Challenger Tech

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Improving confidence and portfolio outcomes in retirement – a practical case study

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It is widely accepted that an allocation to a lifetime income stream can help many clients maximise Age Pension entitlements, improve the confidence of meeting their spending goals and manage longevity risk in retirement. Perhaps less widely known is that a partial allocation to a lifetime income stream, even for those with significant assets, can also help improve total portfolio and estate outcomes.

In this month's article, we introduce retirees Charlotte and Collin and explore how a partial allocation of their portfolio into a lifetime income stream can help improve the likelihood of them achieving their spending goals as well as improve their portfolio and estate outcomes.

Charlotte and Collin

Age: Both age 62

Assets: Homeowners, $1,000,000 each in superannuation (50/50 growth defensive), $100,000 cash/term deposits and $50,000 non-financial assets

Goals: To spend comfortably, but confidently, through retirement

Charlotte and Collin have recently sold their business. Their once-small labour hire business had gone from strength to strength over recent years. A convincing buy-out from a competitor has set Charlotte and Collin up nicely for retirement and earlier than they anticipated. With appropriate planning Charlotte and Collin find themselves in a position where much of their retirement savings are now held via superannuation allowing them to structure tax effective retirement income streams.

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In Charlotte and Collin's own words, they want to be able to spend "comfortably, but confidently" through retirement. In other words, they want to be able to spend as much as they can to enjoy their retirement to the fullest but also ensure that level of spending is sustainable. Ultimately, they want to understand how much they can afford to spend throughout their retirement based on the savings they have built.

They are happy that their current home is where they would like to live for most, or all, of their retirement. They are keen to help out their kids and grandkids from time to time and will do this from their retirement income rather than the capital from their retirement savings. They would like to leave their kids a significant benefit following their eventual deaths (hopefully many decades into the future) and believe that their current home will be sufficient for this purpose.

Comfortable as well as confident retirement spending

Charlotte and Collin's challenge to their financial planner was to develop a retirement drawdown strategy that lets them draw the highest retirement income possible each year, so they can enjoy their retirement to the fullest, and with a suitably high level of confidence or probability that this level of income could continue to be achieved through a long retirement.

Using Challenger's Retirement illustrator (accessible to all financial planners via Challenger's AdviserOnline portal), their financial planner has tested a range of retirement income drawdowns based on them investing their superannuation savings in an account-based pension with a 50/50 growth defensive asset allocation. The table below summarises the financial planner's findings:

First year's income drawdown indexed to CPI each year thereafter	Probability of achieving this income each year until the couple's life expectancy[1] (age 94)
$120,000	45%
$110,000	65%
$100,000	81%

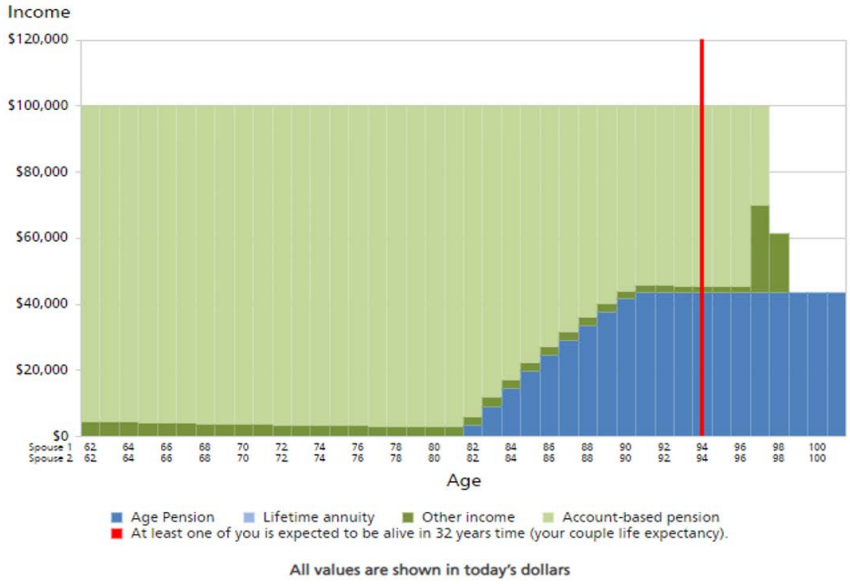
A total retirement income starting at $100,000 p.a. and increasing with CPI is shown to have an 81% probability of being sustained to Charlotte and Collin's couple life expectancy of age 94.

Their financial planner explains that the probabilities are based on testing each income drawdown strategy across 2,000 different market scenarios. With a starting drawdown of $100,000, and increasing by CPI each year thereafter, 1,620 of the 2,000 (81%) different market scenarios allowed Charlotte and Collin to achieve this level of income each year until age 94.

Each market scenario has different asset class returns and related market indicators such as the level of inflation and interest rates. The market scenarios are provided by Moody's Analytics and are generated using the Moody's Analytics Scenario Generator. The scenarios are designed to be representative of how real-world markets could behave in the future.

1 Life expectancy is the average age a person is expected to survive to (or at least one person in a couple will survive to). This calculation are Challenger estimates based on the Australian Life Tables (ALT) produced by the Australian Government Actuary. The mortality rates used are the ALT 2015-17 tables with 25 year improvement factors, allowing for the fact that people are living longer due to improvements in medicine, science and nutrition.

Using fixed returns for illustrative purposes, Charlotte and Collin's $100,000 p.a. retirement income strategy is shown in the graph below.



Assumptions: CPI of 2.5% p.a. Defensive and growth returns of 8% p.a. and 4.5% p.a. before fees respectively. Account-based pension fees of 0.80% p.a. for the growth component, 0.40% p.a. for the defensive component and 0.40% p.a. platform fees. Social security rates and thresholds as at 20 March 2024.

This fixed return analysis shows income projected to last out past age 97 (beyond their couple life expectancy) and will meet Charlotte's and Collin's "comfortable" income requirements.

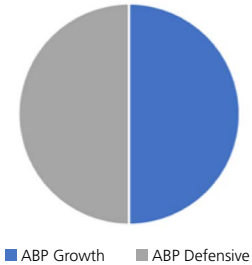
Improving confidence without sacrificing income

While broadly comfortable that there is a 4 in 5 chance they can sustain a comfortable retirement income of $100,000 per annum for their life expectancies, they were also keen to explore any alternatives that can help improve this probability but without needing to sacrifice more income.

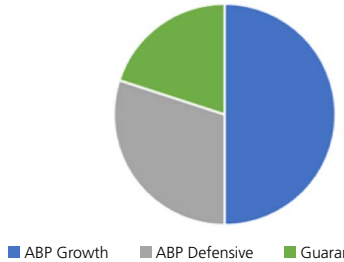
With this in mind, their financial planner modelled the outcomes of a 20% allocation to guaranteed lifetime income (in the form of a guaranteed, CPI-linked lifetime annuity) from Charlotte and Collin's super savings and what that could deliver.

When building out this alternative retirement portfolio their financial planner has carefully ensured Charlotte and Collin's exposure to growth assets is maintained. This is achieved by the replacement of some of the defensive assets within their account-based pensions while maintaining their growth assets. This changes the asset allocation of their remaining account-based pensions from 50/50 to 67/33 but maintains their overall total assets allocation at 50/50 when including the allocation to the lifetime annuity as a defensive asset. The revised account-based pension asset allocation is shown below.

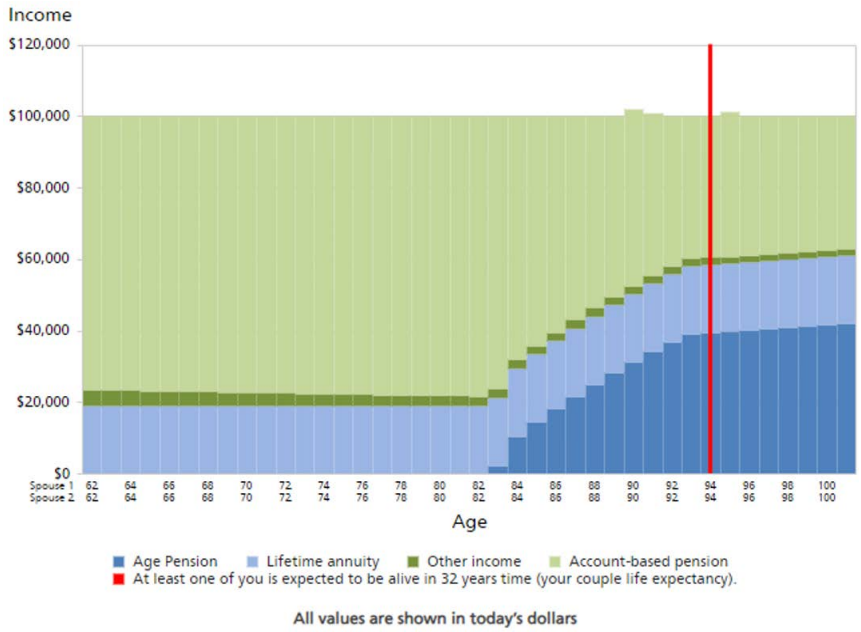
ABP Only asset allocation



ABP and Lifetime asset allocation



Using fixed returns for illustrative purposes, the income from this combination of income streams is shown in the graph below.

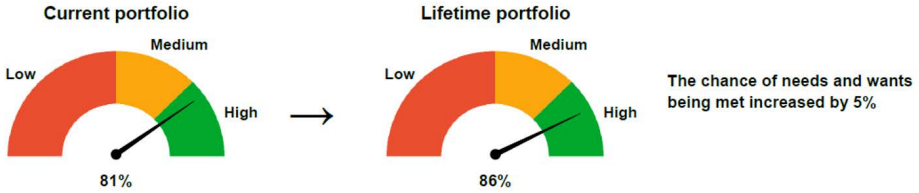


Assumptions: CPI of 2.5% p.a. Defensive and growth returns of 8% p.a. and 4.5% p.a. before fees respectively. Account-based pension fees of 0.80% p.a. for the growth component, 0.40% p.a. for the defensive component and 0.40% p.a. platform fees. Social security rates and thresholds as at 20 March 2024. Challenger's Liquid Lifetime annuity (flexible income immediate payments option) is used as the CPI-linked lifetime annuity with pricing as at 23/05/2024 using default settings from the Retirement illustrator – refer the following assumptions guide for further details.

In this fixed return projection a 20% allocation to a CPI-linked lifetime annuity helps Charlotte and Collin meet their desired level of spending for longer (with their income target of $100,000 p.a. projected to be met past age 100).

When tested across the 2,000 market scenarios, this 20% allocation to a CPI-linked lifetime annuity also (modestly) improves the probability of meeting their desired level of income to the couple's life expectancy from an 81% probability to an 86% probability.

% of times 'needs & wants' income of $100,000 was met to life expectancy



Source: Comprehensive report generated from Challenger's Retirement Illustrator as at 23/05/2024.

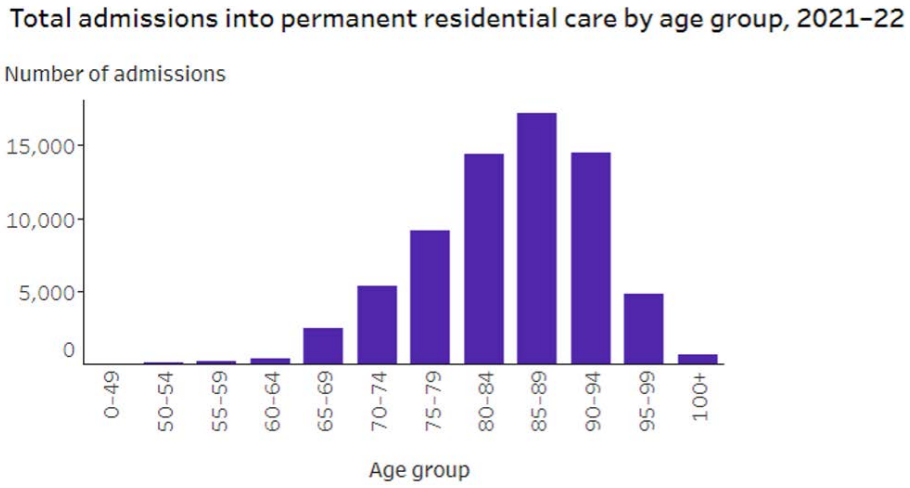
Importantly for Charlotte and Collin, this 20% allocation to a CPI-linked lifetime annuity also ensures that for the 14% probability that their total retirement income objective of $100,000 p.a. is not met (because their retirement savings have been depleted), they would still receive a guaranteed lifetime income of $19,015 p.a indexed to CPI for life in addition to any Age Pension they may be eligible for very late in life – the current maximum rate of Age Pension for a couple is $43,752.80 p.a. This ensures there is never a situation where Charlotte and Collin will need to solely rely on income from the Age Pension alone.

What if one of us needs to enter residential aged care later in life?

Looking into the longer term, and the potential for aged care, Charlotte and Collin are comfortable with the idea of selling the family home to fund any required Refundable Accommodation Deposit (RAD) if both of them need to enter residential aged care at similar times. As RADs are refunded at the end of their tenure in an aged care home, this would still broadly allow them to achieve their estate planning goals and leave a sizable estate to their kids.

Charlotte and Collin are committed, with the help of any available Home Care Package and their kids, to providing care for one another for as long as possible in their home. However, they also want to understand if a partial allocation to a lifetime income stream would impact their liquidity later in life if only one of them were required to move into an aged care home, and the other remaining in the family home.

Statistics from GEN aged care data shows that during 2021-22, 54% of residential aged care admissions were for people age 85 and over, with an average of 83.3 for men and 85.2 for women.



Using the same fixed return assumptions, their financial planner compared the projected balances of Charlotte and Collin's account-based pensions later in life starting at age 85 and summarised the outcomes across the two alternative drawdown strategies in the table below.

Comparison of Charlotte and Collin's ABP account balances at future ages (in today's dollars)

Age	ABP only	ABP and lifetime	Difference
85	$650,742	$650,913	$171
88	$476,216	$522,734	$46,518
91	$327,962	$411,800	$83,838
94	$185,243	$317,927	$132,684

Source: Challenger's Retirement Illustrator as at 23/05/2024.

At age 85 their remaining account balances of their account-based pensions were broadly the same whether or not they had a partial allocation to a CPI-linked lifetime annuity. Later in life however, the account balance was higher if they had a 20% allocation to a lifetime annuity. At age 94 (their life expectancy), their account-based pension balances was shown to be $132,684 higher in today's dollars. In addition to their account-based pensions, they would also have their $100,000 cash balance.

This higher balance at life expectancy comes from a combination of variables including the total return on the lifetime annuity over this period relative to replaced defensive assets, the different drawdowns from the account-based pensions over time, and the assumption that the account-based pension's asset allocation is maintained overtime.

In addition to similar or higher account-based pension balances later in life, Charlotte and Collin would also continue to receive CPI-indexed lifetime income to help with funding aged care costs.

Summary

Based on the analysis and modelling performed (including the assumptions used in the Retirement Illustrator) by their financial planner, Charlotte and Collin are able to achieve the following by incorporating a CPI-linked lifetime annuity into their portfolio:

- Higher portfolio/estate outcomes later in life from their higher account-based pension balances.
- Higher probability and confidence of achieving their target income of $100,000 p.a. for their life expectancy.
- Helped managed longevity risk and ensured they would never need to solely rely on just the Age Pension alone if they lived past life expectancy.

Other considerations of lifetime annuities for clients with significant retirement savings

For clients with even more significant retirement savings, including clients with assets greater than the superannuation transfer balance cap ($1,900,000 in 2024/25), a non-superannuation lifetime annuity may represent a particularly tax-effective structure for retirement income. The availability of a deductible amount in respect of payments (where only the portion of payments above the deductible amount are taxable) will mean, for many clients, less tax payable on retirement savings.

The taxation benefits of lifetime annuities are discussed in detail in this issue of Challenger Tech News.

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