Allocating funds to varying asset classes will lessen risk while still generating returns

ASSET DIVERSIFICATION Steadily increasing longevity and inflation are creating many issues for today's workforce. Managing portfolio risk could be the solution

Spread the risk

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In the UK, retirement at 65 was set in 1925, when life expectancy at birth was 59. Life expectancy exceeded 65 for the first time in 1946 and has been improving fairly steadily ever since. By 2005, average life expectancy was approaching 80 and those aged 65 in that year could expect to live another 18.7 years. It is estimated that the rate of increase at present is five hours per day, or 76 days per year. Women continue to live longer than men, although it is interesting to note that since 1980 men have been catching up.

Until recently, retirement at 65 was firmly embedded in our attitudes to work and financial planning. It was assumed that expenditure in retirement would be lower because dependants would be long gone and leisure activities, like coach trips to Clacton, would be relatively cheap.

Neither is proving to be the case. Between 1971 and 2000, the average age of first births for married couples increased from 24 to nearly 30. The increased availability of higher education has also had an effect, so it is safe to assume that parents will still be receiving calls or texts from their Kippers (kids in parents' pockets eroding retirement savings) for a 'spare £100 for a windsurfing course' when they are well into their 60s. This is without taking into account their own plans to travel the world and take up new and expensive hobbies. In an influential report on demographics, KPMG illustrates these changes by redefining the structure of our lives. Now childhood lasts up to age 12, followed by adolescence that now extends to 30. We become adults at 30 – marriage, children, mortgage – and this lasts until about 55 when we become lifestylers, during which time we may work part-time or certainly with less intensity. Although we may retire at 65, we only become old at 75, when our spending patterns change to those of the 60+ age group a generation before.

Generation gap

In pension terms, the 'golden generation' who were born between 1925 and 1945 are in a strong position. For the next generation, however, the financial arithmetic of retirement has undergone a huge change in only a few years, and the investment implications are only now starting to sink in.

The government and private sector companies are the biggest providers of pensions, but both are stepping away from providing a safety net for pensioners because it is just too expensive. According to the Office for National Statistics there has been a sustained reduction in the percentage of active employees that are members of defined benefit (DB) – or final salary – pension schemes, from 34% in 1997 to 19% by 2005.

Since 2003 the rate of decline has accelerated.

DB/DC difference

The private sector takes on four main risks when providing a final salary pension, which are broadly in order of importance, interest rates, inflation, equity and increasing life expectancy. Investment management techniques can be used to reduce the first three, but only at the expense of increasing longevity risk. It has been estimated that a one-year increase in life expectancy causes a scheme's liabilities to increase by between 3% and 4%. Hence the rush to the exit. Increasingly, our standard of living in retirement will be our own responsibility. Defined contribution (DC) schemes are taking over; the Pensions Regulator estimates that assets in these schemes have now reached £160bn. By way of comparison, DB schemes are worth over £1trn.

DC schemes offer a wide range of investment options and opportunities to structure an appropriate portfolio. The investment risk is firmly with the contributor. Switching from equities to bonds in anticipation of purchasing an annuity normally starts about five to 10 years before retirement. This appears far too early, bearing in mind increasing life expectancy and the corrosive effects of inflation. Generally it is perceived that inflation was a problem in the 1970s, but has not been an issue, until this year, since the early 1980s. Looking at the 25-year periods either side of 1982, this is clearly the case. Up to 1982, prices rose 7.5 times, whereas subsequently, the increase was only 2.5 times.

The risk of assumption

Forecasting inflation looking forward 25 years is challenging and prone to large errors. It is also worth reflecting on the current divergence between 'official inflation' as measured by the retail price index or consumer price index, and the real increase in the cost of living where estimates range from 6%-10% depending on a variety of factors, including age and wealth. Inflation tends to be driven by higher demand, and so it is reasonable to assume that the price of whatever the ageing population collectively chooses to spend its money on will increase at a faster rate than general inflation. None of this is good news for pensioners and those planning for retirement.

KEY STAT

20%

Losses expected during a bear market

If we try to quantify the capital required within a tax-free portfolio to allow an individual to retire at age 65 with the equivalent to an index-linked pension of £100,000 a year, we get a very large number. Assuming average male life expectancy and current market estimates for inflation and interest rates, you would need approximately £2m. The problem for individuals, as opposed to a company scheme, is that if any of the assumptions are wrong there is no one else to underwrite the risk.

Safeguarding the future

A regular salary may be regarded as providing a safety net similar to capital savings. As a rough rule, £10,000 salary is the equivalent of £200,000 capital, so post-retirement investments need to produce not only income to replace salary, but also a higher lever of certainty. It becomes much harder to bounce back than when you are earning a salary. Over a 25-year period assuming 5% inflation, you would need to multiply capital and income by a factor of 3.2 to maintain the same standard of living. Of course capital could be spent, but it would be hard to plan an investment policy that resulted in spending your last £1 on the day you die. Companies and governments can do this because statistics are on their side. Individuals have to be more cautious.

Risk-free investments such as gilts or deposits will not produce a good enough return to generate income for spending while at the same time maintaining the real value of the capital. Therefore, portfolio construction pre and post retirement should include riskier investments such as equities and the range of alternative asset classes now available to private investors through investment in hedge funds, private equity and commodities. A more adventurous investment policy generating a return of 10% a year, or twice the risk-free rate, would achieve the desired result. However, a typical bear market, with losses of 20%, is almost certain to happen at least once – and probably twice – over a 25-year period. If and when that does happen, the investor who continues to spend at the same level would enter into a downward spiral, which would eventually consume their capital and leave them without income.

Building success

Portfolio construction plays a key role. Diversification into a range of asset classes can deliver returns with less risk than a single asset class portfolio. Structured products also have an increasingly important role to play in an actively managed portfolio, with investors giving up some income in return for capital protection; a return profile that has distinct advantages for a risk-averse investor looking for capital growth.

Although taking risk out of a pension fund too early can be dangerous, it does make sense to reduce it over time. However, it should be based on a more realistic view of life expectancy, income needs and inflation. Setting age group risk bands for portfolio construction is the solution and these can be applied throughout an individual's working life and post retirement. Using Redington Partners risk bands approach, it is possible to construct portfolios using a broad range of asset classes that generate income and offer the potential for capital growth at a level of risk acceptable to each age group.

Changing your mindset

For understandable historic reasons, retirement at age 65 is firmly embedded in our attitudes to work and investment. However, it is becoming increasingly clear that these attitudes need to change. The implications for investment policy are clear;

- long-term planning and a concerted effort to save will be required to create a reserve capable of generating sufficient revenue to maintain living standards;
- the investment policy adopted needs to take into account an investor's total portfolio and not just the pension fund in isolation;
- investment for growth of capital and income shall continue for many years past retirement. With the increase in longevity, this means that risk should be reduced over a 20-30 year period and not just at 65.

A clear investment plan is essential. PM

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