PARAMETRIC™
An Eaton Vance Company

October 2020

Parametric Research*Bite*

Income targeting in a Retirement Portfolio: Too much, too little or just right?

Raewyn Williams
Parametric Australia

Josh McKenzie
Parametric Australia

Given the Retirement Income Panel's work over the past year, super funds need no more motivation to answer the critical question: *how can funds deliver an adequate pension to retired fund members?* The question, however, can't be answered without determining what an 'adequate' pension is. This Research*Bite* considers how a hypothetical fund creating an income-targeted Australian equity strategy for its 'CIPR'[1] (or choice) retirement solution could benchmark the yield outcomes of this portfolio in a way that helps answer this question.

Retirement solutions are a new frontier for most funds; not shackled by legacy products, and not the focus of peer surveys or the APRA heatmap. It is a rich 'greenfield'-type opportunity to get back to the specific needs and sensitivities of fund members and embrace problems not yet solved by the industry – truly, a license to innovate.

Let's begin by suggesting a fairly obvious way of measuring and benchmarking yield on a portfolio which has tracking error defined in relation to the S&P/ASX 200 ('ASX 200') in a performance period:[2]

Portfolio yield	Benchmark yield
Dividends + interest / average portfolio NAV	Dividends / average capitalisation (ASX 200)

This sets up a straightforward argument for the fund: the portfolio delivers an 'adequate' pension as long as portfolio yield equals or exceeds the yield of the ASX 200 over the performance period. Longer time periods such as rolling 3 or 12 months can be easily added. However, we can immediately see an opportunity to get closer to the actual retired member experience by adding franking credits to this calculation:

[1] A comprehensive income product for retirement (CIPR) is a retirement solution that provides a retiree with income, flexibility and protection against investment and longevity risk. While for simplicity our analysis focuses on a 100% equity portfolio, we note that equities in a live CIPR solution will form part of a balanced portfolio.

[2] We ignore important performance methodology details like time-weighted versus cash-weighted returns not relevant to explaining our yield ideas. Calculations would, obviously, be period-specific.

Eaton Vance Management (International) Limited (EVMI)
Suite 25.05, Level 25
259 George Street
Sydney NSW 2000
Australia
T 61 2 8229 0222
F 61 2 8229 0249
www.parametricportfolio.com.au

Portfolio yield	Benchmark yield
Dividends + interest + franking credits / average portfolio NAV	Dividends + franking credits / average capitalisation (ASX 200)

This is an important step forward: Franking credits provide significant value to retirees, as is well known.[3] In previous research,[4] we estimated that franking credits on the ASX 200 were worth 1.5% annually to retirees and an active, franked dividend targeting strategy could add as much as 2% in total returns annually to retired fund members (admittedly, with risk implications). A pension-focused Australian equity strategy without franking visibility and 'smarts' misses an important portfolio lever to meet its income targets. It also denies the super fund the opportunity to answer credibly whether the yield produced delivers an adequate pension for retired members.

This market-cap benchmark approach to yield will appeal to many funds: it's relatively simple to implement, reflects familiar performance and benchmark concepts and showcases how a super fund's thoughtful portfolio design can beat a 'dumb beta' equity portfolio yield outcome. Yet, query whether it reflects how the *fund views investment success*, rather than how a *member* would view *pension success*. A way to close this agency-principal gap is to consider the member's appropriate 'counterfactual' - where the (principal) member would have otherwise invested their retirement savings but for the scale and expertise of the (agent) super fund. Let's say existing member data, a pre-retirement member survey or information gleaned from financial advice provided to members allows the fund to identify member cohorts who would otherwise invest their retirement savings in term deposits (cohort A), 5 'blue chip' Australian companies (cohort B) or a rental property (cohort C). This could justify measuring retirement portfolio yield success as follows:

Portfolio yield	Benchmark yield A	Benchmark yield B	Benchmark yield C
Dividends + interest + franking credits / average portfolio NAV	Average term deposit rate	Dividends + interest + franking credits of top 5 ASX 200 stocks / average portfolio NAV	Average rental yield

A different way, again, to answer whether a pension delivered is 'adequate' could get closer still to the heart of what 'success' means to a retired super fund member. Below, benchmark A best captures the Government's proposed legislated objective of super to "substitute or supplement the age pension in retirement"; benchmark B is the most personal, aiming at a yield level that provides a sufficient salary-replacement for the retired member; while benchmark C is perhaps the most aspirational, based on the published ASFA 'comfortable living standard' dollar figure.[5]

Portfolio yield	Benchmark yield A	Benchmark yield B	Benchmark yield C
Dividends + interest + franking credits / average portfolio NAV	Standard age pension entitlement / average account balance	x% pre-retirement salary / average account balance	'Comfortable living' salary / average account balance

Our key message is that as super funds develop and implement their retirement portfolios, they can do better than simply migrate mechanical accumulation portfolio–style yield benchmarks that, in truth, miss the mark for members. Now is the opportunity for super funds to think innovatively and define yield success in a way that more closely reflects what retired fund members would relate to and care about. The estimated 1.8 million members moving into and through retirement in the next five years[6] hope it's an opportunity that super funds don't miss.

[3] The Australian Labor party's proposal to limit franking credit refunds before the 2019 federal election was vastly unpopular amongst retired super fund members who rely on franking credits as a source of yield. Many commentators believe that the pre-election lobbying that took place to protect retiree's franking credits helped deny the Labor party its expected election victory.

[4] Raewyn Williams, Martha Strebinger, Vassilii Nemtchinov and Travis Bohon, 'A Fresh Look at Franking', Parametric, January 2017, https://www.parametricportfolio.com.au/insights-and-research/a-freshlook-at-franking.

[5] See https://www.superannuation.asn.au/resources/retirement-standard. Practical adoption of this benchmark requires decisions around whether to use basic or comfortable, and single or couple, living standards.

[6] Source: KPMG Super Insights Report 2020, https://assets.kpmg/content/dam/kpmg/au/pdf/2020/super-insights-report-2020.pdf