AMP CAPITAL

Hunting for income: a changing landscape

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For most people, their biggest fear when facing retirement is the possibility of outliving their money. With Australians now living longer, and returns from investment markets likely to be constrained, the timing for more than 5 million baby boomers about to leave the workforce couldn't be worse. As many of these investors experienced significant drawdowns in the wake of the Global Financial Crisis, their portfolios cannot afford to fail them again.

In this article, we explore the various options available to investors who will be relying on an income stream to fund their living expenses. We examine areas of the market that we believe present the best yield opportunities for investors, and discuss the need for capital growth and protection from the unknown. We also look at areas of the market where we believe investors should exercise caution, and provide an overview of the red flags to look out for.

Demographics matter

Not only have baby boomers never saved like their parents and grandparents, but in addition to this, people are living longer. According to the Australian Bureau of Statistics, in 2050 the average life expectancy for men in Australia will rise from the current age of 85 to 93, and women are expected to live to an average age of 96. High share prices and lower government bond yields are also playing havoc with the future returns needed for retirement expenses. All in all, it appears that typical share - and - bond investments probably won't support retiring baby boomers like they did 30 years ago. Against this backdrop, many retirees are likely to experience significant shocks to their lifestyles when they retire, or sometime after that. A new way of thinking is needed!

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We analysed a typical balanced portfolio of 60% global and Australian shares and 40% bonds. For someone who retired in 1980 with a balance of $355,000, and who was making annual drawdowns of $35,000, their investments would easily have lasted them throughout their retirement. In fact, after making annual drawdowns of $35,000 adjusted for inflation, after 30 years they would still have had almost $50,000 capital remaining.

Today, the situation is very different. Based on our medium-term assumptions of capital markets, a person retiring today with a balance of $355,000 who is making annual drawdowns of $35,000 adjusted for inflation, is likely to run out of funds within 15 years' time. It could be depleted even faster if inflation and interest rates were to rise as they did from the 1960s to the early 1980s.

Source: AMP Capital, September 2013.

Avoid the 'yield trap'

Although rates are likely to head up when the economy shows sustained signs of improvement, the yield climate will probably remain challenging for the foreseeable future. This has prompted a widespread hunt for income - producing investments such as dividend paying stocks and high yield bonds as investors attempt to dial up the yield on their portfolios.

While there is a strong case for investments offering a decent yield, it needs to be acknowledged that this can come with its pitfalls. The dangers that can be encountered while seeking yield in today's low yield environment have just as much potential to derail retirement for unsuspecting investors as some of the dangers that can be found when seeking high levels of capital growth. What is concerning is that many investors don't realise the risk they are taking. History has shown us how enticing, and dangerous, the yield trap can be. It is critical when investing in yield based investments that investors focus on opportunities that have a track record of delivering reliable earnings and distribution growth and which are not based on significant leverage.

The yield trap - a lesson from the past

When the secular bear market in global shares first commenced last decade this prompted central bankers to reduce interest rates to very low levels. This hurt investors and savers who, in an effort to maintain their income levels, flocked into higher yielding securities. This included highly geared sub-prime mortgage debt, and heavily leveraged property and infrastructure stocks. Although these investments performed well when interest rates were low, as the global share market recovered and rates started to rise, many of these investments witnessed significant losses.

Beat inflation with growth investments

One of the greatest challenges in retirement is ensuring your investments keep pace with inflation. While you can control some of your discretionary expenditure, you can have no control over the level at which inflation is likely to rise. Even if inflation is low, it still has a significant long-term effect on your wealth and will eat away at your retirement savings .

Fortunately you can mitigate inflation and meet the challenge of funding retirement by choosing investments that can outpace inflation over time. While historically the convention has been to hold the bulk of your retirement savings in conservative assets such as cash and fixed income to protect your capital, we believe it is also important to hold some growth assets. Exposure to the right growth investments should enable investors to increase and maintain their capital, so they can periodically tap into their savings to meet their living expenses.

A greater focus on active management

The ongoing need to find yield in the current low yield environment makes it more critical for both pre-retirees and retirees to manage their portfolios appropriately. An overwhelming weighting to equities is obviously not viable and neither is a high cash allocation if capital growth is necessary to fund retirement.

So, is it manageable? We believe so, but it will be important to not have the same set-it-and-forget-it approach that may have been employed in the past. Investors will need to search for yield in areas they have not searched historically. They will also need to be attuned to changes in the marketplace that will serve as their cue to make investment allocation changes. This means that an active management approach will be critical in ensuring investments are performing optimally.

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About the Author

Jeff Brunton joined AMP Capital in January 2008 as Head of Credit Markets. Jeff is responsible for overseeing the credit investment process as well as conducting stock, industry and macro research in credit markets. Jeff is chair of the Credit Investment Committee and is also a member of the Infrastructure Investment Committee.

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