Seeking Retirement Income Solutions in Asia Pacific

A new approach to asset decumulation is needed that takes into account investor preferences.

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KEY INSIGHTS

- Need for retirement income has intensified as elderly dependent-age population grows, while low interest rates limit return from safe-haven bonds.
- Investor preferences must be taken into account when designing retirement income solutions.
- Simplicity and scalability should be key considerations in solution design in the current state, while future technology advances can support customization.

Pension reform has become a new imperative in Asia Pacific as a large swath of the population prepares to enter retirement. Both developed and emerging markets throughout the region are playing catch up to cope with the change and strengthen their retirement systems after enjoying a prolonged period of demographic dividends in which the proportion of working age people meaningfully outnumbered dependents. Recognition that relying on traditional defined benefit (DB) schemes to provide sufficient retirement savings will not be sustainable has in turn spurred growing adoption of defined contribution (DC) pension arrangements[1].

While political will has been exerted to address asset accumulation in Asia's pension landscape, more consideration needs to be shown toward asset decumulation. Australia has made significant strides in this regard with the introduction of the Comprehensive Income Products for Retirement (CIPR), but progress has been limited elsewhere in the region. The retirement income options available to the current cohort of retirees are numerous but choosing the right solution is generally constrained by a "one size fits all" approach that fails to account for unique investor goals and behaviors. Instead, we believe retirees are better served by a suite of solutions, offering choice to better align with their preferences.

Moving to a future state that addresses where the current approach to retirement income falls short will take a consultative effort from regulators, distributors, and end-users. As a starting point, we believe retirement income strategies must account for investor preferences because they are instrumental in shaping an individual's optimal withdrawal policy. Approaches to delivering these strategies must also become more dynamic to account for the vast range of end-users who all face varying circumstances upon

[1] An expanded analysis, Bozeman and Poullaouec, "Target Date Solutions-A Complimentary Option for Asia's Changing Pension Landscape." is available upon request.

entering and during the retirement period.

Growing Need for Retirement Income in Asia Pacific

The need for retirement income is set to intensify in Asia Pacific. That is partly due to an aging demographic profile, with the region set to account for one out of every two people aged 65+ years in 2020. This trend predominates in China, South Korea and Taiwan, but it is also set to take shape in countries that currently skew toward a younger demographic profile (Figure 1). In just one generation's time, India and Indonesia's combined elderly dependent population is expected to double to about 240 million people-equivalent to the total estimated population of the United Kingdom, France, Italy, and Spain[2].

The other challenge awaiting retirees in this region is how to generate enough income in retirement to meet their needs. The current low-interest rate environment means that traditional safe-haven instruments like developed market government bonds no longer offer sufficient yield on their own. Identifying other investments can be a daunting task for most retirees, particularly for those unfamiliar with investing.

As a result, one in two people in Asia Pacific plan to continue working after retiring from their main job to bolster their retirement security[3]. Taking on new work may not appeal to everyone, however, as some may be either unfit or unwilling to forgo the time for personal pursuits. Instead, financial products should be able to play a more helpful role in providing a retirement income solution.

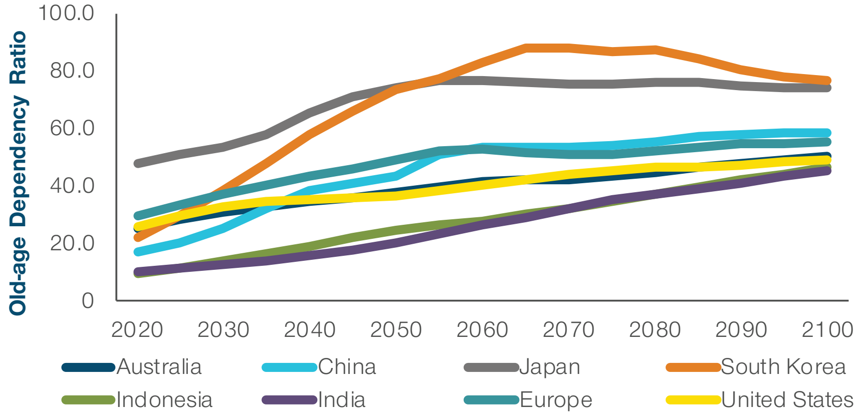
Retirement Income Challenge is Highly Complex

Leading up to retirement, investors all share a similar goal in that they want to maximize accumulated wealth by the time they leave the workforce. Once entering retirement, however, investors have different objectives and start to diverge on how they will actually use that wealth. In this asset decumulation stage, they must decide on two things: (1) an investment strategy to manage their account balance and (2) a withdrawal strategy to determine the cash flow from their retirement accounts.

Investors face a wide array of choices in making these decisions. For instance, investment strategies could include traditional equity and fixed income portfolios, insurance based products such as annuities

(Fig. 1) Asia Pacific's Greying Dilemma

Key Asian economies set for spike in dependent populations



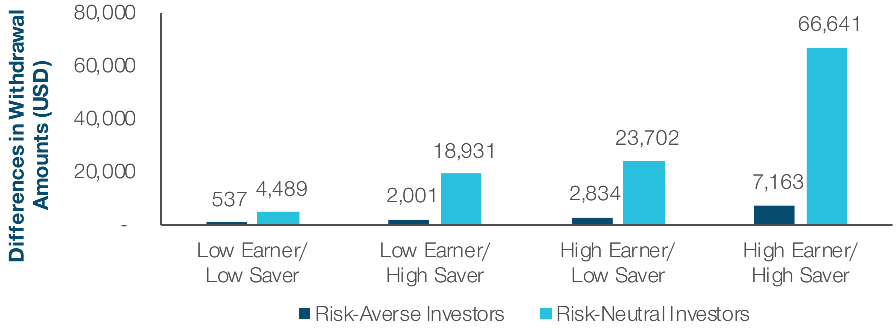
Source: United Nations, Department of Economic and Social Affairs, Population Division, World Population Prospects: The 2019 Revision, New York, 2019. The old-age dependency ratio refers to the number of persons aged 65-years or over per 100 persons aged 15 to 64 years: Old-Age Dependency Ratio = 100 x Population (65+) / Population (15-64).

[2] UN World Population Prospects: The 2019 Revision; one generation is defined as 25 years.

[3] Willis Towers Watson 2017/2018 Global Benefits Attitudes Survey, Asia Pacific.

(Fig. 2) Risk Tolerance Makes a Difference

Comparing optimal constant withdrawal amounts under different mortality assumptions



For illustrative purposes only.
Source: T. Rowe Price.

or innovative solutions such as bond ladders. When it comes to withdrawal strategies, investors could choose from a constant real dollar amount method - amount is adjusted each year by rate of inflation - or an endowment method - amount is a percentage of starting balance each year - to name just a couple options.

Where current retirement income planning falls short is that it focuses too much on financial and demographic information and does not account for individual preferences. Such preferences include attitudes toward consumption risk, liquidity, longevity risk, and legacy. An annuity may be an appealing option for a retiree seeking steady regular income, for example, but it sacrifices on liquidity and may not be suitable for someone who may need access to cash at some point.

Incorporating Investor Preferences

Individuals have different preferences and may display behavioral biases that would affect their retirement outcomes. This is compounded by the fact that they will also confront changing risks that come in many different forms over the course of their lives.

It is worth highlighting how critical investor preferences are when it comes to retirement income strategy design. To demonstrate the primacy of investor preferences, we studied the effect of income-dependent mortality assumptions on an investor's optimal withdrawal strategy. We found that while lifetime earnings are linked to life expectancy, risk tolerance has a much greater impact on how adaptive investors will be in retirement spending and how much of a difference adjusting for a longevity gap will make. In other words, a risk-averse low earner, wary of sequence-of-returns risk, is not willing to increase her withdrawal rate by as much as her risk-neutral equivalent would, even when both are given more precise knowledge of expected mortality (Figure 2)[4]. This is one example of how investor preference could materially alter investment decisions.

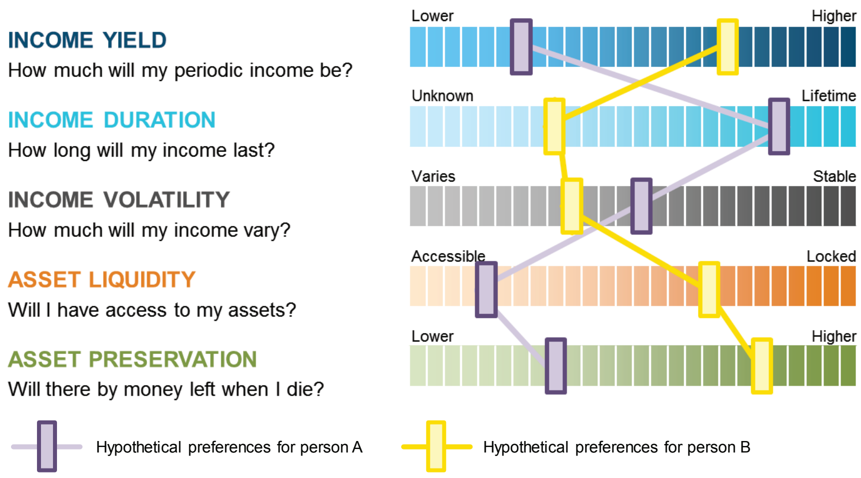
For purposes of discussion, we have identified five distinct income preferences that allow us to map out an investor's retirement profile. As outlined in Figure 3, the purple line shows the hypothetical preferences of one retiree, while the yellow line shows the hypothetical preferences of another. These unique preferences, when shown together, resemble genetic DNA, illustrating how each retiree has a unique "retirement DNA[5]."

This understanding can help providers find new ways to think about and deliver income solutions. A more

[4] An expanded analysis, Dreyer, Pogorelova, and Priestley, "Incorporating Behavioral Risk Preferences in Retirement Income Strategy Design." is available upon request.
[5] An expanded analysis, Latham "It's Time to Get Serious About Retirement Income Solutions." is available upon request.

(Fig. 3) What Are Income Preferences?

A depiction of two different retirees with two different sets of income preferences



For illustrative purposes only.
Source: T. Rowe Price.

structured, objectives-based approach could consist of four key steps:

1. Assessing retirees' income preferences
2. Evaluating the spectrum of solutions
3. Mapping revealed preferences to the solutions that best suit retiree needs, and then
4. Developing communication strategies that better drive understanding, engagement, and outcomes.

This more dynamic approach to retirement income solutions would provide options that better align with investors' unique needs. For instance, a target income-type strategy could be useful to the retiree represented by the purple line who wants to ensure his income will last a lifetime. By contrast, the end-user depicted in the yellow line is more concerned with income yield and may be better served by a potentially higher yielding multi-asset income or target risk-type strategy. This is an oversimplification, of course, but this exercise serves to highlight how a thorough understanding of investor preferences can be utilized by solutions providers.

It is also important that retirement income solutions be easy to understand and simple to communicate since the region lacks a robust financial advisor culture with the exception of Australia. Furthermore, solutions must be scalable in order to reach the vast retiree population throughout the region. While it is critical to account for investor preferences, that insight should be used to inform an array of retirement income solutions rather than build unique portfolios for each individual investor. That is a worthy goal to pursue in the future with the support of technology advances, but it would not be practical in the current state from an operational or infrastructure perspective.

Currently, pension scheme coverage is lagging in the region - China has only half its labor force participating in a mandatory pension scheme, while less than one out of five workers in India and Indonesia do so[6]. The tide is already shifting though as retirement systems continue to develop across the region, and as more workers gain pension coverage and then enter retirement, they will need readymade income solutions that can suit their needs.

[6] OECD (2018), Pensions at a Glance Asia/Pacific 2018, OECD Publishing, Paris.

WHAT WE'RE WATCHING NEXT

In our view, pension reform in Asia Pacific has made great strides but has not yet focused on the importance of the asset decumulation stage. Creating a range of retirement income solutions that incorporate investor preferences must be recognized as a new imperative by regulators, distributors, and end-users alike.

Over time, we expect technology will play a significant role in diagnosing investors' needs and evaluating their preferences. Combining this with a thorough understanding of retirement planning should enable the design of more optimal solutions at scale.

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