Investing for retirement

Plain Talk® Library

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Introduction

When you're building your investment portfolio, it's important to find the right balance between your daily spending needs and long-term capital growth. A good starting place is to work out your financial goals, which can be heavily influenced by your life stage.

When you're building your career and family, you may be able to take a longer-term perspective as spending from your portfolio is not yet a priority.

But when you're nearing retirement or already retired, the balance might shift in favour of generating a regular and stable income stream while maintaining some growth to last the distance.

This Plain Talk® Guide explains the financial challenges you'll face in retirement and outlines some of the ways you can structure your investment portfolio to make the most of your retirement income with the help of a professional financial adviser.

The changing face of retirement

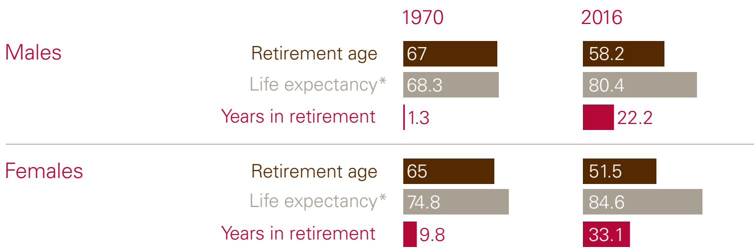
Retirement isn't what it used to be. It's so much more.

Medical advances and healthier lifestyles mean that we're living much longer than previous generations and enjoying more years in retirement, as shown in the following diagram.

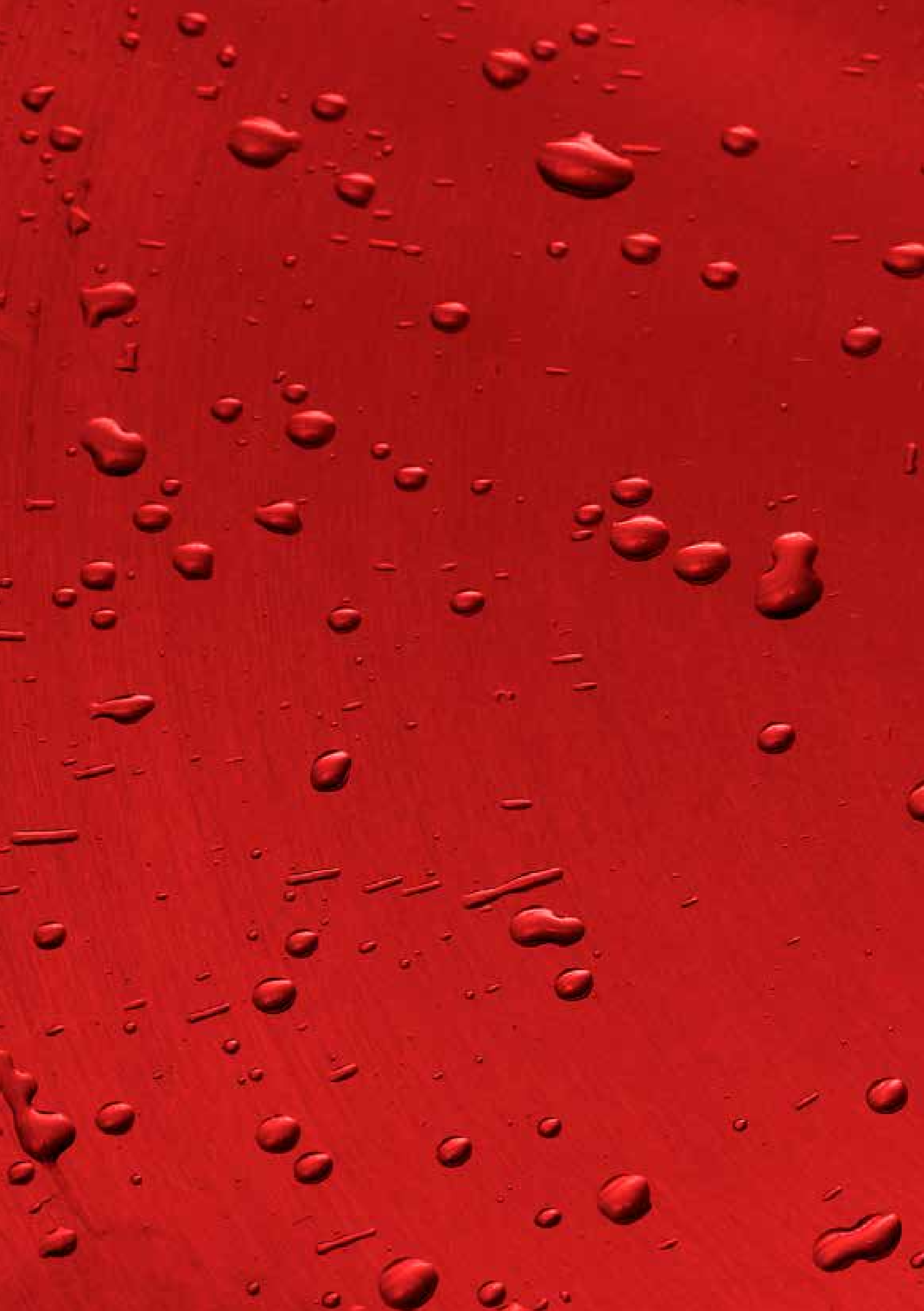
In our grandparents' day, retirement was short and expectations were modest. Now we're enjoying longer and more active retirements than ever before.

So whether it's the overseas trip of a lifetime, kitesurfing on the bay or hitching our wagon to the grey nomad trail around Australia, we're doing more, seeing more and travelling more in retirement.

Australian retirement landscape



* Life expectancy at age birth.
Source: Australian Bureau of Statistics (published 18/10/2017 iro 2014-2016).



What does a comfortable retirement mean for you?

As we enjoy longer and more active retirements, it's worth thinking about the standard of living you expect when you stop working.

One way of thinking about your expenses is in terms of discretionary and non-discretionary spending.

Non-discretionary spending includes all your regular essentials that will continue in retirement—groceries, utilities, insurance, transport and even mortgage repayments if the house isn't paid off yet.

Discretionary spending includes all those extras that make up the lifestyle you expect to maintain in retirement.

You probably expect to get involved in a broad range of leisure activities. You probably expect to be able to buy household goods, electronic equipment, good clothes and a reasonable car. And you probably expect to take the occasional overseas trip, as well as holidays around Australia.

The key to meeting your spending needs is retaining exposure to assets that will replace your monthly pay cheque with a regular income in retirement.

Smart investing tip 1: Think spending and growth

New hobbies, new experiences and new destinations cost money. So without a pay cheque coming in, you may need your savings to do more heavy lifting in retirement to enjoy an active retirement. Your investment portfolio in retirement should look to deliver a balance between your spending needs and capital growth over the long term.

Five big considerations in retirement

One of the biggest challenges as you prepare for retirement is adjusting to your changing circumstances and changing government rules.

1. Risks

There are always risks when you invest. Investing always involves a balance between how much you're seeking in returns and how much risk you're prepared to take.

But when you're coming up to retirement you're faced with a new set of risks.

- Market risk—Market ups and downs can affect you more when you don't have a regular income coming in. It can be difficult to recover from negative market returns while you're drawing an income from your savings. Maintaining a disciplined spending policy and investing in a fully diversified portfolio across a range of assets can help.
- Inflation risk—A 3% yearly rise in the cost of living might not sound a great deal. But it means that prices will more than double over the next 30 years. So it's important to look at 'real returns', which take

Smart investing tip 2: Start preparing early

If you don't prepare properly, you could find yourself having to make hard choices about what sort of retirement you're prepared to accept. Think about how much you need to live on and whether your savings will last the distance. If there's time, think about increasing your super contributions in the lead-up to retirement.

into account inflation, rather than 'nominal returns'. A term deposit that returns 2.5% might seem like a safe investment. But while you're guaranteed to receive your capital back with a set level of interest, you're also guaranteed to lose buying power in real terms as you fall behind inflation.

- Longevity risk—As life expectancy increases, your retirement savings may need to last for up to 30 years or more. Earlier in the more active phase of retirement, you may need more money for discretionary spending on travel and new hobbies. Later on, you may need to spend more on health costs and aged care. And you may also need to think about the legacy you plan to leave to your family.

- Emotional risk—With more time on their hands, many retirees take a closer interest in the markets. But while it's good to be engaged, it can be a double-edged sword. Reading every headline and watching every news report when there's a downturn or a surge in share prices can lead to decisions that aren't in your best interests. If you're not careful, you can easily end up with an unbalanced portfolio that has moved away from the asset allocation that you originally set as part of your long-term investment strategy.

Smart investing tip 3: Manage the risks

Earlier in life, you have more time to recover from losses. But when you approach retirement, you have less time to play catch up. You may need to adjust your risk profile to balance your immediate spending needs with long-term growth.

2. Spending patterns

Your spending patterns are likely to change in retirement.

You could save in some areas… You could make savings on work expenses like transport costs, you'll probably no longer have to pay for school fees and your home loan may be paid off or your mortgage repayments substantially lower.

…but other costs could appear… More leisure time can mean new hobbies and more ways to spend money. Plus you'll still need to pay the bills, service the car and put food on the table. And if you're like many recent retirees, you could still have dependants if your adult children are living at home or your elderly relatives need care.

…and things can change. Earlier in your more active phase of retirement, you're likely to enjoy more activities and trips at home or overseas. But later in retirement, your health costs may increase and you may have to look at aged care options.

3. Tax rates

As you transition from the world of work to the world of retirement, you're likely to move from a higher marginal tax rate to a lower marginal tax rate.

This could affect your decisions about what sort of assets you invest in. So working out the tax implications of the returns generated by the assets you hold is an important part of retirement planning.

A tax adviser can help you work out the best mix of investments for your individual situation.

4. Interest rates

When the Reserve Bank reduces interest rates, the media tends to report this through the lens of home ownership as a positive development. But every government decision creates winners and losers.

Low interest rates are great for homeowners looking to save money on their mortgage repayments. But they are not so good for retirees who may be relying more on conservative investments like bonds and term deposits to deliver returns that outpace inflation.

5. Age pension

As an ageing population puts more pressure on the public purse, the eligibility age for the pension is increasing.

As of 1 July 2017, the qualifying age for the age pension is 65 years and six months. The qualifying age will then increase by six months every two years, reaching 67 years by 1 July 2023.

So while our parents could rely more on the age pension to make ends meet, new retirees will increasingly be expected to fund their own retirements. It's also important to take into account other legislative changes that may affect your eligibility for the age pension.

- Asset and income test—how much the government allows you to hold in assets and receive in income to be eligible for the age pension.
- Gifting rules—how much you're allowed to gift to your children to buy their first home or pay for their wedding.
- Deeming rates—how much income your investments are assumed to have delivered. Deeming assumes that financial investments are earning a certain rate, regardless of the amount they're actually earning. Any returns above the deeming rate aren't counted as income so it's an added incentive to make your own provision for retirement.

Four big decisions to make

Faced with a changing environment there are a number of key decisions you need to make about your retirement.

1. When to retire?

After a lifetime of hard work, many of us dream of retiring early to spend more time with friends and family. But as the pension eligibility age increases and we live longer and enjoy more active retirements, you might want to think about whether your nest egg will last the distance.

And deciding the best time to retire isn't just about money. It's also about staying connected and feeling valued as you enter the new world of retirement. One way to keep working while drawing on your super is through a transition to retirement (TtR) strategy after you reach preservation age.

There are two ways to make the transition to retirement work for you.

- You can reduce your work hours but maintain your after-tax income.
- You can maintain your work hours and boost your super through salary sacrifice.

With both TtR strategies you start drawing a pension income from your super. But remember, if you reduce your work hours your super balance will fall over time.

2. What to do with your super

Deciding what to do with your super is one of the biggest decisions you'll make. After years of building your super savings, your retirement nest egg is finally within reach.

Like the pension age, the super preservation age is increasing as the government encourages us to take more responsibility for funding our own retirements. It's currently 55 if you're born before 1 July 1960, rising to 60 for anyone born from 1 July 1964 onwards.

When you do finally reach preservation age you can take your super as a lump sum or convert your savings into a pension to generate a regular income.

As house prices continue to increase, like many Australians you may be approaching retirement still owing money on your home loan. While it's tempting to take a lump sum to pay off your remaining home loan and enjoy a well-earned holiday, it's important to look at your long-term goals before jumping in.

You may be better off investing your super in a diversified mix of assets while retaining some of your debt.

A financial adviser can help you make the right decision for your particular circumstances.

3. How to meet your spending needs

Once you've worked out your discretionary and non-discretionary expenses, you'll need to look out how you're going to meet your spending needs. A good way to approach this is to look at your non-super income first.

- Your government pension entitlements—even if you're only entitled to a part pension you may still be eligible for substantial savings on healthcare through a concession card.
- Any income from a defined benefit scheme based on your final salary.
- Other sources of income from outside super, like rent from investment properties.
- Continuing paid work—whether part-time, consultant or freelance.

You'll then need to bridge the gap between your income and your expenses. This is where your super comes in. You can convert your super into an income stream. There are two types of retirement income stream—account-based pensions and annuities.

An annuity can deliver a guaranteed income for a set period of time. Annuities can vary quite widely in terms of their features so it's important to pick one that will meet your needs. In the event of your death, some annuities allow you to transfer any remaining income payments to a beneficiary but others stop payments altogether.

While annuities can deliver peace of mind, you don't have the flexibility to choose how your money is invested and there's not the same potential for higher returns. You're also giving up liquidity so one possible solution is allocating part of your retirement savings to an annuity while retaining the rest of your money in a more accessible account.

An account-based (or allocated) pension has no set time period and gives you more choice in how your money is invested. You have to withdraw a minimum amount each year, depending on your age.

But bear in mind that your returns will vary depending on the market performance of the assets you're invested in. So it's a good idea to build some flexibility into your discretionary spending. This means you'll be able to tighten your belt a little when markets go down and loosen the purse strings when markets go up. Investing in a diversified mix of assets can help to smooth your returns and reduce the effect of market volatility.

4. Where to invest

The day you retire doesn't necessarily call for massive shifts in your portfolio's asset mix. So if you've been moving to a more conservative mix in the lead-up to retirement, you may not need to make any changes.

But while it may be prudent to adjust from a high growth to a more conservative strategy as you age, you still need exposure to growth assets if you want your retirement nest egg to last the distance.

Total returns

Low interest rates mean that you can't rely solely on interest to meet your spending needs. You'll need to look at all sources of return, including capital gains and dividends.

As you transition to retirement you'll be increasingly relying on your investments to deliver returns that you can live on. So a diversified mix of assets to meet your short-term spending and long-term growth needs could be the best option.

1. **Defensive assets** like cash and fixed interest (or bonds) can deliver a steady and reliable income with minimal scope for capital growth. While their returns tend to be more stable than growth assets, they don't offer the same capital growth potential.

    a. **Cash investments** like term deposits can deliver a reliable income through the guaranteed return of your capital with interest at a specified date. But as interest rates remain low by historical standards, relying on term deposits could mean your investments struggle to keep pace with inflation.

    b. **Fixed interest investments** like bonds can deliver regular income through coupon payments with a degree of capital protection as you're guaranteed to receive the face value back at the end of the term. But you're at the mercy of fluctuating interest rates, which can affect your income along the way.

2. **Growth assets** like shares and property are primarily geared towards growing your capital (at higher risk) but can help to deliver a regular income.

    a. **Shares** can deliver a regular income through dividends. But it's not guaranteed and dividend yields can fluctuate depending on company performance. Australian shares come with franking credits, which means the company has already paid tax so that you don't have to.

But tax benefits could be less of a benefit once you've reduced your working hours or retired completely and moved onto a lower tax bracket. You can invest in shares directly through a stockbroker or indirectly through a managed fund or an exchange traded fund (ETF), which tracks the market. There are ETFs covering Australian and overseas shares in developed and developing markets.

b. **Property** can deliver a more reliable income than shares. But the value of your investment is exposed to market fluctuations. You can invest in property in two ways.

- Direct property investments. An investment property can deliver regular rental yield but you'll need to take into account operating/running costs and capital gains implications.

- Property funds. Investing in a listed property fund can deliver you exposure to property without the expense and hassle of direct ownership.

Many fund managers offer diversified managed funds with various asset class exposures. Some focus on providing monthly income and predominantly invest in fixed interest and cash type assets, while others include more growth assets like shares and listed property. You need to look for the right mix of defensive and growth assets that will deliver the right outcomes for your particular needs.

Smart investing tip 4: Make a gradual transition

Retiring suddenly from the workforce can come as a shock. Reducing your hours but staying in the workforce for longer can deliver positive benefits for your mental and physical health.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Vanguard's investment principles

Successful investing—hinges on many factors. Some can't be controlled, like market returns. But others can be. Vanguard believes that following these four principles will allow you to focus on the factors within your control, which can be an effective way to achieve long-term results.

1. Create clear, appropriate investment goals

Investors should set measurable and attainable investment goals, develop plans for reaching those goals and regularly evaluate their plans.

Investors with multiple goals like retirement planning and saving for a child's education should have a separate plan for each.

Without a plan, investors commonly construct their portfolios from the bottom up, paying more attention to choosing and buying investment products than to achieving their goals. Investors without a plan often construct their portfolios by evaluating the merits of each investment individually. If the evaluation is positive, they add the investment to their portfolio, often without considering whether it fits. This process can lead to a mismatch between the portfolio and its objectives. Common and avoidable mistakes include performance chasing and market timing.

2. Develop a suitable asset allocation using broadly diversified funds

A successful investment strategy starts with an asset allocation suitable for its objective. Investors should establish an asset allocation using reasonable expectations for risk and returns. The use of diversified investments helps to limit exposure to unnecessary risks.

When developing their portfolios, investors should select the combination of equities, bonds and other investments offering the best chance for success. This top-down asset allocation decision is among the most important factors in determining whether investors meet their objectives.

3. Minimise cost

While you can't control the markets, you can control how much you are willing to pay. Every dollar that you pay for management fees or trading commissions is a dollar less of potential return. Lower-cost investments tend to outperform higher-cost alternatives in the long term.

4. Maintain perspective and long-term discipline

Investing can evoke emotion that disrupts the plans of even the most sophisticated investors. Some make rash decisions based on market volatility, but investors can counter that emotion with discipline and a long-term perspective.

Rebalancing should be done on a regular basis. This will bring your portfolio back in line with the asset allocation you originally established to meet your objectives.

When equities are performing poorly, you may naturally be reluctant to sell other assets like bond funds that are performing well and buy more equity funds. But the worst market declines can lead to the best buying opportunities. If you don't rebalance your portfolio during these difficult times you may be jeopardising your long-term investment goals.

Seek financial advice

Whatever decision you need to make about the right balance for your portfolio—whether it's a lump sum or income stream, account-based pension or annuity, defensive or growth assets—a professional financial adviser can help.

A financial adviser can work out the best way to invest your money in a diversified range of assets to put yourself in the best possible position to enjoy a comfortable retirement.

The Vanguard difference

When you invest with Vanguard, you have more than 40 years of investing experience behind you. So no matter which investment products suit your needs, you can feel confident that Vanguard investments are built on a rigorous investment philosophy that stands the test of time.

Since launching the first index mutual fund for individual investors in 1976, Vanguard has strived to be the world's highest-value provider of investment products and services. We have an unwavering focus on our clients with a commitment to champion what's best for investors by offering outstanding service, while keeping costs low.

Low-cost investing

We know we can't control the markets, but we can control the costs of investing. To that end, providing low-cost investments isn't a pricing strategy for us. It's how we do business.

We can keep our costs low because of our unique ownership structure in the United States, which allows us to return profits to investors through lower costs so investors can earn more over time.

Our range of managed funds and ETFs

Vanguard offers a complete range of funds across all asset classes.

To see our complete product offerings, visit vanguard.com.au.

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