

Down the retirement risk zone with gun and camera

Angela Ashton | PortfolioConstruction Forum | 15 October 2014

"Down the Retirement Risk Zone with Gun and Camera" by Geoff Kingston and Lance Fisher, CIFR Working Paper No. 05/2014, March 2014

This paper – by two Australian academics at Macquarie University, Geoff Kingston and Lance Fisher – is a good summary of literature on the issue of sequencing risk, or the Retirement Risk Zone, as it is popularly known. Interspersed with their own opinions on retirement income, it is a particularly relevant review, because it focuses on the Australian experience and considers the effect of Australia's age pension on retirement spending strategies.

Kingston and Fisher have a couple of important things to say. The most important is that they believe sequencing risk is not a "primary" risk to retirement portfolios, per se. They believe it is a "derivative" or secondary risk, which comes about due to the fact that the asset allocations used in retirement portfolios don't change and are highly weighted into growth assets. They argue that if a glide path approach were used, sequencing risk would be avoided.

In terms of the academics who have looked at the issue of how to best structure retirement income, Kingston and Fisher review the work of Bill Bengen, Robert Merton, Ken Henry, Moshe Milevsky et al and Michael Drew et al.

You might recall from our previous research reviews that [Bengen introduced the idea of the 4% withdrawal rate in retirement](#). Since his first work 30 years ago, this rate, correct or not, has become the unofficial starting point for many discussions on retirement income. However, Kingston and Fisher don't believe that Bengen's idea of a constant withdrawal rate (increased each year for inflation) is the best approach. They think an alternative method put forward by Merton, whereby withdrawals change based on a more complex formula primarily based on age, should be used.

Ken Henry, of tax review fame, makes the point that many portfolios for people at or near retirement in Australia might have 10% to 30% in defensive assets, while most standard portfolios run by offshore institutions are closer to 50% or more in defensive assets. He showed that given the possibility of losses in late working life, people may well prefer safe assets to risky ones, even with higher expected return. He also pointed out that as life expectancy increases, people should expect to either work more or save more.

Milevsky raised the idea of using derivatives to protect against large losses in early retirement (so-called retirement collars). Bateman, meanwhile, showed that the equivalent

portfolio is very conservative, and an investor may well be better off with a changing asset allocation.

Michael Drew et al have done more than most to popularise the issue of sequencing risk in the minds of Australians. However, they have not managed to discuss potential solutions in any depth as yet and Kingston and Fisher argue that Drew et al have not clearly linked the source of sequencing risk as being due to growth-oriented asset allocations.

Kingston and Fisher believe that the idea of a Glide Path, whereby allocations to growth assets fall as retirement draws closer, is the best approach to retirement funding. (This dovetails nicely with [last week's research review of Michael Kitces' and Wade Pfau's work on glide paths](#).) The exact trajectory of the Glide Path is up for discussion, however, as there is not yet a lot of research on the topic. Initial estimates are that glide path might be about 40% during employment (that is, a fall of 40% in growth asset exposure) and then another drop of 10% on day of retirement.

During retirement, Kingston and Fisher believe, spending plans should drive asset allocation (which effectively equates to a bucket approach, whereby near-term expenditures are funded by low risk assets – for more on [a bucket approach to portfolio construction, see Michael Kitces' presentation at the recent PortfolioConstruction Forum Conference](#)). Bequests can then be used as shock absorbers, so that rising allocations to growth assets over time can be achieved. In fact, Kingston and Fisher argue, this approach is actually the traditional cycle of asset class exposure. A couple would get a mortgage early in their working lives (that is, they gear into a risky asset), they generally pay it off by retirement and save extra money, effectively lowering the exposure to risk assets in the portfolio. At retirement, they receive either a lump sum or some pension payment from work, thereby lowering risky asset exposure dramatically on the day of retirement. During retirement, liquid assets are used to fund expenditures, increasing risky asset exposure (usually meaning the family home). The children inherit the house ensuring the goal of leaving a legacy is met. They call this approach a Displaced V.

All in all, as a review of different approaches to retirement income funding, particularly in the Australian context, this paper is well worth reading.

[Read "Down the Retirement Risk Zone with Gun and Camera"](#)