One of the main financial risks of retirement is a market downturn occurring shortly before or after retirement (sometimes called ‘sequencing risk’). Although an investor is always vulnerable to adverse market movements, it’s at these times that their retirement assets are likely to be at their peak. That means there is the greatest risk of a negative impact to their post-retirement income.

This article discusses some strategies for protecting retirement investments by managing this risk.

**Who needs to protect their retirement investments?**

Retirement protection may suit investors who want:

- more certainty of an outcome (income security, capital preservation or both)
- income for life, perhaps to supplement the Aged Care Pension
- to transition from an accumulation-style portfolio to an appropriate retirement income portfolio in order to manage the increased risks of approaching or being in retirement, or
- to mitigate the risk of drawing down capital in the early years of retirement if markets are weak.

**Talking points**

- Investors are at greatest financial risk if market downturns occur around the time they retire.
- Retirement protection strategies can provide greater financial certainty by reducing the risks to investors’ retirement income and capital.
- A wide range of products and protection strategies are available to help investors achieve their retirement goals and lifestyle.

**The financial ‘life cycle’ of an investor**

To understand why investment protection in retirement is important, it’s helpful to consider the main stages in an investor’s financial life cycle (see chart 1 over the page). At different stages, different strategies may be more suitable for addressing investors’ changing needs and circumstances.

**Phase 1: Accumulation**

In this stage, an investment portfolio is designed to maximise wealth. The choice of portfolio depends on the investor’s risk tolerance, but growth assets dominate. The main risk is losing wealth due to a market downturn or poor performance, and this is best mitigated by diversification. Earning capacity is greatest at this stage, so life insurance to protect against disability or premature death is appropriate.
Strategies for a more secure retirement

Chart 1: The financial life cycle

<table>
<thead>
<tr>
<th>Accumulation phase</th>
<th>Transition phase</th>
<th>Drawdown phase</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maximise wealth</td>
<td>Protect capital</td>
<td>Protect income</td>
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Age 55 | Age 65 | Age 75

Source: ThreeSixty Research

Phase 2: Transition (pre-retirement)
In this critical pre-retirement stage, the investor’s wealth is approaching its peak. The sole focus on accumulation starts to change to the need to preserve capital and protect lifestyle. Sequencing risk is a significant risk as retirement approaches and an investor is most likely to consider protection for their assets at this time.

Phase 3 Retirement – drawdown
In retirement, the investor’s main concerns are a secure income and assets, and managing the risk that their assets won’t last their lifetime. A sustainable income stream strategy is needed.

Options for protecting retirement assets
Investors have the greatest need to protect their retirement assets in the transition and retirement phases. Investment products with protection features come in many forms, from ‘risk free’ (cash) to highly complex structured products that provide specific risk and return outcomes.

Investors who use cash as a complete portfolio solution have decided that avoiding market risk is the best form of defence. However, for most retirees investing solely in cash, there is still the risk they will outlive their wealth and the income from it.

Pure income solutions, like term deposits, also have drawbacks: there is no immediate access to funds and returns have, on average, been lower than other investments such as shares in the long term.

Lifetime annuities, which provide a guaranteed income stream for life, are often considered a solution to the risk of running out of wealth. Because lifetime annuities offer a secure income, they can play an important protection role in the drawdown phase. However, as they generally aren’t redeemable, an investor can’t change their mind if circumstances change. They also depend on the guarantor’s creditworthiness.

Another option is structured products that offer guarantees. These may play a useful role in the critical pre-retirement phase. The downside is that these products come at a cost and may be highly complex and illiquid.

An alternative is investment protection products, which are specifically designed to protect retirement investments. These products have a relatively simple structure and combine some of the features of insurance (protection) with the benefits of investing in growth assets. MLC’s MasterKey Investment Protection is one of these.

Many investment protection products offer protected income and protected capital options. Pages 4 and 5 show examples of how these options work in MLC MasterKey Investment Protection.
Retirement protection strategies
Here are some strategies that may help investors protect their assets in retirement and achieve their retirement goals.

An ‘income floor’ for a portfolio
The aim of this strategy is to lock in an investor’s future income needs by building an income floor into the portfolio. There are many ways of achieving this, including using an investment protection product or other income-generating products like annuities and (to a lesser extent) term deposits.

One method is to replace the fixed income component of the investor’s portfolio with a protected income option (for life). This provides an income floor and a solution that stretches throughout retirement. It also offers flexibility, as protection can be stopped if the investor has unexpected financial needs. Depending on the investor’s wealth, this could supplement the Aged Care Pension.

Certainty of income in early years of retirement
Lifestyle activity and expenditure tend to be highest in the first decade of retirement, when retirees are relatively active. This is also when they are most sensitive to market forces that could seriously impact their life savings.

Investing in a protected income option for a 10 year term is one way to generate the income needed to fund this comparatively expensive life stage. Another approach is ‘laddering’— matching future liabilities with bonds or term deposits that will mature at different times when the funds are needed.

Capital preservation during the critical stage
During the critical period between age 55 and 75, capital preservation is often an important goal.

Using an investment protection product is one way to manage the transition to retirement. A protected capital option can protect a portion of wealth during this period, when sensitivity to market risk is highest.

An investor can transform the accumulation-style portfolio they hold in the lead-up to retirement into a dedicated retirement income portfolio by selling the fixed income component and using the proceeds to buy a protected capital option. This strategy can also offer flexibility, as protection can be stopped if the investor has unforeseen financial needs.

There are also structured products that have long terms, but these are usually inflexible if an investor’s circumstances change.

A retirement protection strategy that suits the investor
There are many options available for achieving security in retirement and, in particular, for dealing with sequencing risk. The most appropriate strategy for a particular investor will depend on the investor’s financial position as they approach retirement, their goals for retirement and how they are positioned in relation to those goals.
MLC has developed MLC MasterKey Investment Protection so you have the potential to grow your retirement savings with the confidence of knowing your savings or income are protected even if the market falls.

You can choose from two types of protection, Protected Capital or Protected Income.

**Protected Capital**

Example of how it works

1. You invest $200,000 in an eligible investment option with Protected Capital for 10 years. It becomes your protected capital value and the minimum amount you’ll receive at the end of your term.

2. Your investment moves up and down with markets but your protected capital value is locked in.

3. Each year on your investment anniversary, if your investment is higher than your protected capital value, your protected capital value will increase and be locked in at this higher amount.

4. At the end of your 10 year term your protected capital value is higher than your investment so you receive the protected capital value amount.

![Diagram showing the protected capital value over 10 years with investment value fluctuating but protected capital value remaining constant and locked in at a higher amount at the end of the term.](image-url)
**Protected Income**

**Example of how it works**

1. You invest $350,000 in an eligible investment option with Protected Income for the rest of your life. It becomes your protected income base and the amount used to calculate how much income you’ll receive each year.

2. Your investment moves up and down with markets but your protected income base is locked in.

3. You retire at age 65 and start your protected income payments. As your protected income base has increased to $400,000, you’ll receive $20,000 per year.

4. Each year on your investment anniversary, if your investment is higher than your protected income base, your protected income base will be locked in at this higher amount.

5. In this example, your protected income base has increased to $425,000, so you’ll now receive $21,250 per year.

And, no matter what happens to markets or if your money runs out, you know your income is protected for the rest of your life.

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**Important information:**
The information contained in this article is current as at February 2013 and is prepared by GWM Adviser Services Limited ABN 96 002 071749 trading as ThreeSixty, registered office 150-153 Miller Street North Sydney NSW 2060. This company is a member of the National Australia Bank group of companies.

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This communication includes a summary of important information in the MLC MasterKey Super & Pension Fundamentals Product Disclosure Statement at mlc.com.au/pds/mkspf. You should consider this Product Disclosure Statement before making a decision about whether to invest in this product.