Using a bucket strategy to maximise your client's SMSF balance in the face of market volatility

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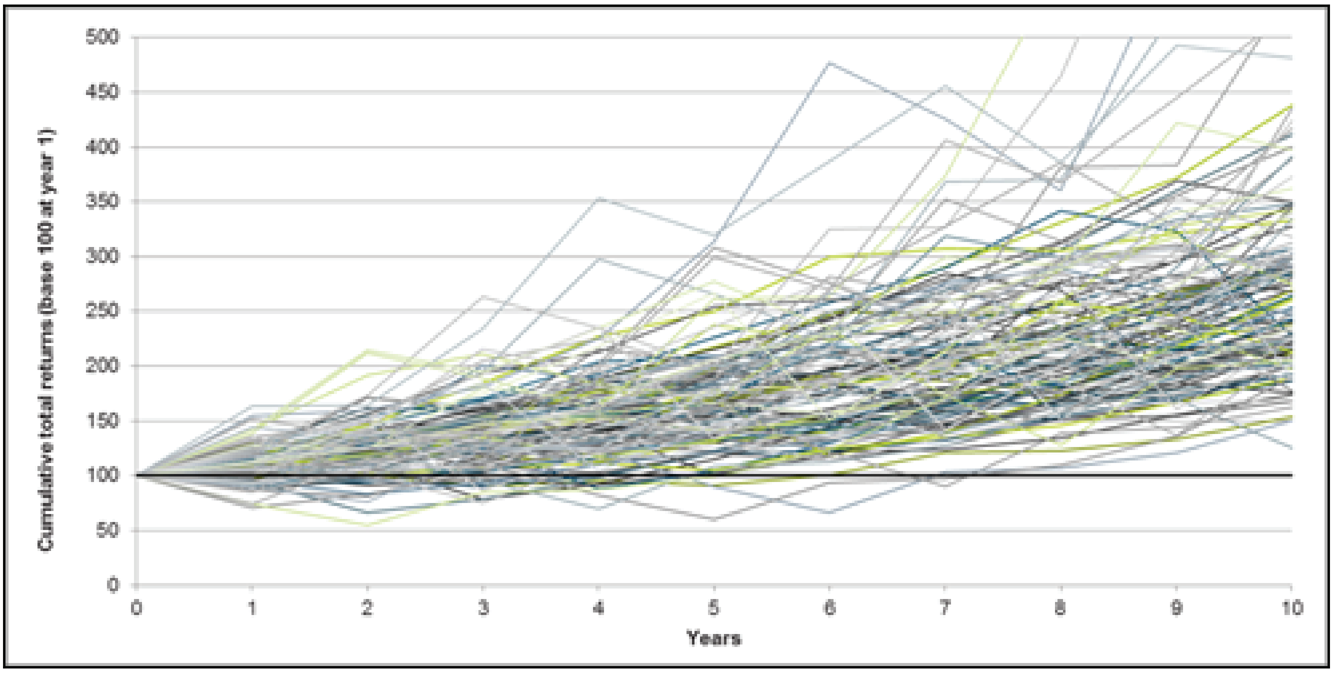
Recent months have been an important reminder that stock markets can be unpredictable. Market swings present a significant risk for SMSF retirees in pension phase who are required to draw a minimum pension each year.

ATO statistics show SMSFs in pension phase hold on average 70% of their wealth in growth assets . Investing in growth assets[1] like equities can provide the potential for greater long-term returns leading to a higher standard of living in retirement. However, most would accept that equity investing generally comes at a cost to security, including exposure to increased volatility and potentially significant falls in capital values.

Poor returns at the start of retirement when balances are their highest can have a significant negative impact on your client's savings. In addition, where income is insufficient to meet minimum pension requirements, the SMSF may be forced to sell assets with a reducing value. This means those assets may be realised at a loss to meet the pension standards, and locks in poor returns.

What if you could implement a strategy to maximise your client's returns without taking on additional risk?

The chart below shows Australian equity returns over every 10-year period since 1883. It highlights that, historically, even after the worst downturns, equity markets typically recovered their nominal value after 7 years. SMSF retirees can take advantage of this.



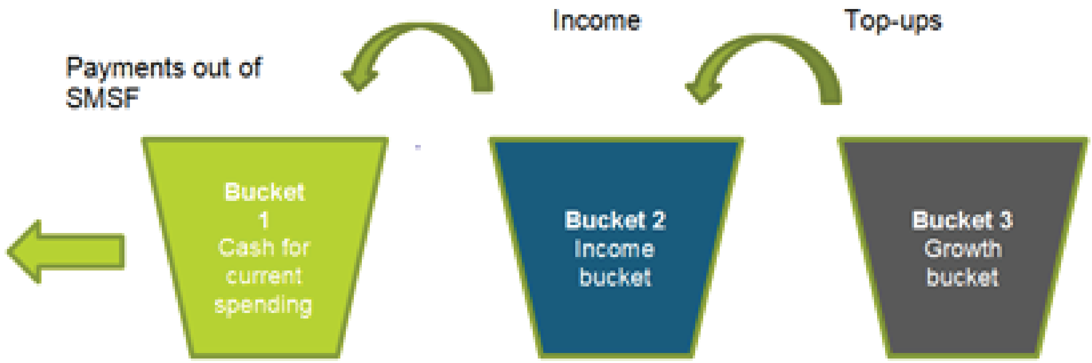
Where cashflow requirements can be secured so the SMSF does not need to draw down on growth assets during periods of volatility, Accurium's research shows this can increase SMSF balances across a wide range of scenarios.

1 ATO: Self-managed superannuation funds – a statistical overview 2013-14

The SMSF income buckets strategy

Consider a strategy where an SMSF's assets are divided into three buckets. The first bucket, typically the SMSF's bank account, is used to cover day to day cashflow requirements for the next 6 months.

The second bucket provides secure income to cover the SMSF's cashflow requirements, so that the remaining assets in the third bucket can be invested for long term growth.



The key to this strategy is securing cashflow in the income bucket for long enough that, should there be a downturn, there is sufficient time for growth assets to recover without being drawn on.

The bucket strategy is useful for aligning cash flow security and long term growth potential to maximise SMSF returns.

Case study: Adam and Jess drawing minimums from their SMSF:

Household details	Male and female, both aged 65
SMSF balance at retirement	$1.1 million
SMSF investment mix	Balanced = ATO average for SMSFs in pension phase[2]

Each household will differ around spending patterns and needs. Adam and Jess have decided over the next ten years they will be drawing the 5% pa minimum from their account-based pensions.

They would like to examine how the bucket strategy could maximise their SMSF returns. Using Accurium's retirement adequacy model, which considers 2,000 scenarios of market and inflation outcomes as well as the range of lifespans, we consider whether the income bucket strategy could improve the balance of Adam and Jess' SMSF after 10 years compared to a traditional balanced portfolio.

2 ATO: Self-managed superannuation funds – a statistical overview 2013-14. Assumed asset mix is Australian equities 45.0%, International equities 0.4%, Property 13.9%, Cash 13.6%, Fixed interest 15.7%, Other growth 11.4%.

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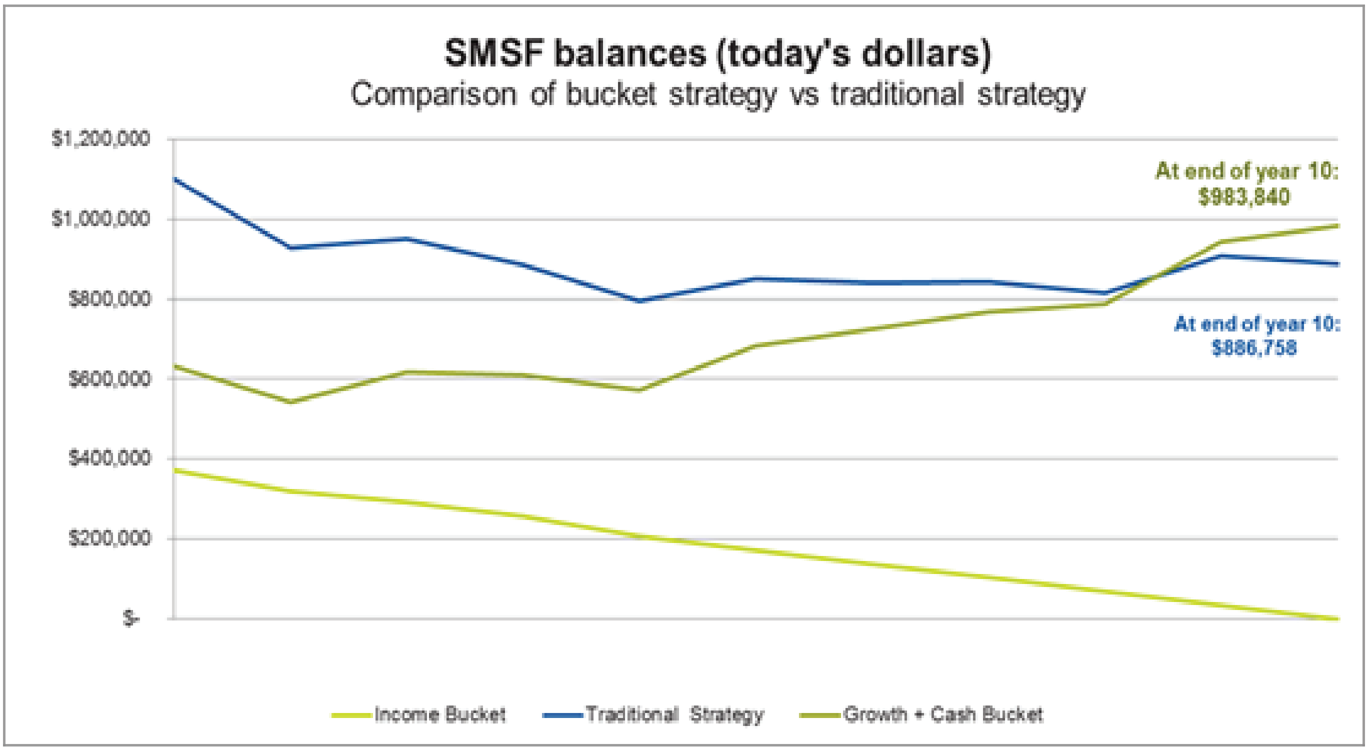
The chart below considers Adam and Jess' SMSF over the next ten years under one possible market scenario.



The blue line shows the projection of Adam and Jess' SMSF balance under the traditional strategy with their assets invested in the balanced asset mix. After drawing the minimums each year the value at the end of year 10 has reduced to $886,753 in today's dollars.

Consider instead that Adam and Jess decided to implement the bucket strategy by securing $55,000 in income for ten years. They decide to purchase a 10 year term annuity which has zero residual capital value (RCV0) to secure this income with $468,000[3] of their SMSF balance. Based on this income bucket, Adam and Jess will receive a monthly payment in their SMSF which includes a return of capital plus interest totalling $55,000 each year for ten years.

The remaining SMSF balance is invested in the growth and cash buckets. The growth bucket is invested in the same mix of growth assets as the traditional strategy, with 5% in the cash bucket.

The projected value of the income bucket over the ten year period can be seen by the light green line and the projected value of the growth bucket by the dark green line. The sum of these is the total value of the SMSF.

The RCV0 term annuity provides Adam and Jess with an annual income stream of $55,000 towards meeting their required pension payments. This allows their remaining assets time to grow, protected from being drawn on.

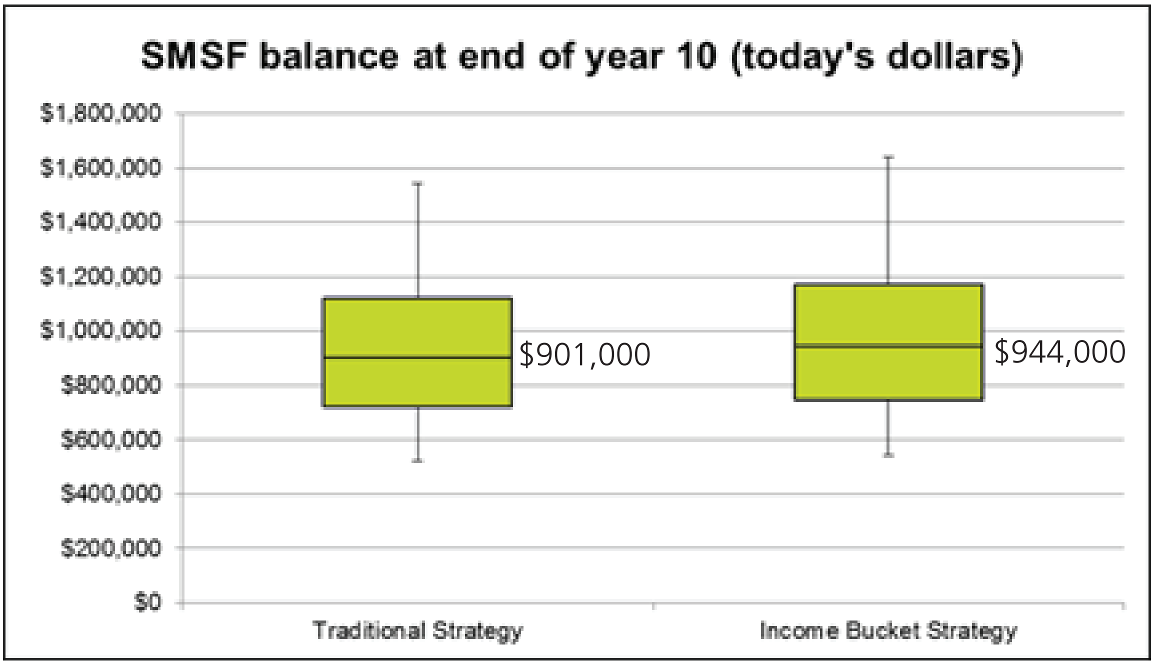
The result in this scenario is that by the end of year 10 when the secure income has been exhausted, the SMSF balance has reached $983,840, 11% higher than the balanced portfolio.

How the strategy performs across a full range of market scenarios

The previous case study illustrates just one possible market outcome. It will be useful for Adam and Jess to understand how likely this strategy is to work across a range of investment scenarios.

3 Based on market rates for a Challenger Guaranteed Annuity, RCV0 10 year term, payable monthly, payments not indexed, no adviser fees. Correct as at December 2015.

Looking at the outcomes across all 2,000 scenarios tested by Accurium's retirement adequacy model we analyse the SMSF balance at the end of the ten years for each strategy. This is shown in the following chart.



The bucket strategy outperforms the traditional balanced strategy under a range of market scenarios. The box and whisker chart showing the distribution of SMSF balances at the end of 10 years has moved up. The median balance is 5% higher when using the bucket strategy at $944,000. The strategy also generates a higher SMSF balance under both poor and good market conditions.

Each SMSF retiree will have a different risk appetite, goals and expected lifestyle in retirement. However, Accurium's modelling shows that an income bucket strategy can outperform a traditionally balanced portfolio when looking to grow your client's SMSF balance without an increase in risk.

Further details on Accurium's research into the bucket strategy can be found in its research paper, SMSF Retirement Insight – Pension strategies for retirees

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