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From cautious to confident

A retirement philosophy for advice practices

Produced by the AMP Retirement Confidence Hub

The AMP Retirement Confidence Hub empowers advice practices with thought-leadership and structured resources to help improve the confidence of your clients as they approach and enter retirement. Led by a highly-credentialed advisory committee including internal and external retirement experts, the Retirement Confidence Hub provides resources such as this Retirement Philosophy to support advisers in creating clear, client-centred approaches that boost confidence and satisfaction for retirees.

Section 1

Why a retirement philosophy?

Retirement advice planning requires a structured approach informed by a deep insight into the needs of retirees. AMP has developed this Retirement Philosophy template to assist advice practices to deepen their thinking on provision of retirement advice and as an aid to developing their own philosophy.

A well-defined retirement philosophy is valuable for several reasons. Firstly, it enhances the value provided to clients by offering a clearly articulated approach to retirement planning. A demonstrated process for retirement advice ensures that clients receive consistent guidance, which can significantly improve their confidence and satisfaction.

Moreover, having a retirement philosophy brings clarity to the advice team. It provides a framework that advisers can follow, making it simpler to deliver coherent and comprehensive guidance.

Lastly, a documented retirement philosophy contributes to brand presence. It positions the firm as a thought leader in retirement planning, attracting more clients and enhancing the firm's reputation.

This document is intended to serve as a template, prompting you to develop your own thinking and then produce a Retirement Philosophy that aligns with your beliefs, your practice and your clients' needs.

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Section 2

Risks in retirement – SMILE

Clients face a range of risks as they transition from their working years into retirement. Returning to full time work is generally not an option – and certainly not desired – so the focus shifts to making the most of the existing to retirement savings, which includes managing the risks. While these may be characterised in many ways, we've condensed them to six key risks – the SMILE (+R) risks.

Figure 1: SMILE (+R) retirement risks

Sequencing: Poor market results close to retirement can badly affect client retirement outcomes. Sequencing risk is particularly significant in the seven years pre- and post-retirement, when clients are approaching peak financial wealth.

Market: The higher the expected returns, the higher the risk. In seeking long-term growth, clients are exposed to increased market volatility, which can be unnerving even for experienced investors. Around 60% of drawdowns in retirement are typically sourced from investment earnings generated after retirement, so maintaining sufficient growth asset exposure is key.

Inflation: Inflation erodes savings over time and can eat away at purchasing power. Just like we can't predict how long we will live, it's also impossible to predict how much things will cost in the future. Preserving the purchasing power of clients' income in line with cost of living increases, will enhance their confidence to spend.

Longevity: Thanks to medical advances and healthier lifestyles, clients may live longer than they expect. That's why it's important to create a plan for clients to ensure their money lasts as long as they do. Protection against longevity risk addresses client FORO (fear of running out) which creates confidence in their ability to spend and hence enjoy their retirement years. Refer to the Spotlight on Longevity Risk below for more information.

Emotional: Emotional factors often inhibit clients' ability to make smart choices when it comes to investing money for retirement. Evidence shows that for most investors, emotion overrides rationality, leading to buying when markets are strong and selling when they are weak. Retirees may be more prone to this behaviour given they are generally no longer contributing to super and hence may be unable to make up for any shortfall in retirement funding.

Spotlight on longevity risk – the 80% confidence age

A central goal of retirement planning should be to ensure that the essential costs of living can be met with certainty for the lifetime of the client, their spouse, and any dependants.

Yet it is too common for retirement planning to target income that lasts only to life expectancy, perhaps with an additional buffer of around five years. This approach exposes many retirees to longevity risk and exacerbates FORO.

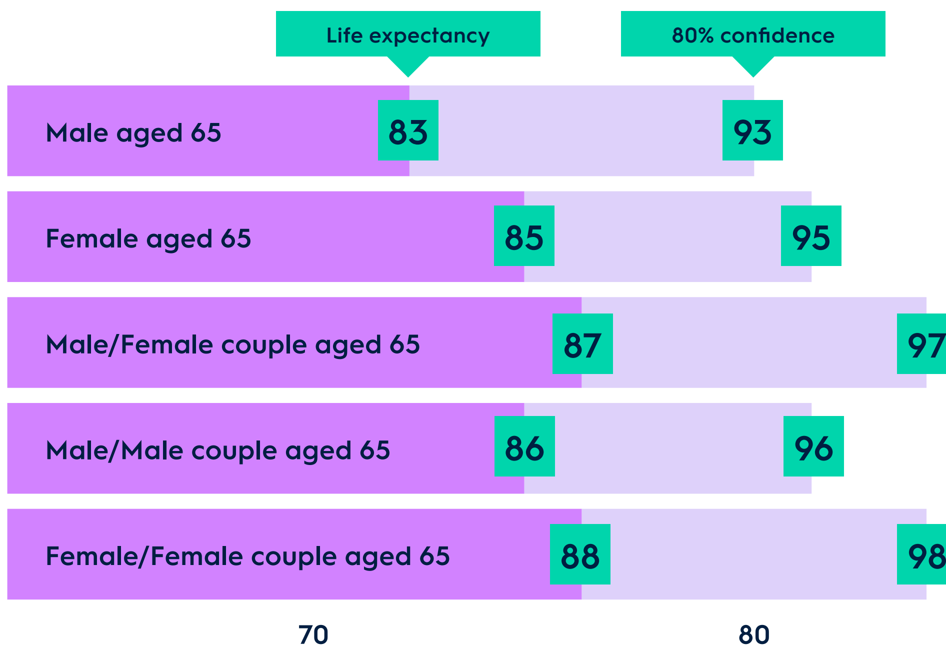

Fig 2: Life expectancy and 80% confidence

Many clients are quite surprised how long they need to plan for in retirement to ensure they have 80% confidence of not running out of money, as demonstrated in Figure 2 below. This is the age that clients have only 20% chance of outliving, calculated for both singles and couples. Couples have higher 80% confidence ages because the chance of either spouse living to an advanced age is higher than their individual chances.

Besides the SMILE risks, there's a further risk that may only appear towards the end of retirement – **Regret**. The Retirement Income Review found that a typical account-based pensioner dies with ~90% of their starting balance intact, and retirees might come to regret things like not spending more, not travelling enough, not retiring earlier, or not providing more financial assistance to their children at a time that would have been more helpful.

Mitigating the SMILE (+R) Risks

A successful plan for retirement must address each of the SMILE risks, plus regret risk. The Tinbergen rule in economics, named after Nobel laureate Jan Tinbergen, states that you can't achieve multiple policy goals with a single instrument. Yet, we see many retirees attempting to manage all the SMILE (+R) risks in retirement with investment strategy alone. A broader suite of tools is required to tackle these risks successfully.

A number of strategies are available to mitigate the SMILE (+R) risks – some traditional, some innovative. Examples of such strategies are set out below.

SMILE Risk	Mitigation Strategies
Sequencing	• Portfolio diversification and bucketing • Reduce risk exposure (derisking) as client approaches retirement • Centrelink eligibility strategies such as innovative retirement income streams (IRIS) – age pension has no sequencing risk
Market	• Portfolio diversification • SMAs to outsource portfolio management improve execution efficiency • Capital guarantees to protect downside risk • Accessing home equity
Inflation	• Income streams that allow an allocation to assets that traditionally have a negative correlation with inflation (e.g. commodities) • CPI-linked annuities • Centrelink eligibility strategies such as IRIS – age pension is fully hedged against inflation
Longevity	• Underspending (not recommended) • Traditional annuities • IRIS strategy that reduces trade-offs of traditional annuities
Emotional	• Long-term investing • Financial advice to keep emotions in check • Education on behavioural biases and how they can impact decision making • Build confidence with strategies that provide protection against key risks
Regret	• Needs-based planning framework (see next section) – once other risks are addressed, regret can be proactively mitigated by optimising achievement of goals

Section 3

The Five L's – A needs-based framework for retirement planning

Retirement planning is complex. The uncertainty of lifespans, the range of risks to be managed, the variety of client needs and the apparent trade-offs between various priorities can be challenging for both advisers and clients.

We believe this challenge benefits from a structured approach, which adds clarity for advisers and can aid understanding and instil confidence in clients. As a first step, let's consider the various types of financial 'needs' (broadly defined) retirees may have during their retirement. This classification of needs could be done in various ways – for example, by itemising various spending buckets such as housing, health, food, leisure etc. However, in order to develop a robust retirement planning framework, it's helpful to categorise needs in a different way – using the Five L's as set out in figure 3.

Figure 3: Client needs in retirement

This categorisation of needs into the Five L's promotes consideration by advisors and clients of the relative levels of different types of retirement spending – such as what is 'essential' living and what is 'lifestyle' – and also the trade-offs between spending 'now' and the desire or need for later life or bequest spending.

The Five L's is a cascading hierarchy of needs from left to right. For example, clients with only sufficient funds to cover liquidity and living expenses will have limited focus on lifestyle or later needs. Too often, legacy planning is reactive or inadvertent – beneficiaries often receive 'whatever is left over', which ironically can be higher than anticipated due to underspending as a result of FORO. However, clients with sufficient funds to allocate to each need have an ability to proactively manage legacy needs earlier, with greater effect.

The next step in a structured framework is allocating assets to needs using available solutions and strategies to optimise client outcomes. A starting point for retirement advice using this framework is set out in Figure 4 below. The purpose is to help guide advisers to an appropriate strategy for their clients. Advisers should use professional judgement and expertise to determine the appropriate advice and product solutions based on client's specific circumstances.

Need	Description	Timeframe	Suggested Solutions	Suggested Portfolio Allocatio
Liquidity	Short-term funding and emergencies.	Immediate needs or those that could emerge at short notice.	Cash in bank and accessible liquid assets in super and pensions.	No more than 12 months' spending in cash.
Living	Recurring expenses of everyday living, ensuring inflation protection as living expenses are non-discretionary.	For the entire lifetime (not life expectancy) of client and any dependants.	Age pension and IRIS[1], supplemented by other passive income streams e.g. other pensions, annuities, or rental income.	Sufficient to cover living expenses for life, noting than an IRIS can increase age pension eligibility – typical allocation is 50%.[2]
Lifestyle	Discretionary lifestyle spending, which can divert from leisure to aged care over time as needs change.	Until an 80% confidence age - 93 for males, 95 for females and 97 for male/female couples.	Account based pension and other investment income.	Sufficient to ensure lifestyle can be maintained to an advanced age – typical allocation is 50%[3].
Later	Funds not needed until future years - during accumulation, all super is for later needs.	Future needs some years into the future.	Deferred IRIS, investment guarantees and non-super assets including family home.	Before retirement - 100% in IRIS; In retirement - depending on client needs, use investment guarantees instead of de-risking.
Legacy	Funds for beneficiaries.	Ideally before death to optimise beneficiary utility and client enjoyment.	Family home, non-super assets, and remainder of account-based pension.	Depending on client needs, but consider gifting early where other needs are fully satisfied[4]

Fig 4: Structured retirement advice framework to address the Five L's

How spending and needs change through retirement

The chart below demonstrates a summary of spending patterns throughout retirement for Australian in the top-quartile expenditure range.

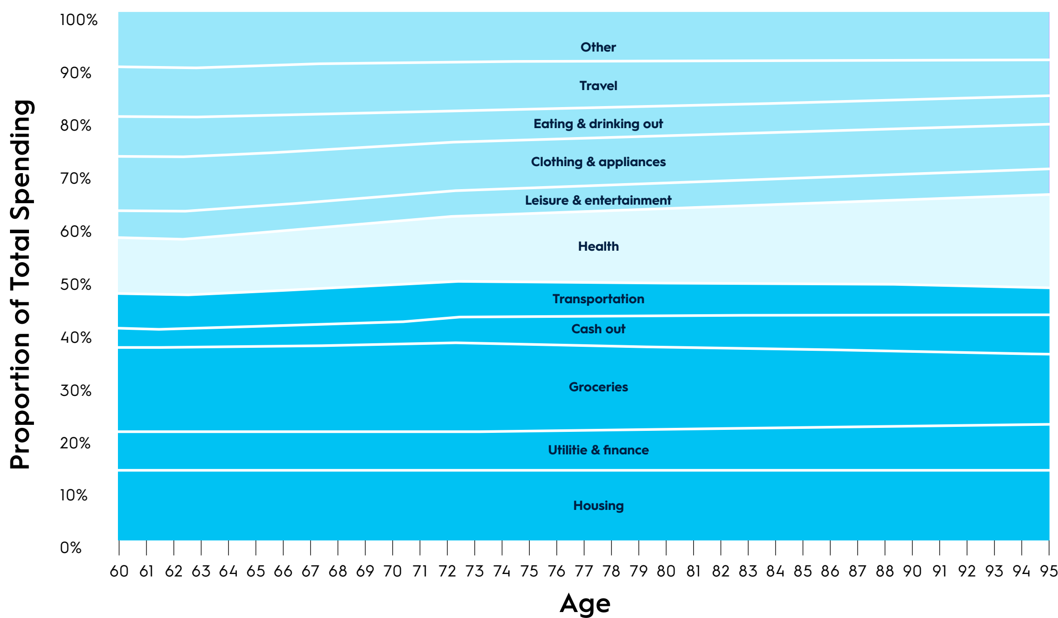

Fig 5: Spending by category for top-quartile Australian retirees, as a proportion of total spending

It demonstrates that living expenses (housing, utilities and finance, groceries, cash and transportation) are relatively stable, maintaining at around 50% of total spending. Health expenditure on average increases by around 10%, and the increase Wis offset by decreases in lifestyle spending (leisure and entertainment, clothing and appliances, eating and drinking out, travel and other).

A sensible portfolio allocation for a typical client might be to cater for all living expenses including initial health expenses though a combination of the age pension and an IRIS, to ensure these needs are met for life. An account-based pension and other assets can meet the lifestyle needs and any subsequent increase in health needs such as ongoing aged care expenses, noting that lifestyle spending will correspondingly reduce.

It should also be noted that total spending typically falls in real terms over retirement, with various studies indicating that inflation-adjusted spending falls by an average of 1-3% p.a[5]. throughout retirement, though not in a straight line. This fall provides a further buffer for any increases in health spending in later life, and should provide clients with confidence to maximise lifestyle enjoyment in the early yeas of retirement.

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Footnotes

1. Innovative Retirement Income Stream. An IRIS should be considered for clients in retirement with assets up to 200% of the age pension assets test upper threshold, and for all pre-retirement clients
2. An IRIS can improve eligibility for age pension, so this process may require an iterative approach to determine the appropriate IRIS allocation. The average IRIS allocation on North is 50%
3. The average ABP allocation on North is 50% when used in conjunction with an IRIS
4. Note that the impact of gifting on age pension entitlement will need to be recognised
5. Includes studies by Milliman Australia and JP Morgan