Financial **Focus**

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Welcome to Financial Focus. I hope you enjoy the articles and find them interesting and informative. If you have any feedback, questions, or would like to review your financial plan, please feel free to contact me.

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How much can you afford to spend in retirement?

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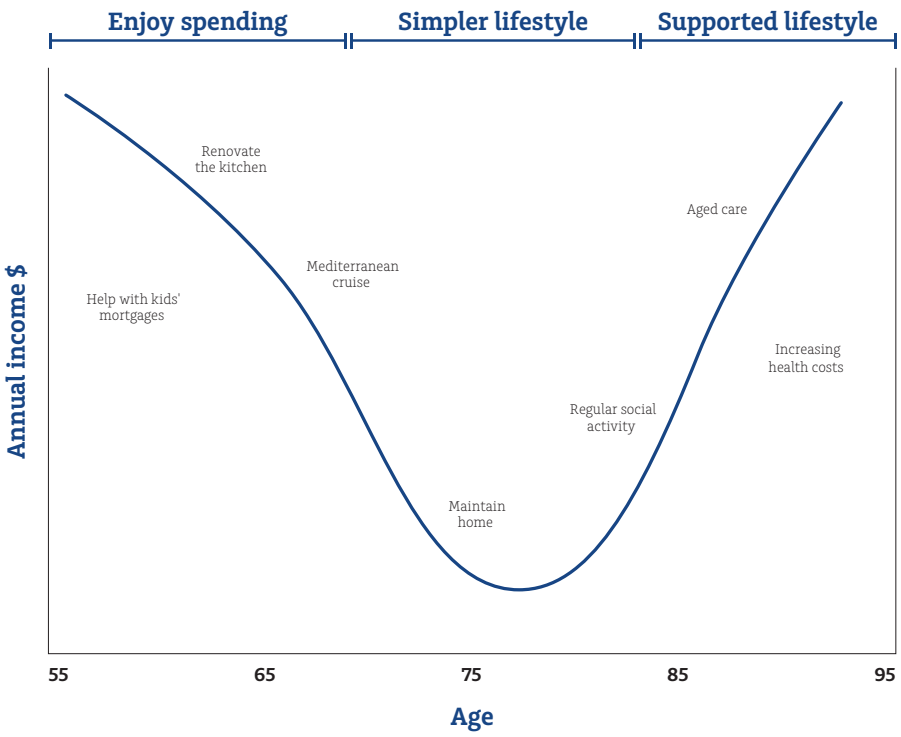
How much you can afford to spend in retirement is determined by a number of different factors including investment markets, your super balance and lifestyle. But is there more you can do to help yourself have a better retirement? Understanding your expected spending patterns and ensuring you have an appropriate investment and drawdown strategy can help you determine whether you can support your desired retirement lifestyle.

One of the most important steps in your retirement planning is figuring out how much you'll need to spend each year to support your desired retirement lifestyle. However, many people struggle to plan for the various stages of spending that they may require as they move through retirement.

The chart on page two shows how retirement spending can change over time. Many people spend a lot initially, supporting their new lifestyle, before settling into a simpler life. As we age, accommodation and medical costs tend to rise.

Chart 1: Typical spending during retirement



How much will you spend in retirement?

A few guidelines to help you work out your retirement spending budget include:

- Government regulations – the Superannuation Industry (Supervision) SIS regulations mandate minimum pension withdrawals, ranging from 4% pa for those aged under 65 through to 14% pa for ages 95+.[1]
- Association of Superannuation Funds of Australia Limited (ASFA) Retirement Standard – provides the annual budget benchmarks to fund either a 'comfortable' or 'modest' standard of living, for both singles and couples. It is updated quarterly to reflect changes to inflation, as measured by the Consumer Price Index (CPI).[2]
- Replacement Ratios – these measure your income in retirement relative to the income you earned during your working life. The benefit of these ratios is that they directly relate to the wealth and lifestyle that you enjoyed during your working life.
- Mercer Retirement Income Framework – this alternative framework recognises that in the earlier active stage of retirement (ages 65 – 74 years) the SIS minimum withdrawal rate may not be enough. It proposes a drawdown strategy where retirement income includes either a minimum threshold to cover 'essentials' or a target income level to afford 'extras'.[3]

The importance of the investment strategy

There is generally a clear relationship between your desired level of spending, how much your savings are and the way in which the retirement savings are invested. This is referred to as a drawdown strategy.

In essence, a good drawdown strategy may require you to balance the following objectives:

1. Sustain a stable and comfortable standard of living in retirement. Ideally similar to what you were accustomed to prior to retirement
2. Maximise your Age Pension and any other potential social security benefits
3. Protect the value of your savings against being eroded by inflation and adverse market conditions
4. Provide you with access to your savings to pay for unplanned expenses (without significant penalties for early withdrawal of your capital), and
5. Minimise the risk that you will outlive your wealth, at least for essentials.

And remember as we get older, it generally becomes harder to solve new problems and process new concepts meaning we often find we shy away from complex decision making.[4] Therefore, it's important to develop a drawdown strategy early that works for you, which accounts for this cognitive decline and that lets you easily change your investments as your needs change during retirement.

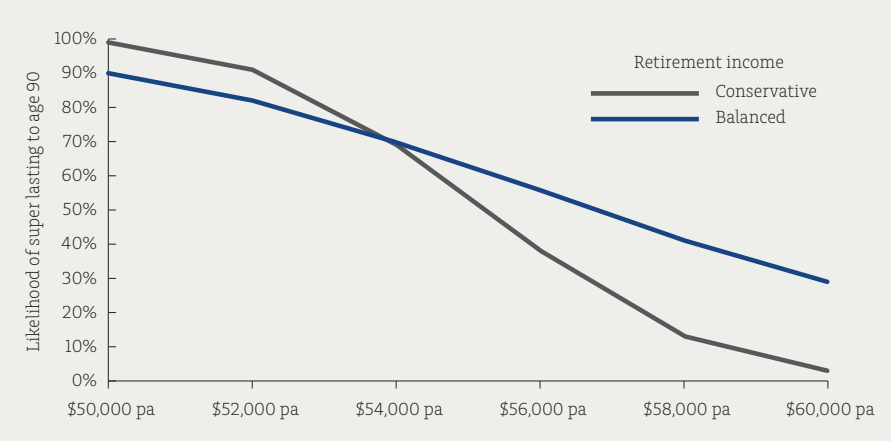
What are growth and defensive assets?

Generally, asset class can be grouped as growth or defensive.

- **Growth assets,** like shares and property securities, are mostly used to provide capital growth in a portfolio. They're higher risk than defensive assets but usually provide higher returns over the long term.
- **Defensive assets,** like cash and fixed income, are generally included in a portfolio to help stabilise returns as income is often a big part of the return from these assets. Defensive assets usually provide lower risk and lower returns over the long term.

[1] Schedule 7, Superannuation Industry (Supervision) Regulations, 1994.
[2] 'ASFA Retirement Standard', December 2016.
[3] 'Retirement Income – A framework for a complex problem', Mercer, 2015.
[4] Kulatunga. K., 'Five investment barriers to recognise if you're over 55', NAB Asset Management, 2016.

Chart 2: Impact of spending strategy and investment option on likelihood of super lasting to age 90.



Note: Includes the couple's hypothetical Age Pension entitlement. Results reflect the superannuation and Government Age Pension rules applicable from 1 July 2017.

So what could this look like?

A 65-year-old retired couple has combined superannuation assets of $500,000 and want to make their savings last 25 years. Chart 2 shows the impact of different spending strategies for two of the most common account-based pension (ABP) investment portfolio options - conservative and balanced.

If the couple adopted a spending strategy of $50,000 per year, they have at least a 90% likelihood of success for both options (that is, their superannuation assets lasting at least 25 years).

Alternatively, if they spend $56,000 annually, the likelihood of success drops to 56% with the balanced option and 38% with the conservative option. The balanced option has a higher likelihood of success, due to its larger allocation to growth assets. This increases the portfolio's expected level of both long-term returns and risk. In contrast, the conservative option is made up of more defensive assets.

What can I do now to help achieve my desired retirement lifestyle?

It's important to have a spending and investment strategy in place that is flexible enough to respond to a variety of factors and risks, including the changing patterns of your retirement income needs. Unexpected lump sum expenses, external influences on retirement savings (eg adverse market movements) and regulatory changes (eg variations to Age Pension and superannuation rules) must be considered.

It's also good to have a trusted financial adviser or family member who understands your drawdown strategy, and can help you to make decisions about your investments in the future.

Super Strategies

Make insurance more affordable

It may be more affordable to take out life and total and permanent disability (TPD) insurance in a super fund rather than outside super.

How does the strategy work?

If you buy life and TPD insurances in a super fund, you may be able to take advantage of a range of concessions not available when insuring outside super. For example, in the 2017/18 financial year:

- **If you're eligible to make salary sacrifice contributions,** you may be able to purchase insurance in a super fund with pre-tax dollars (see Case study on page four).
- **If you make personal super contributions,** you may be able to claim the contributions as a tax deduction— regardless of whether they are used in the fund to purchase investments or insurance.
- **If you earn less than $51,813[5] pa and you make personal after-tax super contributions,** you may be eligible to receive a Government co-contribution of up to $500 that could help you cover the cost of future insurance premiums.

These concessions can make it cheaper to insure through super, or help you get a level of cover that might otherwise not have been affordable.

Another benefit of insuring in super is that you can usually arrange for the premiums to be deducted from your account balance without making additional contributions to cover the cost.

This can make insurance affordable if you don't have sufficient cashflow to pay the premiums outside super.

The trade-off, however, is that you will use up some of your superannuation savings that could otherwise meet your living expenses in retirement.

5 Includes assessable income, reportable fringe benefits and reportable employer super contributions (of which at least 10% must be from eligible employment or carrying on a business).

Other key issues to consider

- Lump sum tax may be payable when a death or TPD benefit is paid from a super fund in certain circumstances.
- You (or your eligible dependants) may be able to receive a TPD (or death) benefit from super as an income stream.
- Where this is done:
  - lump sum tax won't be payable when the income stream is commenced[6], and
  - the income payments will be concessionally taxed.
- Any contributions made to a super fund including contributions made to cover the cost of insurance premiums, will count towards the contribution caps. If these caps are exceeded, significant tax penalties may apply.

Seek advice

Your financial adviser can help you determine whether holding insurance in super suits your needs and circumstances.

Case study

Justin, aged 44, is married to Alison, aged 41. Alison is taking a break from the workforce while she looks after their young children. Justin works full-time, earns a salary of $150,000 pa and they have a mortgage.

After assessing their goals and financial situation, their adviser recommends Justin take out $1.5 million in Life and TPD insurance so Alison can pay off their debts and replace his income if he dies or becomes totally and permanently disabled. The premium for this insurance is $2,200 in year one.

Their adviser also explains it will be more cost-effective if he takes out the insurance in super.

This is because if he arranges with his employer to sacrifice $2,200 of his salary into his super fund, he'll be able to pay the premiums with pre-tax dollars[7]. Conversely, if he purchases the cover outside super:

- he'll need to pay the premium of $2,200 from his after-tax salary, and
- after taking into account his marginal rate of 39%[8], the pre-tax cost would be $3,607[9].

By insuring in super he could make a pre-taxsaving of $1,407 on the first year's premium and an after-tax saving of $858, after taking into account his marginal rate of 39%.

	Insurance purchased outside super (with after-tax salary)	Insurance purchased in super (via salary sacrifice)
Premium	$2,200	$2,200
Plus tax at marginal rate of 39%[4]	$1,407	N/A
Pre-tax salary received or sacrificed	$3,607	$2,200
Pre-tax saving	N/A	$1,407
After-tax saving	N/A	$858

[6] The maximum amount that you can transfer to pension phase in your lifetime is $1.6 million. This amount is indexed periodically.
[7] Because super funds generally receive a tax deduction for death and disability premiums and pass this deduction back to the member, no tax is deducted from salary sacrifice super contributions. If an individual earns more than $250,000 in 2017/18, they'll incur an extra 15% tax on some or all of their concessional contributions.
[8] Includes Medicare levy.
[9] $3,607 less tax at 39% ($1,407) equals $2,200.