Income layering: What? Why? When? & How?

Aaron Minney | Challenger | 10 January 2018

Many practitioners are curious about income layering and how it might help their clients in retirement. Like *The Curiosity Show* of the 1970s and 1980s, here we'll attempt to answer questions around the What? Why? When? & How? of income layering, leaving you to decide on the 'Who?'.

WHAT IS INCOME LAYERING?

Income layering is a goals-based approach to building an investment portfolio. Academic literature sometimes calls it income diversification. It recognises that different expenditure types are valued differently by those spending the money. The simple case involves a separation of expenses into needs and wants. More detailed versions can add other layers, but the concept is the same.

Needs, as the name suggests, are the items that someone absolutely requires and any failure to be able to meet these is a large negative, potentially catastrophic. For most people, this will reflect basic living requirements such as food, shelter, clothing and utilities, but the quality required will vary from person to person.

Wants are everything else. These are often what makes life enjoyable, so it is preferable to maximise spending on wants. However, as they are not essential, the downside from missing out is less dramatic. It might be possible to defer or skip consumption either for a period or altogether. Not taking an overseas trip following a market downturn is one example of how people manage when funds to meet wants are not available.

The basic concept in income layering is to match cash flows from investments and other income sources to the overall budget for spending on needs and wants. Unlike other approaches, such as income buckets, which segment spending by time, income layering segments the requirements for spending by type. To ensure that spending needs will always be met, investments are partitioned so that cash flows for needs will always be available from secure sources. Ideally, wants will be funded in an income-maximising way.

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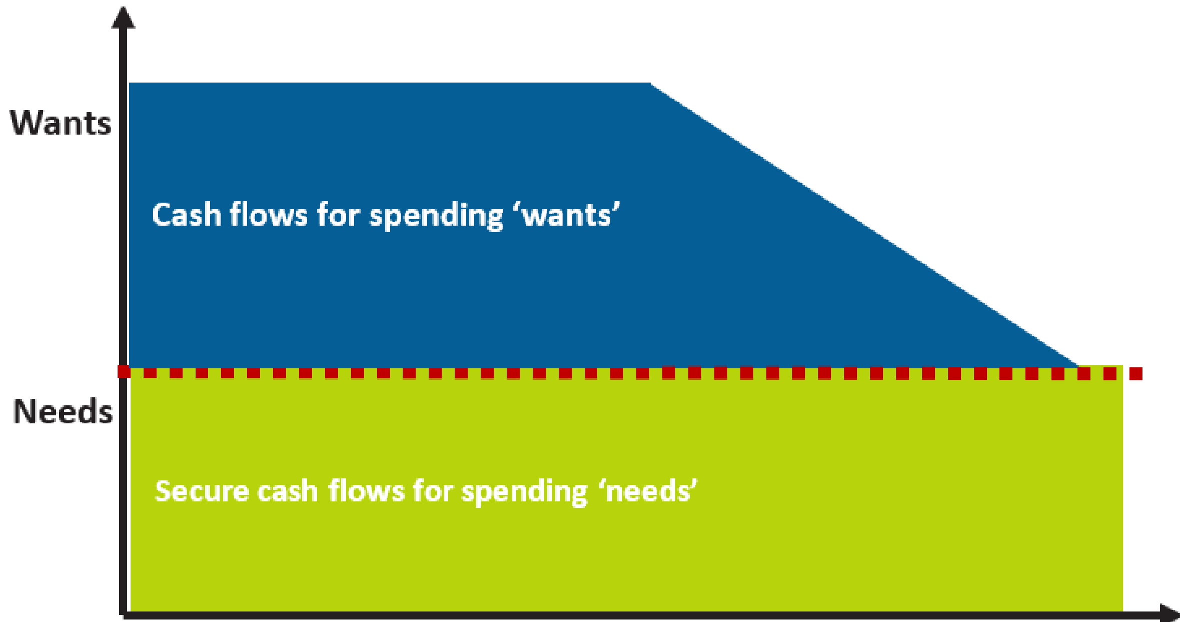
Figure 1: Income layering for needs and wants



Source: Challenger

WHY SHOULD INCOME LAYERING BE CONSIDERED FOR SOME CLIENTS?

A goals-based approach for investing is suited to many clients. It can increase the likelihood that the client will stick to the investment strategy that is implemented. For many, the distinction between needs and wants will be easily understood and, by aligning with that distinction, income layering will identify which assets need to be secured.

Income layering is also useful in managing longevity risk. If the risk that a retiree might run out of capital to support a desired lifestyle is relatively high, an income layering strategy is useful to redefine their lifestyle elements. It doesn't necessarily change the overall risk that capital can be depleted, but it changes the severity of the impact. An income layering strategy will ensure that the lifestyle needs are always met. At older ages, the risk from capital depletion is only that wants will be foregone. While not desirable, this is not as problematic for most as being forced to live below a needs benchmark. Indeed, many people reduce their spending on non-essential items later in life. The ASFA retirement standards highlight this change showing that at older ages, the modest standards are similar to younger age standards, while the comfortable standards are about 10% lower.

By solving income needs for a long time, potentially the rest of life, income layering is often suited for risk-averse clients. Having highlighted specific needs, some clients will worry more about meeting those needs in the future. With a typical bucket strategy, this worry recurs whenever the buckets are reset as they only cover a limited time frame.

WHEN SHOULD INCOME LAYERING BE IMPLEMENTED?

Income layering is a useful way to generate a stream of cash flows from an investment portfolio. As an investment strategy, this will be most useful when the investor doesn't have another source of income to meet all their spending needs. This is exactly what happens to us all in retirement. There is a new requirement to generate income from accumulated life savings, rather than earned income, to enjoy the desired lifestyle.

It is also important to consider other income elements in an income layering approach. With the means-tested Age Pension in Australia, this is more important here than in other countries. Many countries provide a social security entitlement to retirees that does not change (beyond indexation). In those jurisdictions, a constant supply of secure income for needs can be assumed.

However the Age Pension entitlements of Australian retirees can change over time because of the assets test (aside from the political risk of changes to pension rates and entitlements). A retiree with no current entitlement due to their assets can receive a part, or even full, age pension at older ages. This feature is important in implementing an income layering strategy.

Income layering is relatively simple to maintain. Once the secure layer has been set up, the remaining portfolio can be invested relatively freely. This makes income layering a good option for someone who might not have the time nor the ability to be actively managing their investment portfolio.

HOW CAN INCOME LAYERING BE PRACTICALLY IMPLEMENTED?

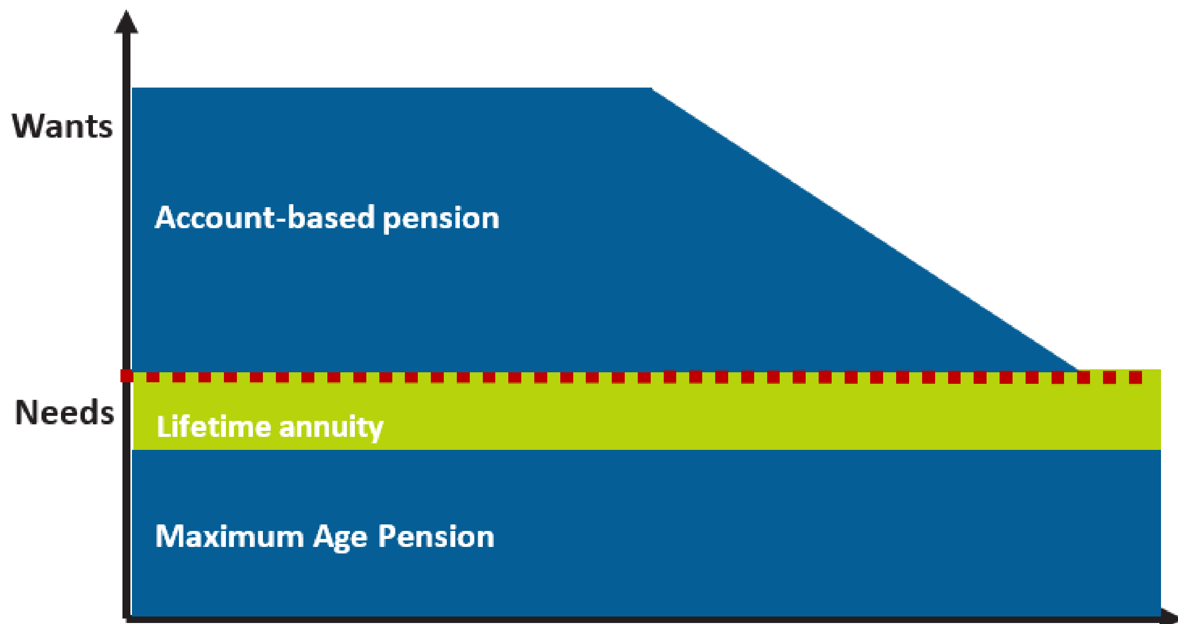
The key element to an income layering approach is to secure cash flows for the spending needs. Availability of the Age Pension affects how much income needs to be secured. Age Pension payments can be considered as secure income for a retiree using an income layering strategy. Retirees only need to generate enough secure income to meet their needs above their maximum Age Pension entitlement.

Relying on the maximum Age Pension

It is not immediately obvious that the maximum Age Pension rate can be used as a source of secure income, but there is a simple logic as to why and it reduces the cost of securing an income layer for spending needs. The means tests for the Age Pension only apply if a retiree has either income above a certain threshold or assets above another threshold. In either case, the retiree would be able to support their lifestyle by spending some of their additional income, or potentially reducing their assets. A non-performing asset can (and probably should) be sold to provide income if necessary. If the assets and other income fall to zero (or

below the relevant thresholds) then the retiree would get the maximum Age Pension.

Figure 2: Income layering with a lifetime annuity above the maximum Age Pension



Source: Challenger

Setting a budget

It can be difficult for some clients to set a budget. In practice, this should be a spending target (rather than a restraint) for the retiree. Splitting expenses by category might help to break the budget into needs and wants, but knowledge of current spending can be sufficient. All that is needed is an estimate of what the client could give up from current spending if they had to – the residual is the needs budget.

The four basic steps for implementing the strategy are:

- Step 1. Estimate a needs budget.
- Step 2. Needs budget less maximum Age Pension = secure income requirement. If the needs budget for a client is less than the Age Pension, skip step 3.
- Step 3. Secure the income requirement with a guaranteed lifetime income stream, such as a lifetime annuity. Other structures are possible here, but a traditional lifetime annuity is the simplest.
- Step 4. Invest the remainder of the portfolio according to the client's risk preferences.

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In general, only a minority of the overall portfolio will be required to secure the income for needs. Also, as income layer protects against the largest risks in retirement, the remaining portfolio can be invested in a similar manner to investing in the pre-retirement phase. The key difference is the fact that the role of the defensive assets switches from capital protection (through diversification) to producing income. A switch from bonds to lifetime annuities is a natural flow that aligns with this requirement in an income layering strategy.

WHO MIGHT BENEFIT FROM INCOME LAYERING?

Income layering is likely to be beneficial for a wide range of retirees. While anyone could use the strategy, it is likely to be more beneficial when:

- The retiree expects to spend down a large proportion of their accumulated savings through retirement. This is often the case for retirees eligible for a part Age Pension.
- The retiree is worried about how they will be able to sustain spending in the later stages of their retirement.
- The retiree has a concept of a minimum lifestyle standard, which equates to their overall spending needs.

Aaron Minney is Head of Retirement Income Research at Challenger.

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