

Submission: Superannuation in Retirement

Griffith Centre for Personal
Finance and Superannuation

Director, Retirement Income and Adequacy Unit
Retirement, Advice and Investment Division
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Dear Sir/Madam,

Re: Submission to ‘Superannuation in Retirement’

The following is our submission to the consultation titled ‘*Superannuation in Retirement*’ and its discussion paper titled ‘*Retirement Phase of Superannuation*’ (issue date: 4 December 2023) by the Griffith Centre for Personal Finance and Superannuation (GCPFS), Griffith University, Queensland. The Centre is a source of expertise and excellence in four distinct streams: Personal finance and superannuation; Investment; Professionalisation of financial services; and, Financial education. This submission was co-authored by the following researchers:

- Dr Robert Bianchi, Professor of Finance, Griffith Business School, Griffith University.
- Dr Michael Drew, Professor of Finance, Griffith Business School, Griffith University.

In the discussion paper, the Australian Government has posed a comprehensive series of questions. Rather than providing an itemised response to each question, the following provides a set of themes that require attention to assist in the formulation of future retirement policy in Australia.

Issue 1: Who bears the investment risk? The retiree or the retirement investment manager?

The objective function is the foundation on which a sound, member-aligned retirement product strategy sits. It defines success and thus guides the ‘right’ actions and investment strategy to achieve the success that an individual seeks in retirement. Put another way, the objective function acts as a compass to steer the retirement product to its ‘true north’. We posit that retirement products should be designed with the aim of creating income sufficiency, rather than wealth maximisation (Drew and West, 2021). In short, the allocation of assets to satisfy a high probability of achieving a desired income *through retirement* is a radically different goal from the goal of maximising wealth *at retirement* (Drew and West, 2021).

Most superannuation options on the market today aim to maximise the amount of savings at retirement at a certain level of risk. Whether you choose a conservative or aggressive investment option, within the asset allocation constraints of these products, these funds try to achieve the maximum amount of wealth at the end of the product’s life. But the objective of superannuation fund members is often quite different. They seek to maintain a certain standard of living, which in investment terms means they seek to secure a certain level of income in retirement (Drew and West, 2021).

We need to speak plainly about the risks inherent in retirement product design. The vast majority of Australians hold an underfunded liability – retirement income – on their household balance sheet at retirement. This can be the result of exogenous (interest rate changes, stock market losses) and/ or endogenous (insufficient contributions, career breaks, unemployment) factors. In a retirement income system without pooling (that is, the Australian system), retirement products face a myriad of investment risks in order to generate the necessary real income streams throughout a retiree's lifetime. Again, some of these are exogenous (market volatility, interest rate risk, inflation risk) and others endogenous (longevity risk, unexpected health shocks). The evidence around the world suggests that achieving these objectives is, to put it mildly, challenging (Drew and West, 2021; Drew, Walk and West, 2016).

Investment risk and retirement income security are constant bedfellows (Drew, 2021). In a system without pooling (a key advantage of defined-benefit plans), the importance of compounding (both positive and negative) during the accumulation phase of retirement saving and the income (or decumulation phase) is a risk that requires careful control for those in DC plans (Drew, 2021; Drew, Walk & West, 2015; 2016). The work of Drew (2021) and others shows that the balancing act between investment risk and reward is akin to walking a tightrope, with the public pension acting as a form of safety net. The key driver to prioritising and managing such risks is the objective function on which the retirement product is designed (Drew and West, 2021).

Issue 2: Annuities are not the solution

The work of Yaaari (1965) shows, in theory, that retirees can benefit enormously through the purchase of annuities, and as a result, there are many who advocate the use of annuities as the key retirement solution product. Unfortunately, the empirical evidence to date reveals that annuity products are not the solution in the eyes of retirees around the world. There appears to be a significant gap between theory and practice. Evidence from various countries show the continual lack of demand for annuity products which is referred to as the 'annuity market participation puzzle' or more simply 'the annuity puzzle' (Benartzi, Previtero and Thaler, 2011; Brown, 2007; Davidoff, Brown and Diamond, 2005; Inkmann, Lopes and Michaelides, 2011; Ramsay and Oguledo, 2018). Furthermore, research reveals that annuities are poor solutions when managing inflation risk and longevity risk (Blake, 1999; Hari, Waegenare, Melenberg and Nijman, 2008). Finally, annuity markets are exposed to adverse selection whereby those individuals who are most likely to die will not purchase annuity products. There is the potential to legislate the compulsory purchase of annuity products for retirees but this solution comes at the cost of reducing the retirement outcomes of those most frail and vulnerable (Poterba, 2001).

Issue 3: The retirement product has not been developed yet!

The global investment industry is an innovative ecosystem that continuously seeks to create new products as opportunities arise. The Australian government seeks to support such innovation through regulation. That is the good news. The practical challenge in securing sufficient retirement savings to an underfunded retirement income liability has become increasingly difficult both here and abroad. An objective function that seeks to ensure retirement income sufficiency is, we argue, the critical missing component (Drew and West, 2021). Such an objective function requires commitment over many decades of working life. It is updated through an individual's life course and it anchors to an agreed 'north star' – retirement income. It would de-risk an investment strategy through time as the probability of achieving the 'north star' was realised. Imagine that. A superannuation strategy that actually de-risked an individual's asset allocation on achieving retirement income targets. How would that look at the trustee table against the Your Future, Your Super benchmarks? Oh, that's right, those benchmarks assume the objective function relates to the maximisation of some 'pot of gold' at some retirement date in the future (and that cash flows are not drawn regularly from the portfolio, as happens with retirement products). The

challenge here is that money-weighted returns are very, very different to time-weighted returns in the retirement product context. If we are serious about achieving multiple objectives, namely, real income for retirees, protection from inflation risk, and management of longevity risk, then we need to agree the objective function on which the retirement product is based. We need to also acknowledge the potential impacts of negative compounding on regular retirement income withdrawals (see Drew and Walk's work on sequencing risk and safe withdrawal rates).

Issue 4: Time-weighted returns versus money-weighted returns

Current Australian federal government policy intends to measure retirement outcomes by employing conventional time-weighted returns. The Australian Treasury discussion paper (p. 19) outlines potential solutions to measure and monitor the performance of retirement products, yet, there is the absence of any discussion about money-weighted returns. As retirees withdraw funds over time, money-weighted returns is the correct metric to evaluate the performance of retirement products (Bianchi, Drew, Evans and Walk, 2014; Drew and Walk, 2016, 2019; Drew and West, 2021). Our humble recommendation is that The Australian Treasury needs to evaluate retirement products by analysing money-weighted returns.

Issue 5: Australian Policy Risk due to Continual Change

Both current and past Australian federal governments are continuously 'tinkering' and making policy changes to both superannuation and pensions. This era of constant change in policy translates into a lack of confidence in the Australian retirement system. We recommend that changes are small and incremental as significant changes will reduce the confidence that Australians have in our superannuation/retirement system.

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About the Authors

Professor Robert Bianchi

Dr Robert Bianchi is Professor of Finance at Griffith University and Director of the Griffith Centre for Personal Finance and Superannuation (GCPFS). Robert's research expertise is in the areas of asset allocation, superannuation/retirement and alternative investments. Robert has co-authored more than 40 peer reviewed research articles in publications including the *Journal of Banking and Finance*, *Journal of Economic Dynamics and Control*, *Journal of Portfolio Management*, *Accounting and Finance*, *Journal of Applied Corporate Finance* and the *International Review of Financial Analysis*. Robert has more than 25 years of experience in the investment management industry, including directorships at H3 Global Advisors (alternative investments manager), Venitia Pty Ltd (Member of the Sydney Futures Exchange) and he was a bond portfolio manager at Queensland Treasury Corporation (QTC). Robert holds a Bachelor of Commerce from Griffith University, Graduate Diploma in Applied Finance and Investment from the Securities Institute of Australia, Master of Business (Research) and a PhD in Financial Economics from Queensland University of Technology.

Professor Michael Drew

Michael E. Drew is a financial economist specialising in the areas of investment governance, asset allocation, and outcome-oriented investing. He has held previous academic appointments at the Australian National University and QUT, and senior industry appointments with JB Were & Son, Myer Family Company, Ord Minnett, QSuper, QIC, and Wilson HTM. Michael's research has appeared in leading practitioner journals, including the *Journal of Portfolio Management*. He has been invited to testify before numerous committees, including the *U.S. Department of Labor and Securities Exchange Commission joint hearing on Target Date Funds*, and the *Productivity Commission hearing on Superannuation: Assessing Efficiency and Competitiveness*. Michael is a regular media commentator and consultant on investment-related matters and has authored over 85 scholarly papers. Michael's work has been cited by numerous agencies (incl. *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*, and the *U.S. Senate Hearing before the Special Committee on Aging*). Michael's research agenda has been supported by leading granting agencies and he is a former member of the ARC College of Experts. Concurrently, Michael serves as a Trustee Director of CareSuper, a member of the Investment Advisory Board of the Petroleum Fund of Timor Leste, and a Trustee of Mary Aikenhead Ministries. Michael received his PhD in the field of economics from the University of Queensland, is an Accredited Investment Fiduciary Analyst™, a Fellow of the Australian Institute of Company Directors, and Life Member of FINSIA.

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