ETFS Investment Research

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No retirement for investments

Managing a retirement portfolio for income and growth

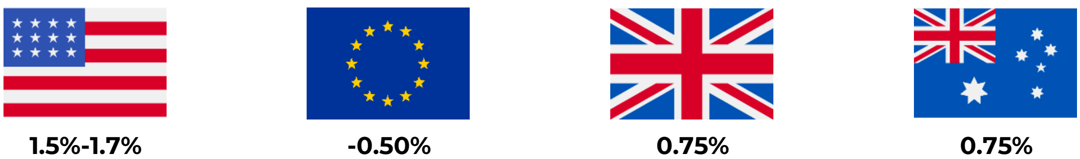
Retirement portfolios need to generate a stable income, preserve capital and still offer some level of growth to allow investors to manage inflation and longevity risks, along with a reasonable standard of lifestyle. Retirees also need to be cost conscious, understanding how fees can affect their overall returns and balance. This poses more challenges to structure compared to managing portfolios in accumulation phases.

The current Association of Superannuation Fund Australia (ASFA) retirement standards can paint a confronting picture of this investment challenge. According to the standards, a comfortable retirement for a single means an annual income of $43,787 per year. This income is generated by having savings at retirement of $545,000 and assumes that the single will own their own home mortgage free, will drawdown their finances completely, take a partial pension and receive annual investment earnings of 6% annually[1].

It is this last figure that poses particular concerns.

Fixed income has traditionally been the primary source of retiree income, with 20.71% of SMSF total funds under management in cash and term deposits[2]. The low interest rates globally are forcing retired investors to consider a wider range of investments and product types to generate the income and capital they need.

Major economy interest rates



Source: Bloomberg, 20 January 2020

While many investors may have just moved straight to direct shares with the aim of generating an income through dividends, considering managed products like exchange traded funds (ETFs) may offer a more efficient and cost-effective solution.

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[1] https://www.superannuation.asn.au/resources/retirement-standard

[2] https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Super-statistics/SMSF/Self-managed-super-fund-quarterly-statistical-report---September-2019/

ETFs as a retirement solution

ETFs have a number of characteristics to appeal in a retirement portfolio.

Cost is a key consideration, in terms of access as well as fees.

ETFs typically have lower management costs compared to using actively managed options, with purchase involving a brokerage fee, much like shares. They also offer more cost effective diversification and access – owning individual shares covering the entire ASX200 or the S&P500 may be out of reach for most investors, but using an ETF which invests in all of these, thus providing exposure to all these companies may be within the cost budgets.

There's also the matter of administration.

ETFs are easy to use and generally liquid investments which can be traded on the stock exchange compared to filling out documentation for managed funds or physical assets. They are also less time consuming than individual share and asset ownership.

Tracking and maintaining hundreds of shares involves far more work in terms of research and tax management compared to investing in an ETF. It is also far easier to buy or sell an ETF to change exposures and tilts with instant diversification compared to adjusting a large direct share portfolio.

Finally, there is a wide range of ETFs available on the Australian stock exchange, covering a range of assets, sectors and styles, meaning investors are more likely to find an investment to meet specific needs or gaps in their portfolios.

Just as other investment types that retired investors might consider, it is possible to identify ETFs which offer dividends or other forms of income. It is also possible to identify ETFs to support capital preservation or risk-managed growth.

The next question for many retired investors might be which assets and sectors to consider in constructing their portfolio.

Dividends for income

Equities play a dual function in a retirement portfolio with the aim to offer both growth as well as some form of income.

Using equities for dividend income is a well-known strategy, but retired investors also have to be wary of the higher risk of loss and volatility in equities compared to fixed income. There are a few approaches to consider depending on risk tolerance. Investors could focus on high yield paying equities, or they could also look at investing in less cyclical and more stable sectors and industries.

High yield paying equities have an obvious appeal, but investors also need to be aware that high dividends can also be a sign of company distress or can also be unsustainable in the long-term, making it an unsuitable as an income choice for retirees. It can be difficult to identify those high yielding companies with solid cashflow and earnings prospects and at a fair valuation. It is not uncommon for companies paying high dividends to also hold high pricing which may not reflect true value.

This is where there is value in paying for a managed option like an ETF. It removes the challenge of identifying the best prospects and offers diversified exposure. Smart beta, or rules-based ETFs are an ideal option to consider as depending on the design, they can identify or eliminate companies for investment based on certain characteristics. For example, the ETFS S&P/ASX300 High Yield Plus ETF (ZYAU) offers exposure to the 40 stocks with the higher shareholder yields from the S&P/ASX300 Index which meets certain quality and liquidity requirements.

Retired investors are often highly leveraged to Australia, which is where diversification to international assets are valuable. International equity markets offer investors exposure to sectors less available in Australia and companies which may operate at larger scales compared to some of those listed on the ASX. An ETF like the ETFS S&P 500 High Yield Low Volatility ETF (ZYUS) seeks to manage volatility risks and offer diversified high yield investments by tracking the S&P 500 Low Volatility High Dividend Index. This index identifies the 75 highest yielding eligible shares from the S&P 500 and then selects the least volatile options for inclusion.

High yield may not be the right approach for all retired investors, which is where considering investing in less cyclical and more stable sectors and industries may be ideal.

Income from infrastructure

Those investors looking for stable and defensive industries with consistent dividend streams might look towards the infrastructure sector. This sector includes many essential services areas such as utilities, telecommunications, industrials and transport. These tend to be less vulnerable to market cycles and movements.

Many Australian investors will have some infrastructure as part of their portfolios, with a greater leaning towards real estate, but may be missing diversification to international assets offering wider scale of operations.

Infrastructure tends to have lower risk (as measured by standard deviation of returns) compared to other sectors, such as technology or real estate making them worth investigating for retirement portfolios. The reason for this comes down to their structure and nature.

Infrastructure industries typically have high capital costs, low elasticity of demand, long business timelines and often exist as regulated oligopolies or monopolies.

Their capital-intensive nature means that they are very difficult and, in some cases, like energy distribution networks, nigh impossible to disrupt.

Some examples of companies in this sector include Fortis Inc, Atmos Energy and Taiwan Mobile. Investors looking for broad and liquid exposure could consider an ETF like the ETFS Global Core Infrastructure ETF (CORE) which offers exposure to the 75 least volatile listed infrastructure companies selected from global developed market exchanges.

Investors looking at other growth assets which tend to be relatively stable could also look to commodities, within the alternatives space of their portfolio.

All that glitters in the alternatives space

Generally retired investors steer clear of alternatives, assuming these will be higher risk and higher cost. Though investments like hedge funds may tend to fit this assumption, commodities like gold can offer diversification and stability.

Gold is often treated as a safe haven asset and holds both defensive and growth characteristics. Its position as desirable from both a consumption and investment perspective has allowed it to perform in a range of markets. For example, the below chart shows its performance compared to equities during a range of market events.

	Date	Gold Price Change 1 Year Forward	World Equities Price Change 1 Year Forward	Relative Price Change
Global Financial Crises	15-Sep-08	28.5%	-6.5%	35.0%
9/11 Terror Attack	11-Sep-01	9.9%	-12.3%	22.2%
Dotcom Bubble	11-Mar-00	-7.0%	-16.3%	9.3%
Iraq Kuwait War	02-Sep-90	-10.3%	6.8%	-17.1%
Desert Storm (First Gulf War)	02-Aug-90	-6.0%	-0.7%	-5.3%
Junk Bond Crash	13-Oct-89	6.9%	-14.6%	21.5%
Black Monday	18-Oct-87	-11.6%	-0.7%	-10.8%
Nixon's Registration	09-Aug-74	6.5%	4.9%	1.7%
Yom Kippur War	06-Oct-73	61.4%	-42%	103.4%
Average		**8.7%**	**-9.1%**	**17.8%**

Source: Bloomberg, ETF Securities

It also has a low (and at times, negative) correlation to other asset classes making it an appropriate diversification tool for retired investors.

<u>Table 1:</u>

	Australian Equity	Global Equity	Australian Fixed Income	Global Fixed Income	Commodities
Correlation	-0.29	-0.12	0.37	0.06	0.31

Source: Bloomberg data as at 31 December 2019. Correlations are calculated monthly over 20 years in Australian dollars. Australian equity is represented by the S&P/ASX200 Total Return Index. Global equity is represented by the MSCI World Total Return Index. Australian fixed income is represented by the Bloomberg AusBond Composite 0+ Yr Index. Global fixed income is represented by the Bloomberg Global Aggregate Total Return Index. Commodities are represented by the Bloomberg Commodity Total Return Index.

Using a gold-backed ETF like ETFS Physical Gold (GOLD) can be an effective means of access for retired investors. Features like ease of use and liquidity mean that retired investors can swiftly build up exposure or sell to free up cash when needed. It is also low cost, particularly compared to actively managed funds or even physically purchasing gold bars. This is a key consideration for retired investors with a shorter investment horizon and ability to tolerate the effects of fees on their portfolio.

While gold tends to be more popular, other precious metals can be appealing for investors too.

Silver historically performs in a similar way to gold. Where it differs from gold is that its price is driven by non-investment demand as well as investment demand. It has wide applications for industry and technology manufacturing, and 52% of global use of silver is for this purpose[3]. Investors may consider incorporating silver through an ETF like the ETFS Physical Silver (ETPMAG).

Source: Bloomberg as at 31 January 2020

While considering defensive properties from commodities like gold and silver, a balanced retirement portfolio should still maintain exposure to fixed income and cash, even in the current low interest rate environment.

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[3] GFMS, Refinitiv/Silver Institute, 31 July 2019

Managing fixed income investments for yield

Fixed income and cash still have an important role in an investment portfolio, even as investors are forced to find other means to generate yield. Fixed income continues to offer some predictability and stability of income and assists in offering a buffer against volatility in equity markets.

Just as with equities though, many Australian investors may be too concentrated towards Australian fixed income and currency. The low interest rates in Australia and the weaker Australian dollar are a reminder of the value of diversifying internationally, in this case to access potentially higher yield but as a long term play, should be considered to help buffer against changes in any country where an investor is likely to have exposures.

The US is particularly appealing to investors at the moment. It currently has the highest cash rate in the developed world, meaning it can offer higher yield in fixed income investments. International fixed income can be difficult for investors to access which is where ETFs can assist with offering easier access.

Investors can also generate income through cash investments internationally – and where international currencies appreciate against the Australian dollar, there may be the opportunity to realise capital growth. As with fixed income, the US dollar has been appealing for a number of investors but may be difficult to access for many, with managed investments like ETFs offering an effective access point.

A future view on retirement portfolios

While the current environment may have posed challenges for investing a retirement portfolio, it has highlighted the importance of a diversified approach to assist with growth and income. More than other investors, retired investors also have constraints around risk and costs to consider and this is where ETFs can be an effective solution for portfolio construction.

We are looking at the new world for retirement investing, and even if we see interest rates return to highs, retired investors should heed the lessons of today. Diversifying yield across more investments than just cash and fixed income will increasingly be seen as the standard, for risk management and to help with achieving overall income goals.

For more information on using ETFs in retirement portfolios, please speak to ETF Securities.

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Disclaimer

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