicate trade-off involved here – the required investment return may not be achievable without taking a degree of risk beyond the client's comfort zone. The fact that volatility is inherently negative for a fund which is in depletion mode is under-appreciated – assuming a constant monetary encashment, a higher proportion of the portfolio will always be sold 'low' than sold 'high'. This is the mirror image of the familiar benefit of 'dollar-cost averaging' to the investor accumulating assets.

Advisers will appreciate that being involved in a dialogue which involves clients going into higher-risk investments than they would otherwise choose is fraught with danger. Funds or portfolios which are shown to clients and which take on more risk in pursuit of necessary higher returns should ideally show (and record) for a number of risk graduations:

- Projected values in real and nominal terms based on core assumptions
- Likely depletion dates
- Sensitivity to changes in key variables including inflation
- Portfolio risk characteristics, probably derived from historical simulation of volatility and maximum drawdown over a reasonable test period

The above may represent a degree of rigour beyond the current practices of many advisers but it will be worthwhile in terms of:

- Demonstrating a very high level of professionalism to the client
- Informing better decision-making
- Providing a robust defence to any complaint

ARFs should provide significant business potential for advisers over the next number of years: however they warrant a very careful and in many cases significantly more sophisticated investment approach.

The ARF Portfolio Design Process