

Generating Reliable Retirement Income

June 2023

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Generating Reliable Retirement Income

Agenda

Risks in retirement

Investor priorities and challenges

Challenging times for defensive assets

Sustainable income

Applications of lifetime income

Q&A

Generating Reliable Retirement Income

Risks in retirement

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Risks in retirement

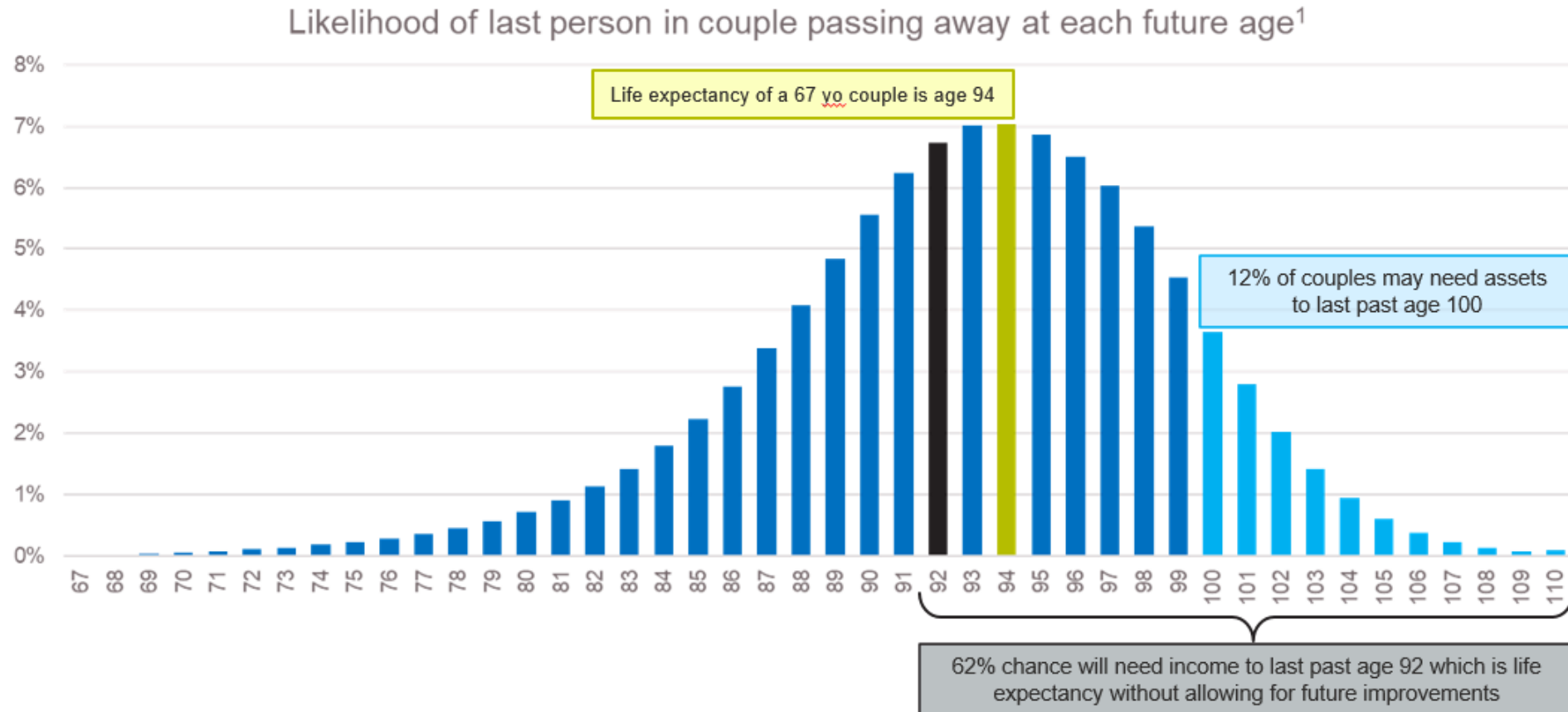
Adviser discussion

What are the issues that retirees most want your advice to address?

What are the risks that clients are most exposed to in retirement?

Risks in retirement

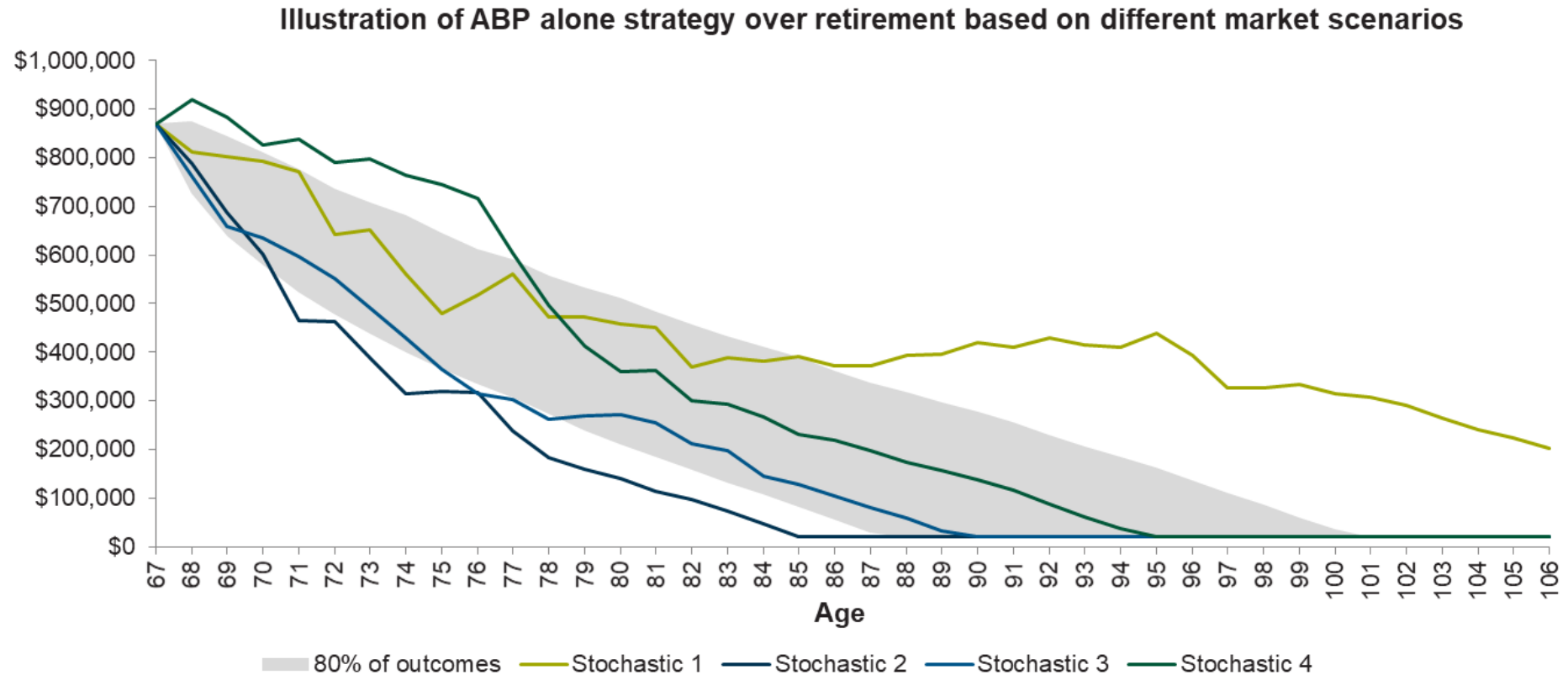
Longevity risk – retirement could be a long time



¹Australian Government Actuary ALT 2015-17, with 25 year improvement factors. Assumes a male and female exactly age 67, calculated at May 2022

Risks in retirement

Market and sequencing risk

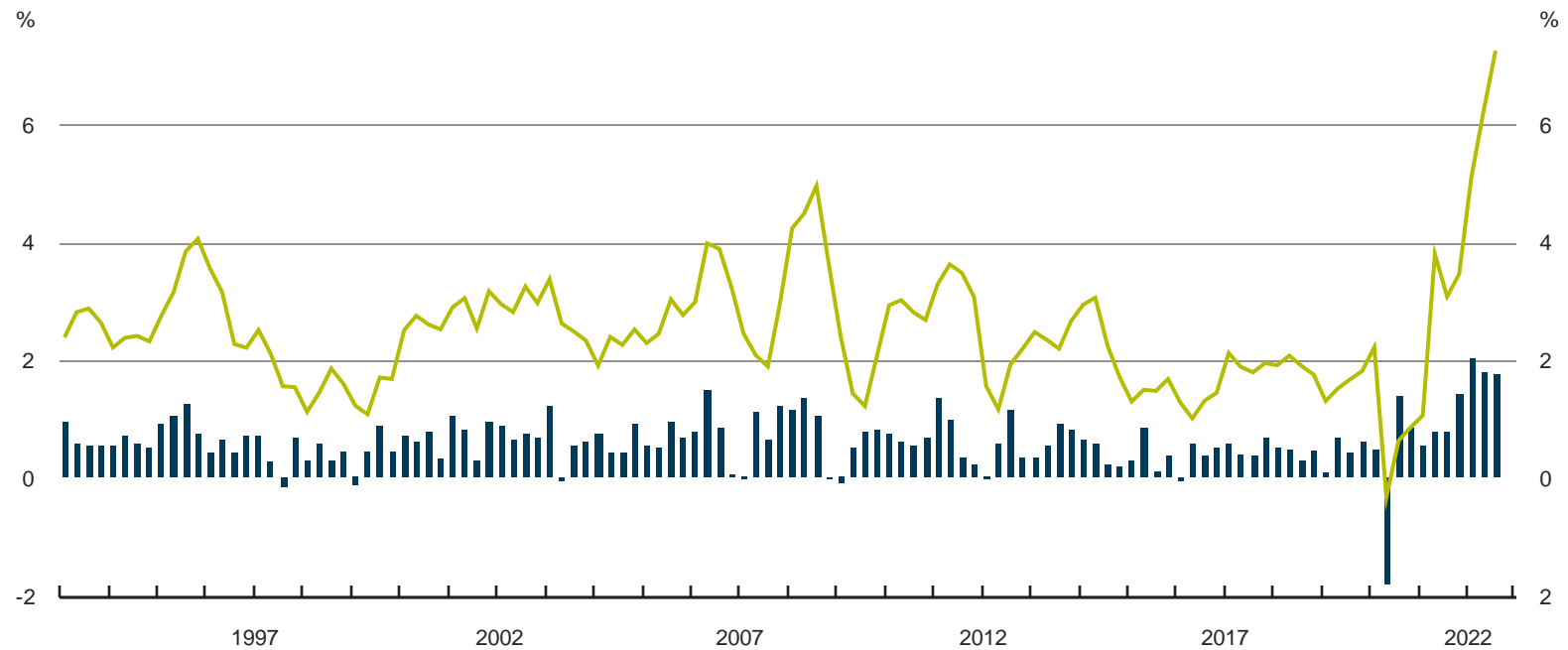


Source: Challenger Retirement Illustrator model using Social Security rates and thresholds effective 20 March 2022. 2,000 simulations of market returns and inflation provided by Moody's Analytics. \$64,771 p.a. desired income increasing annually with price inflation. Amounts shown are in today's dollars. See Challenger Retirement Illustrator for default fee assumptions and methodology guide

Risks in retirement

Inflation

Consumer Price Inflation*



Source: RBA - Measures of Consumer Price Inflation | RBA

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Investor priorities and challenges

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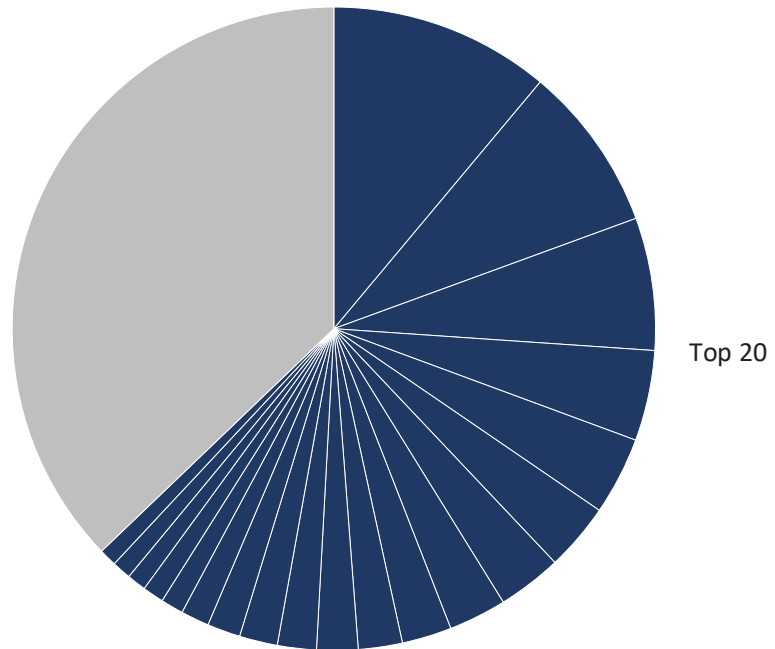


Investor Priorities and Challenges

- ❖ High demand for income producing investments
- ❖ Heightened sensitivity to capital loss
- ❖ Excessive bias towards large cap equities and index hugging managed funds
- ❖ As a result many investors have taken on unnecessary levels of risk

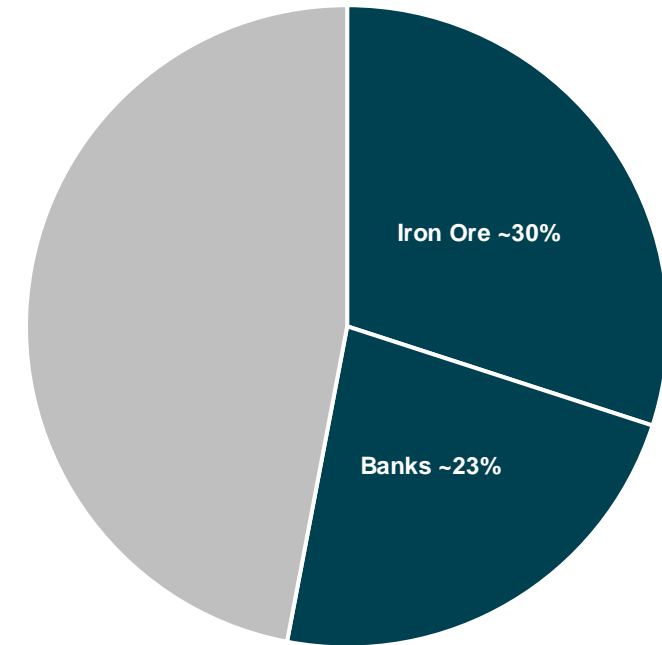
Index unaware portfolio provides diversification

The ASX200 is skewed to ultra-large companies



Source: Bloomberg as at 31 December 2022.

ASX200 dividends are skewed to macro sensitive companies



Source: Bloomberg, average contribution to ASX200 gross yield over the next year.

More diverse sources of income and growth

Generating Reliable Retirement Income

Challenging times for defensive assets

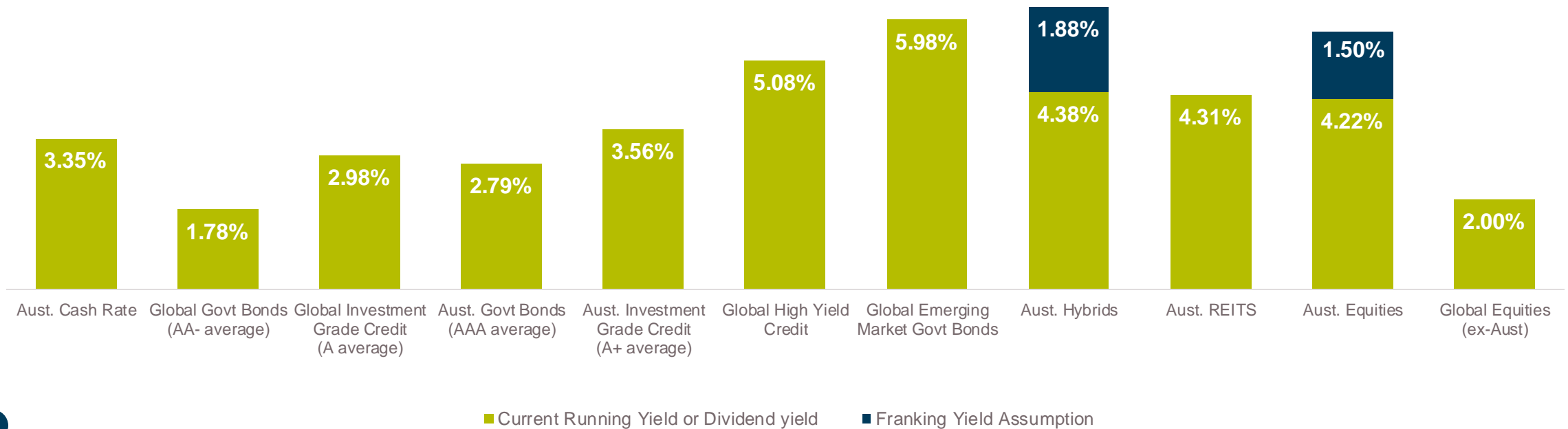
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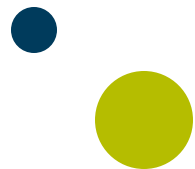
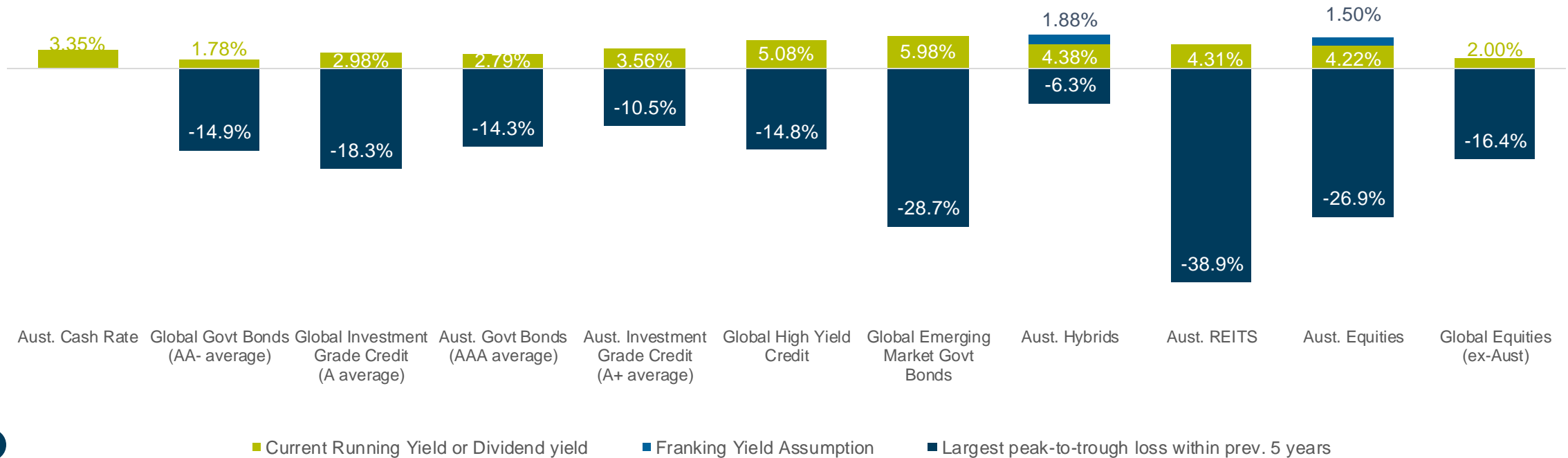
Current yields on different asset classes



Source: Representative ETF issuer holdings data (Vanguard, Blackrock, Betashares). This graphic is for illustrative purposes only and reflects current running yields of underlying assets within representative ETFs as at 1 March 2023. At different points in the market cycles this income and growth relationship will not be relevant or will change. This does not show the volatility of each underlying asset class to generate those returns.

Looking at it another way

Current yields against largest peak-to-trough drawdown in the last 5 years



Source: Representative ETF issuer holdings data (Vanguard, Blackrock, Betashares) and Lonsec iRate for drawdown analysis. This graphic is for illustrative purposes only and reflects current running yields of underlying assets within representative ETFs as at 1 March by the ET2022. At different points in the market cycles this income and growth relationship will not be relevant. Drawdown shows the largest cumulative peak-to-trough loss that the asset class, as represented F or index, has suffered in the last 5 years.

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Sustainable income

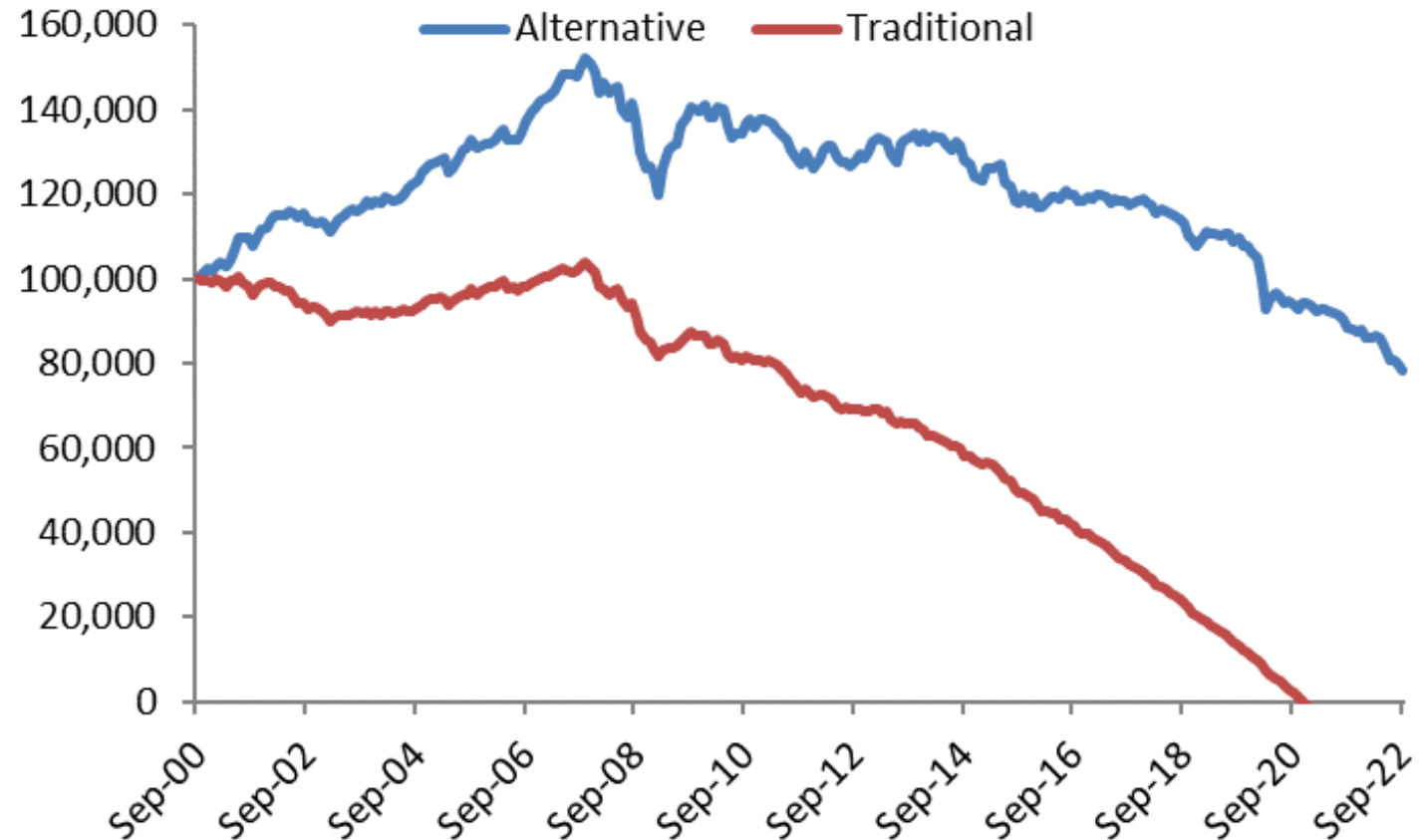
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“Sustainable Income” means capital is largely preserved

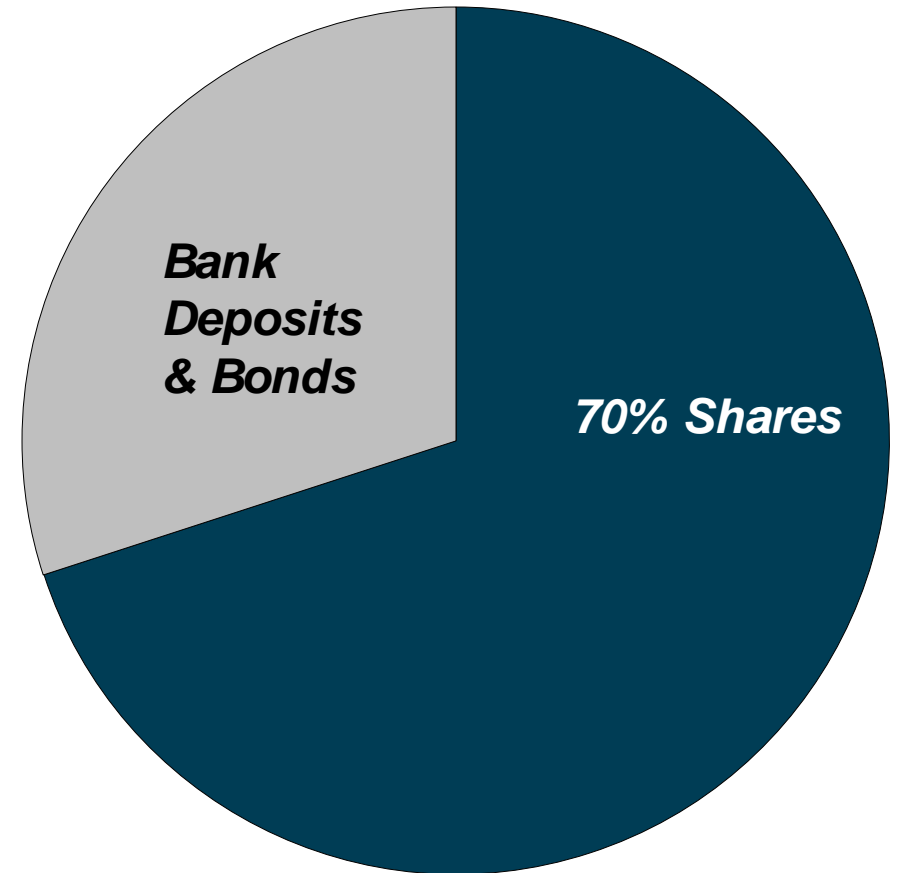
Capital
(Post 7%
Initial Income
Growing at CPI)



Return based on implementing strategy over 22 years to September 2022 and includes estimated franking credits. Traditional Asset Allocation represents 30% passive shares & 70% bank bills. Alternative Asset Allocation represents 40% hedged value shares with 30% downside protection and 60% bank bills.

Accumulators – Illustrative Asset Allocation

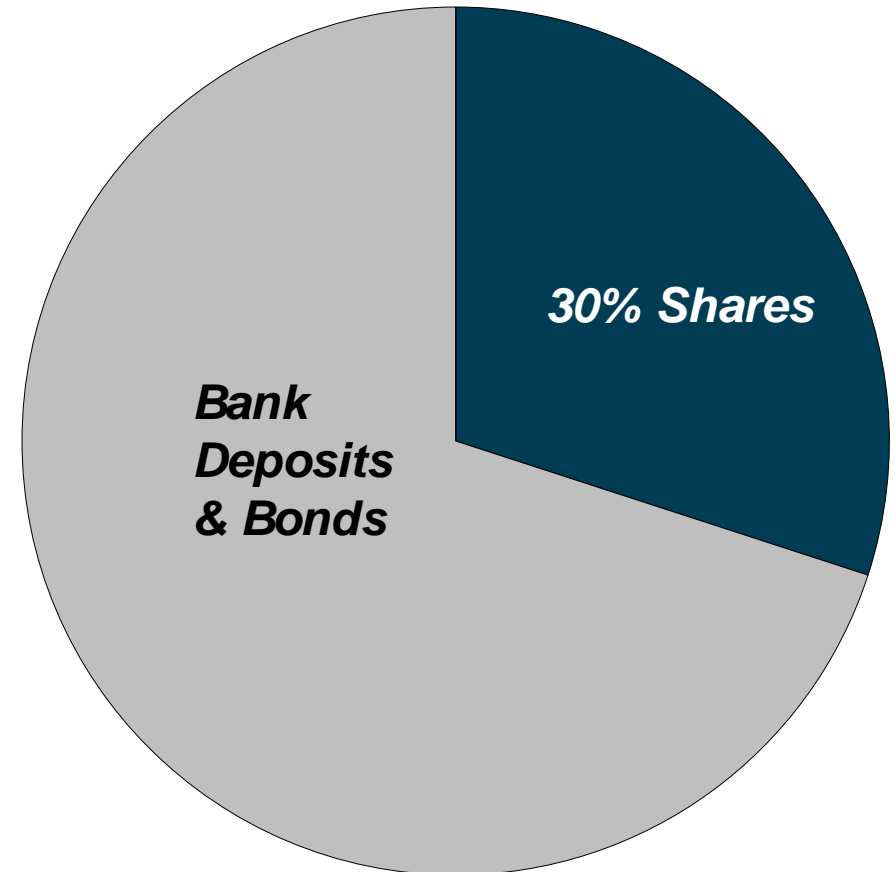
- ❖ Return = 8% pa
- ❖ Biggest drawdown= 33% (Oct-07 to Feb-09)
- ❖ Income = Not important
- ❖ Liquidity = Less important



Return & drawdown based on implementing strategy over 22 years to September 2022 and includes estimated franking credits.
Return on shares reflects AS200. Return on bank deposits & bonds reflects 30 day bank bill returns.

Post Retirement – Illustrative Asset Allocation

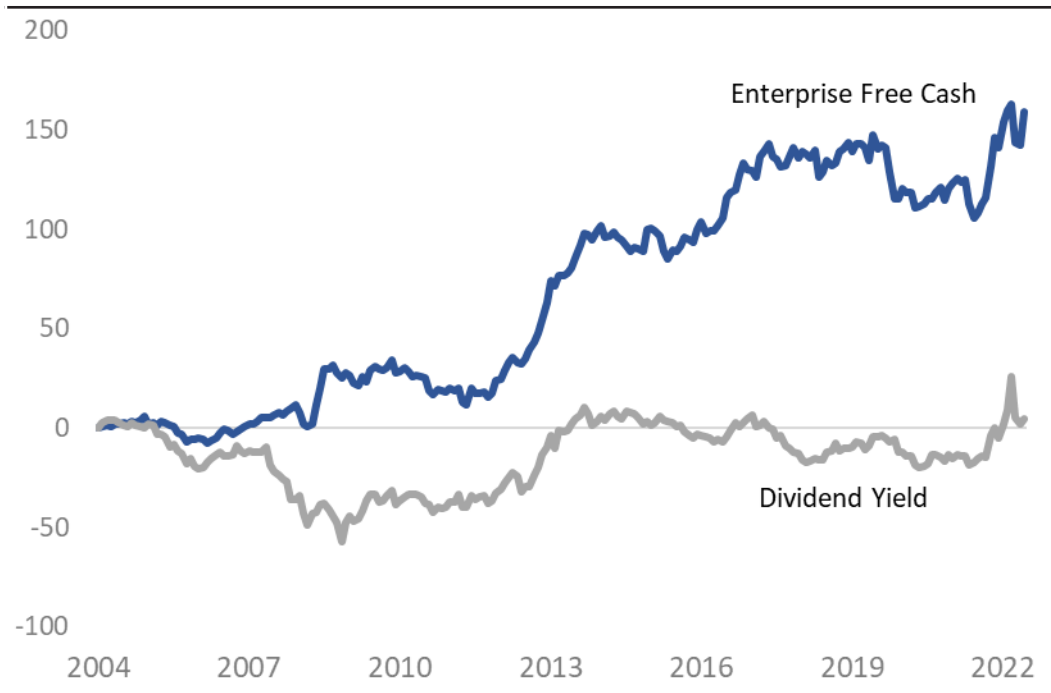
- ❖ Return = 6% pa
- ❖ Biggest drawdown= 11% (Oct-07 to Feb-09)
- ❖ Income = 7% pa growing at CPI
- ❖ Liquidity = More important
- ❖ Residual capital = 0% of initial investment



Return & drawdown based on implementing strategy over 22 years to September 2022 and includes estimated franking credits.
Return on shares reflects AS200. Return on bank deposits & bonds reflects 30 day bank bill returns.

A focus on free cash flow provides downside protection

Free cash flow a better measure than dividends



Free cash flow ultimately funds dividends

What is EFCF?

- ❑ Cash flow to pay lenders and shareholders
- ❑ Accounts for capital to sustain and grow business

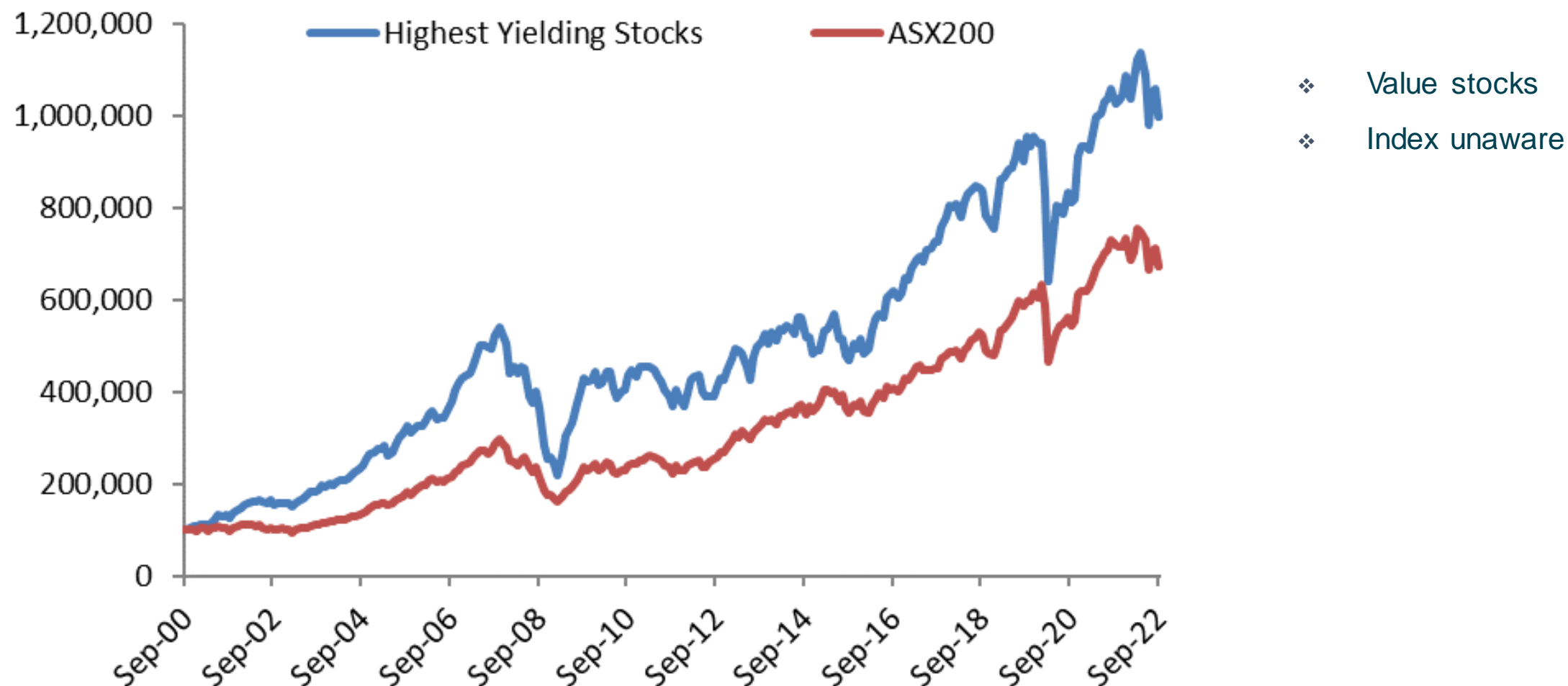
Why it outperforms?

- ❑ Cash flow looks through accounting manipulation
- ❑ Penalises companies if debt levels too high

Relevance to Income Investing

- ❑ Dividends sustainable if funded from cash flow
- ❑ Dividends sustainable if debt levels manageable

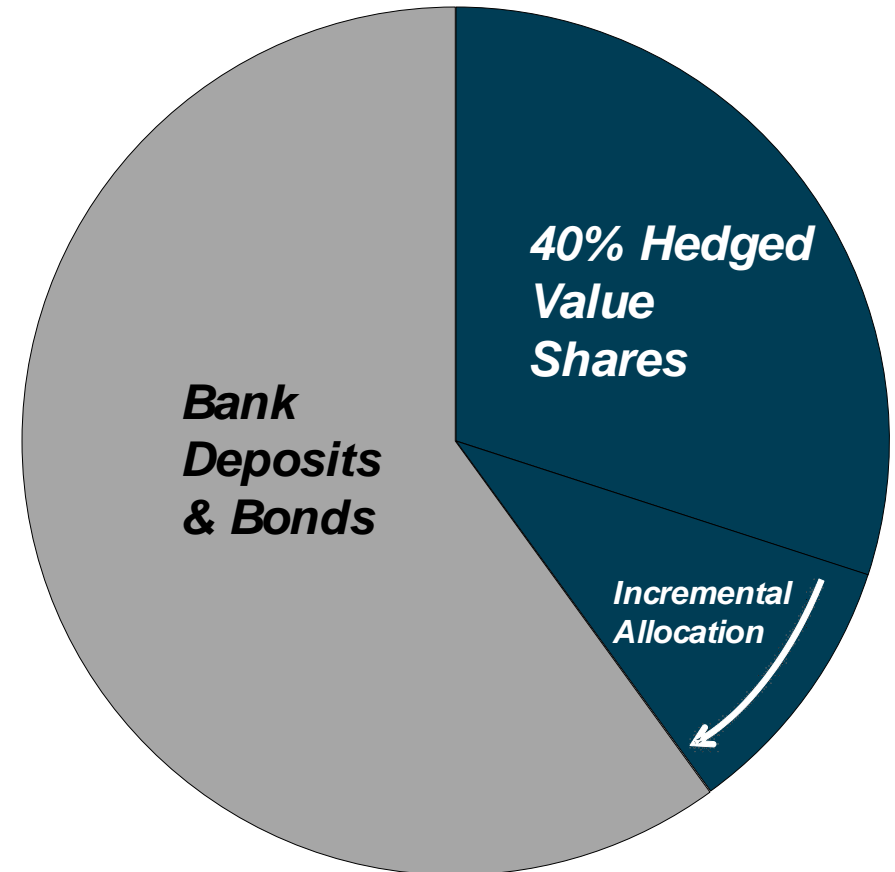
High yield stocks vs. the Market – Value of \$100,000



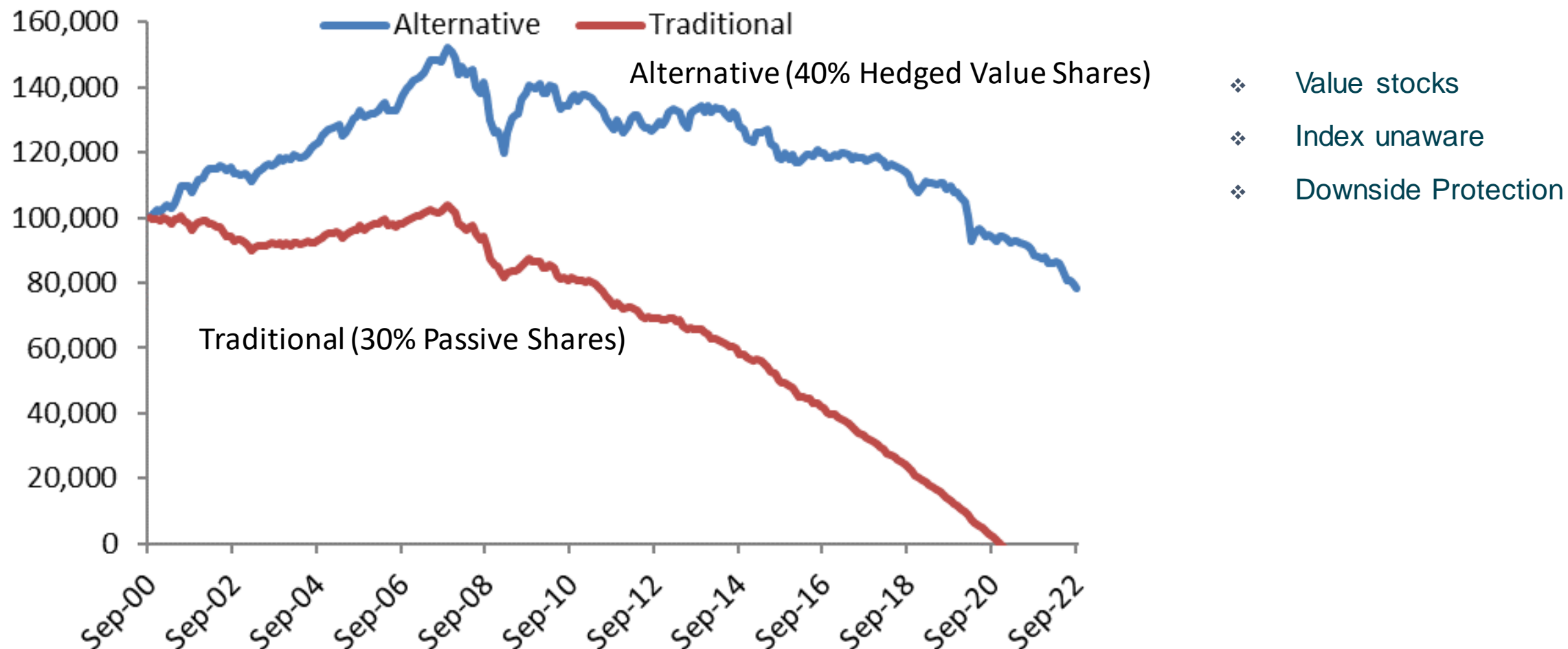
Return based on implementing strategy over 22 years to September 2022 and includes estimated franking credits
Source: Bloomberg, Merlon

Post Retirement – Illustrative Asset Allocation

- ❖ Return = 7% pa
- ❖ Biggest drawdown= 14% (Oct-07 to Feb-09)
- ❖ Income = 7% pa growing at CPI
- ❖ Liquidity = More important
- ❖ Residual capital = 78% of initial investment



Capital Preservation – 7% Initial Income Growing at CPI



Return based on implementing strategy over 22 years to September 2022 and includes estimated franking credits. Traditional Asset Allocation represents 30% passive shares & 70% bank bills. Alternative Asset Allocation represents 40% hedged value shares with 30% downside protection and 60% bank bills.

Generating Reliable Retirement Income

The Merlon approach

Andrew Fraser

Principal and Portfolio Manager
Merlon Capital Partners



How the Merlon Approach is Different

Sustainable Income

Paid monthly and majority franked

with capital preservation

Fundamental Research

*Focused on
sustainable cash flow*

Portfolio Diversification

Benchmark unaware

Downside Protection

*Through research &
Downside Protection overlay*

Deeply considered investment philosophy

We believe people are motivated by short-term outcomes, over-emphasise recent information and are uncomfortable having unpopular views

Long-Term Perspective

- ❖ We only pay for what is sustainable
- ❖ We look through fads and fashions
- ❖ We aim to understand the risk of losing long-term capital

Independent Thinking

- ❖ We are always sceptical
- ❖ We are wary of popular opinion
- ❖ We do all our own research

A Culture of Ownership

- ❖ We own our business
- ❖ We co-invest in our funds
- ❖ We actively engage with companies

Implementing our investment philosophy

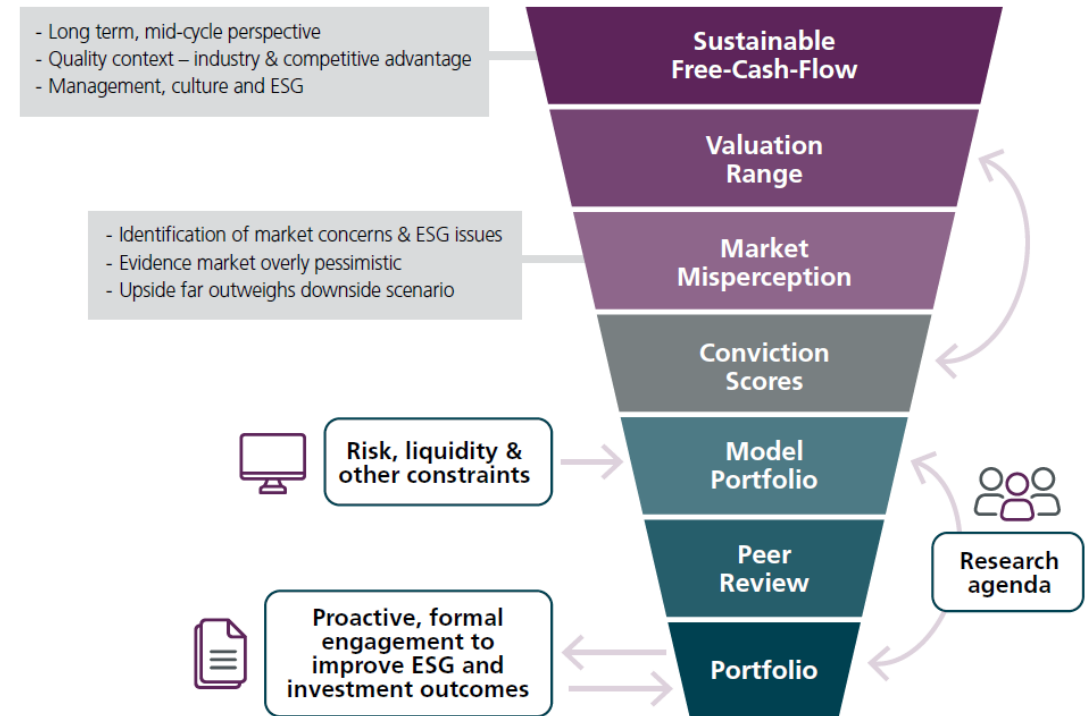
Value: Stocks trading below fair value will outperform through time

- ❖ We measure value by sustainable free cash flow yield
- ❖ We value franking credits similarly to cash
- ❖ We take a long term view

Markets are mostly efficient: Cheap stocks are cheap for a reason

- ❖ We focus on understanding why cheap stocks are cheap
- ❖ To be a good investment, market concerns need to be priced in
- ❖ We incorporate these aspects with a “conviction score”

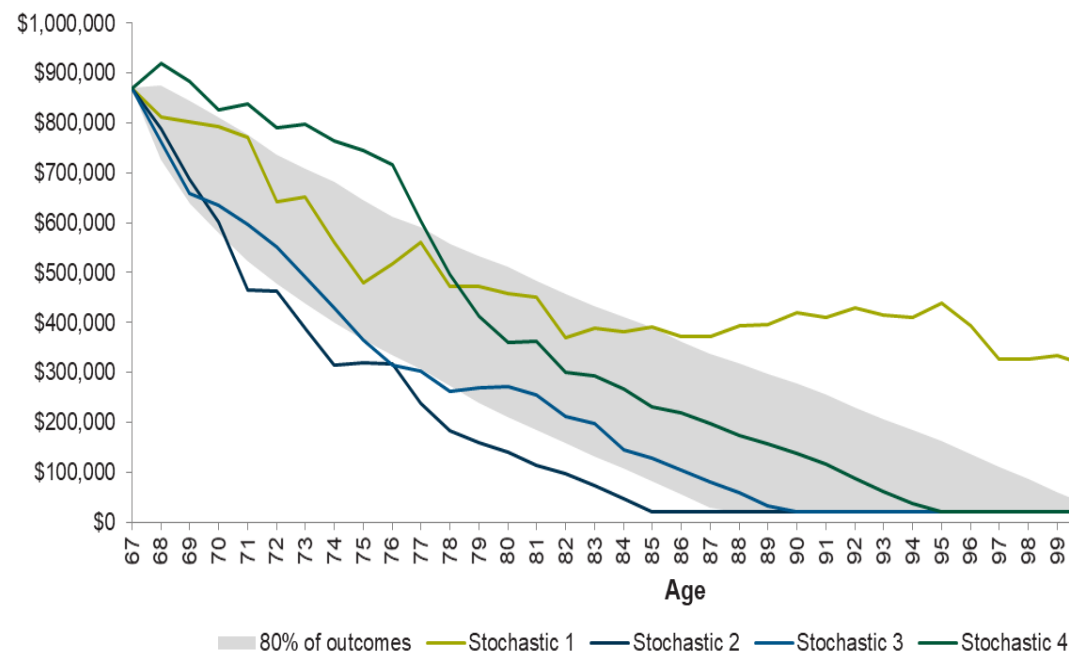
PROCESS DRIVEN BY DEEP FUNDAMENTAL RESEARCH



Risks in Retirement and the need for Downside Protection

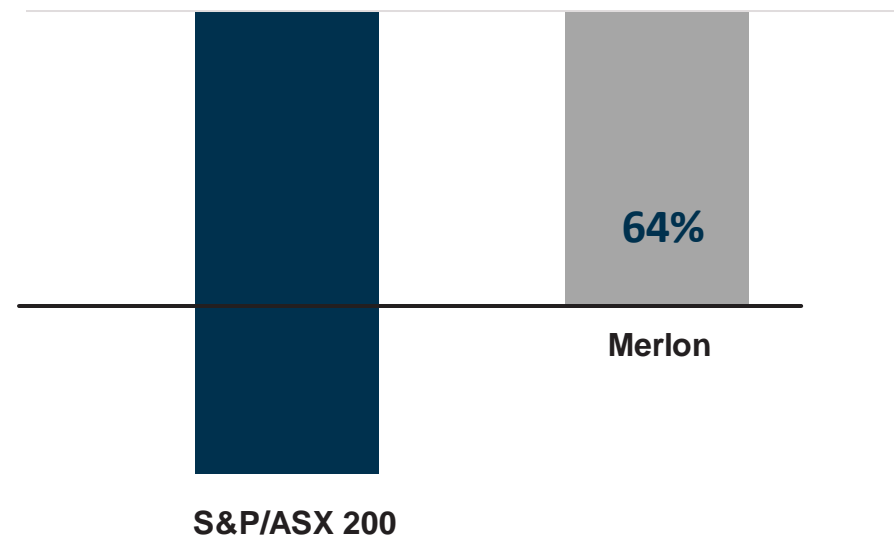
Sequencing and Market risk considerably impact savings longevity

Illustration of ABP^ strategy over retirement based on different market scenarios



Source: Challenger Retirement Illustrator model using Social Security rates and thresholds effective 20 March 2022. 2,000 simulations of market returns and inflation provided by Moody's Analytics. \$64,771 p.a. desired income increasing annually with price inflation. Amounts shown are in today's dollars. See Challenger Retirement Illustrator for default fee assumptions and methodology guide. Challenger Presentation "Retirement Incomes" Nov 2022. ^Account Based Pension

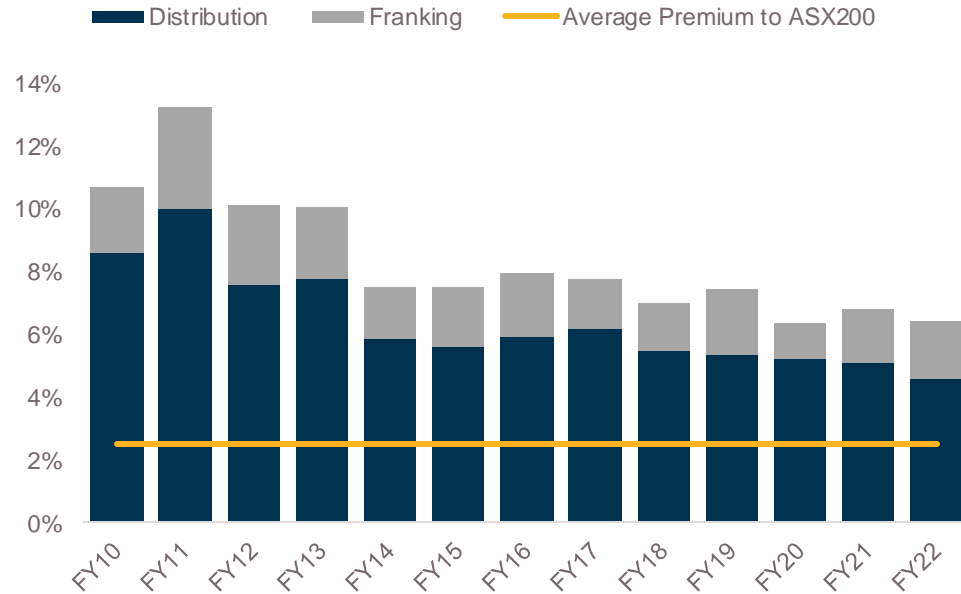
Performance in down markets



Source: Merlon/Fidante. Average relative return compared to ASX200 where ASX200 monthly return is negative since July 2010 using gross returns including franking credits. Data to 30 April 2023. **Past performance is not a reliable indicator of future performance.**

Sustainable income, paid monthly and majority franked

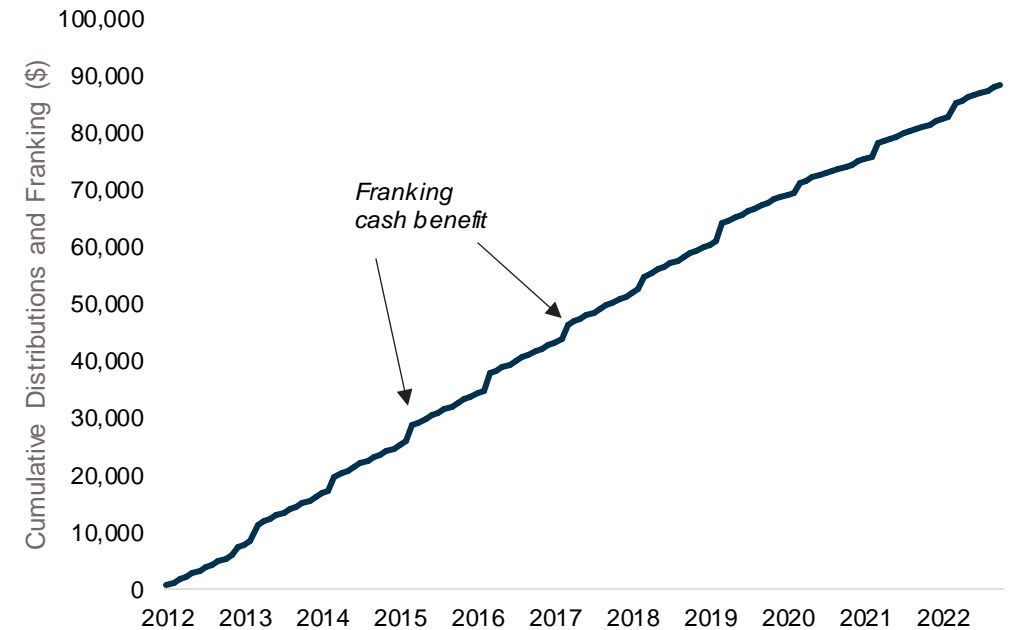
Historic distribution yield



Source: Merlon, Fidante
Past performance is not a reliable indicator of future performance.

Average yield premium of 2.5% p.a.

Cumulative income on \$100,000 invested in July 2012



Source: Merlon, Fidante at 30 April 2023. Assumes no reinvestment. Franking is accrued monthly and assumed to be paid to investor in Sept after the financial year end. Cash distributions beyond date of this presentations are forecast guidance.

7.3% p.a. gross income over 10 years

Generating Reliable Retirement Income

Applications of lifetime income

Andrew Lowe

Head of Technical Services
Challenger

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Applications of lifetime income

Introducing Emiko and Eric



Emiko and Eric

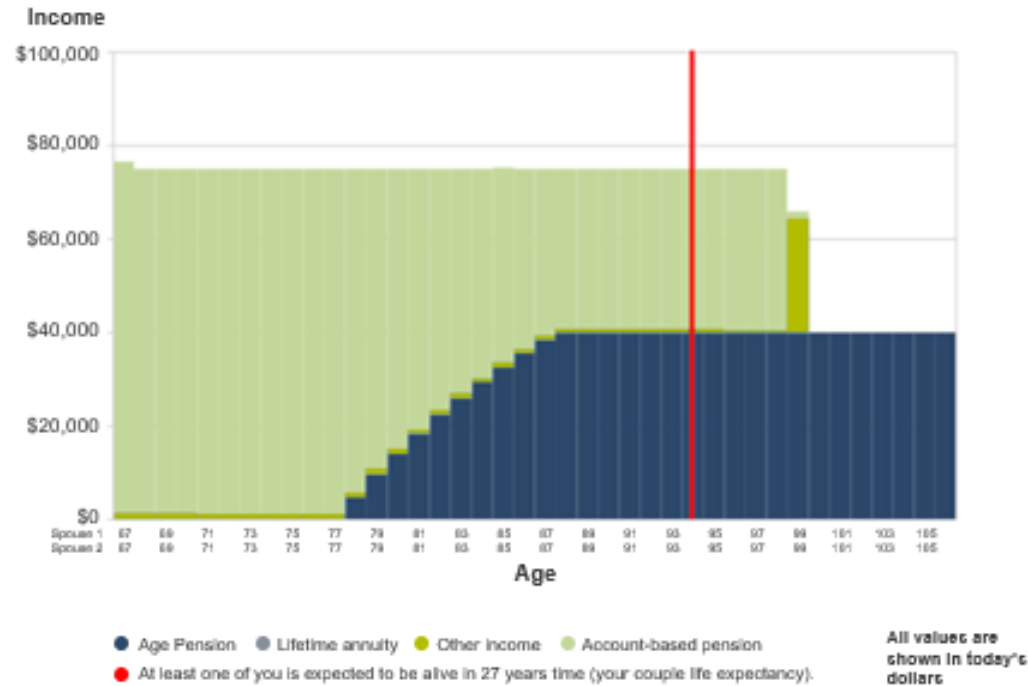
Adviser discussion

How sustainable is Emiko and Eric's drawdown strategy?

What strategies could we suggest to improve retirement outcomes?

Emiko and Eric

ABP-only



Chance of \$50,000 'needs' income being met

Account-based pension only



78%

Chance of \$75,000 'needs' and 'wants' income being met

Account-based pension only



75%

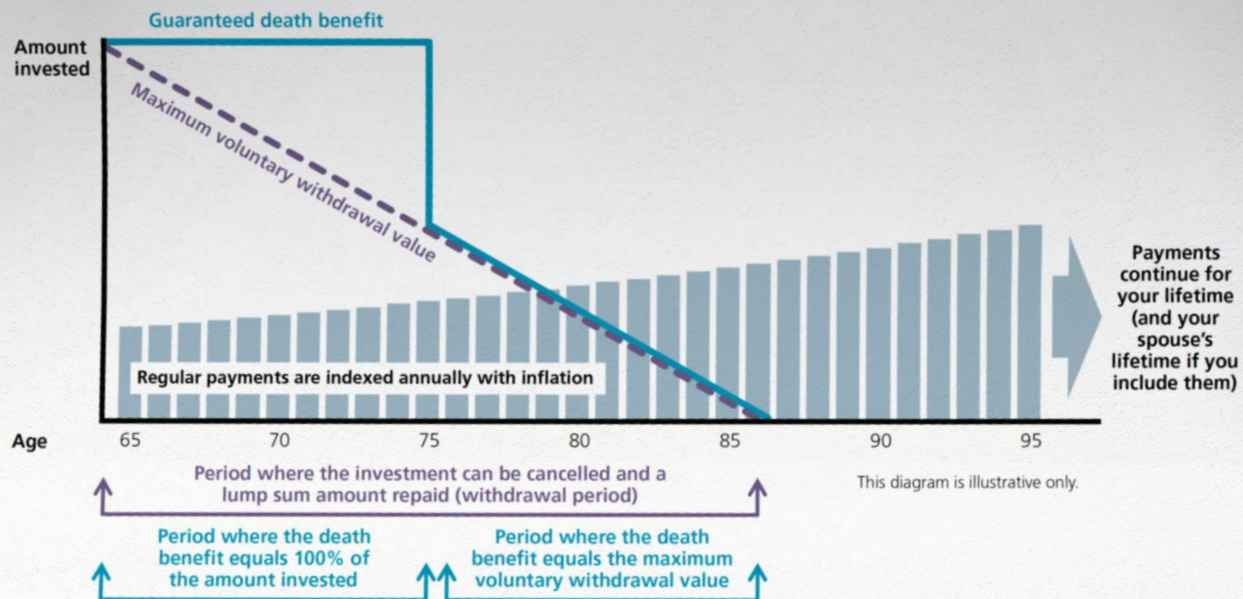
Source: Challenger Retirement Illustrator (04/10/2022) using Social Security rates and thresholds effective 20 September 2022. 67 year old male/female client couple. \$750,000 each in account-based pension. Assumes returns of 3.0% p.a. for defensive assets and 6.0% p.a. for growth assets before fees. \$50,000 cash/TDs earning 3% p.a. interest. Non-financial assets of \$20,000. \$75,000 p.a. desired income including \$50,000 p.a. essential income. Amounts shown are in today's dollars. CPI of 2.5% p.a. See Challenger Retirement Illustrator for all assumptions. Reference number: RIC221004000264.

CPI-linked lifetime income

**Guaranteed payments for life:
Irrespective of market performance
or how long a client lives**

Flexible Income (immediate payments)

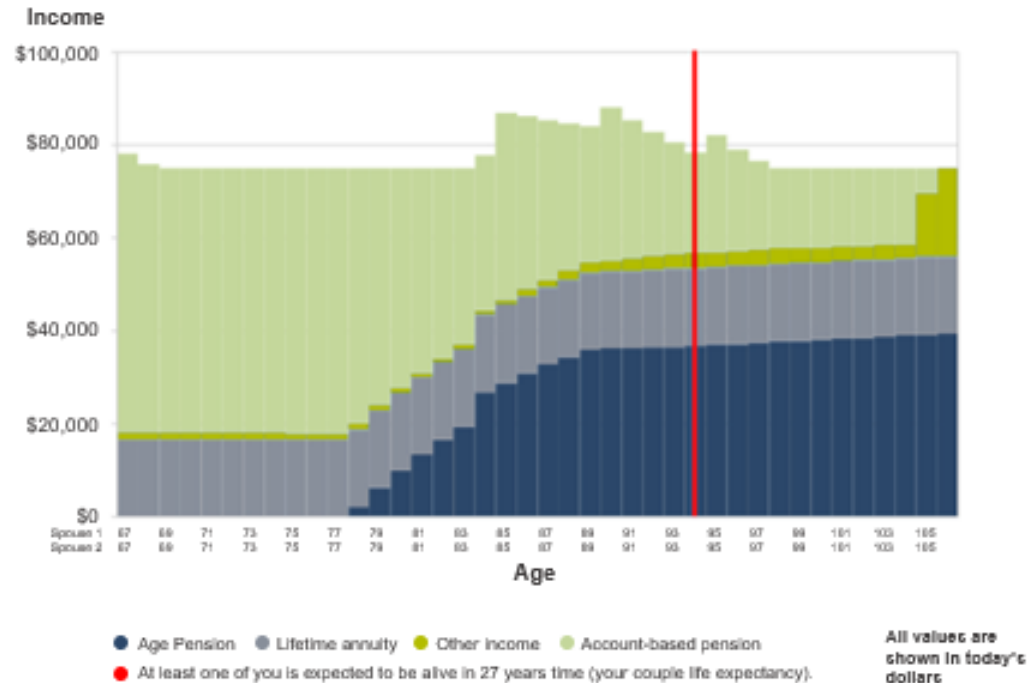
An annuity that starts paying you lifelong income immediately. It has a withdrawal value and a guaranteed death benefit for a period based on your life expectancy.



65-year-old female. Challenger Liquid Lifetime annuity, monthly payments, CPI indexation.

Emiko and Eric

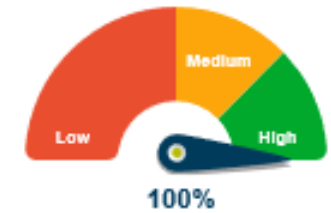
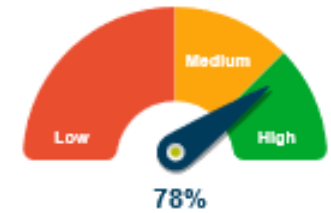
20% allocation to CPI-linked lifetime



Chance of \$50,000 'needs' income being met

Account-based pension only

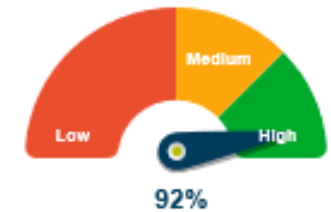
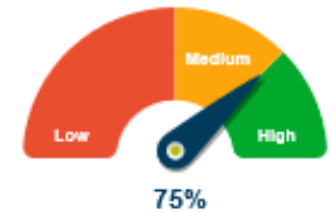
Comprehensive lifetime portfolio



Chance of \$75,000 'needs' and 'wants' income being met

Account-based pension only

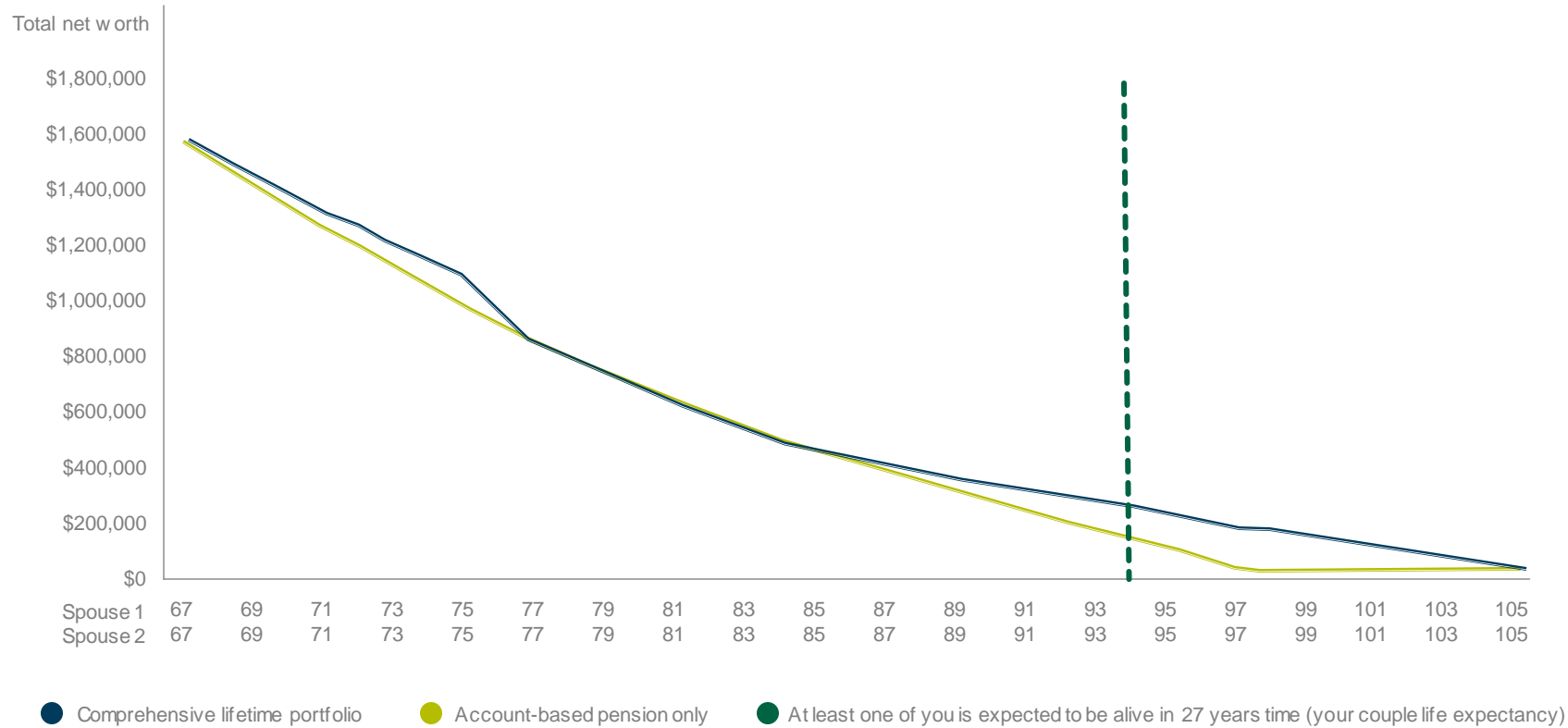
Comprehensive lifetime portfolio



Source: Challenger Retirement Illustrator (04/10/2022) using Social Security rates and thresholds effective 20 September 2022. 67 year old male/female client couple. \$750,000 each in account-based pension. Assumes returns of 3.0% p.a. for defensive assets and 6.0% p.a. for growth assets before fees. \$50,000 cash/TDs earning 3% p.a. interest. Non-financial assets of \$20,000. \$75,000 p.a. desired income including \$50,000 p.a. essential income. Amounts shown are in today's dollars. CPI of 2.5% p.a. See Challenger Retirement Illustrator for all assumptions. Reference number: RIC221004000264.

Emiko and Eric

20% allocation to CPI-linked lifetime



Estate (bequest) value comparison

The chart on the left compares the median estate (bequest) value based on the 2000 market scenarios.

Source: Challenger Retirement Illustrator (04/10/2022) using Social Security rates and thresholds effective 20 September 2022. 67 year old male/female client couple. \$750,000 each in account-based pension. Assumes returns of 3.0% p.a. for defensive assets and 6.0% p.a. for growth assets before fees. \$50,000 cash/TDs earning 3% p.a. interest. Non-financial assets of \$20,000. \$75,000 p.a. desired income including \$50,000 p.a. essential income. Amounts shown are in today's dollars. CPI of 2.5% p.a. See Challenger Retirement Illustrator for all assumptions. Reference number: RIC221004000264.

Emiko and Eric

20% allocation to CPI-linked lifetime



20%
allocation to
CPI-linked
lifetime
income



Lifetime income for as long you live in addition to any Age Pension you may receive. The lifetime income amount **in the first year is \$16,585.**



A 100% chance of meeting income 'needs' (an **increase of 22%** over the non-lifetime portfolio).



A 92% chance of meeting desired 'needs and wants' (an **increase of 17%** over the non-lifetime portfolio).



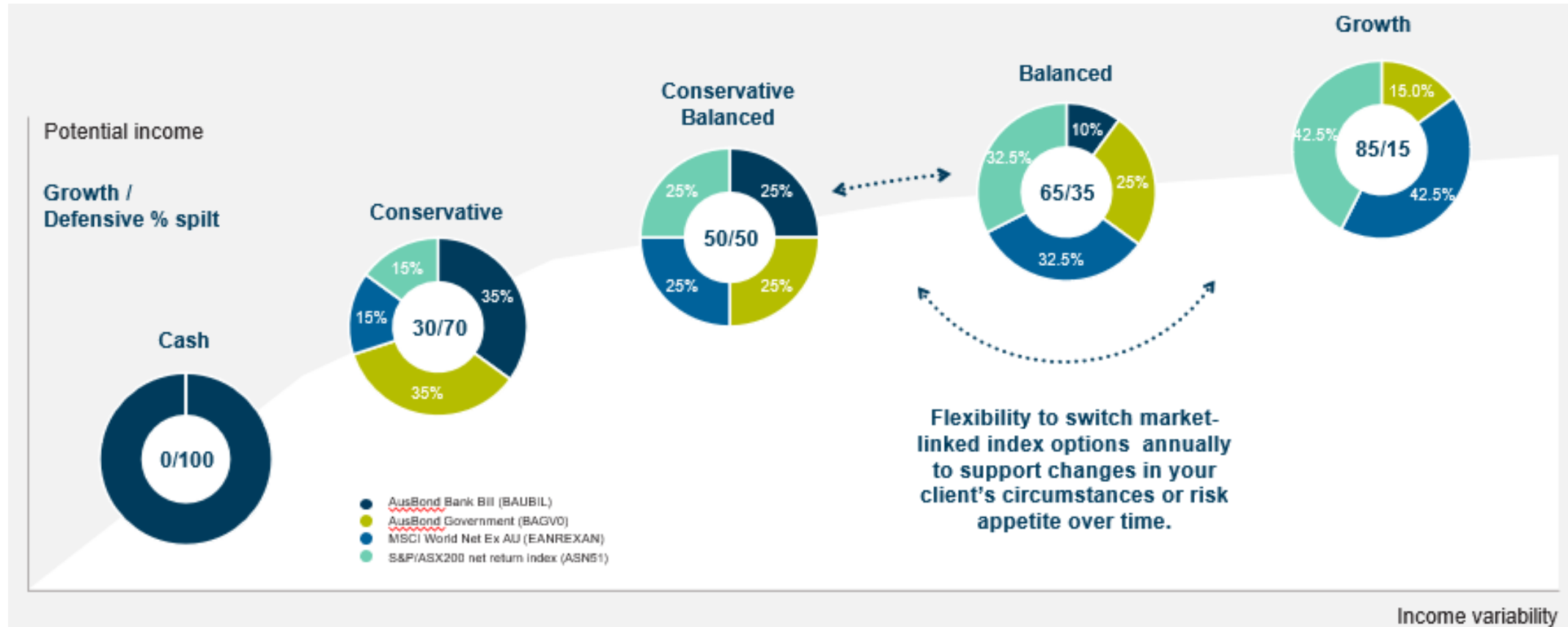
Total retirement income paid over 27 years **increased by \$93,079** (in today's dollars).



The Estate value at the end of 27 years **increased by \$109,845** (in today's dollars).

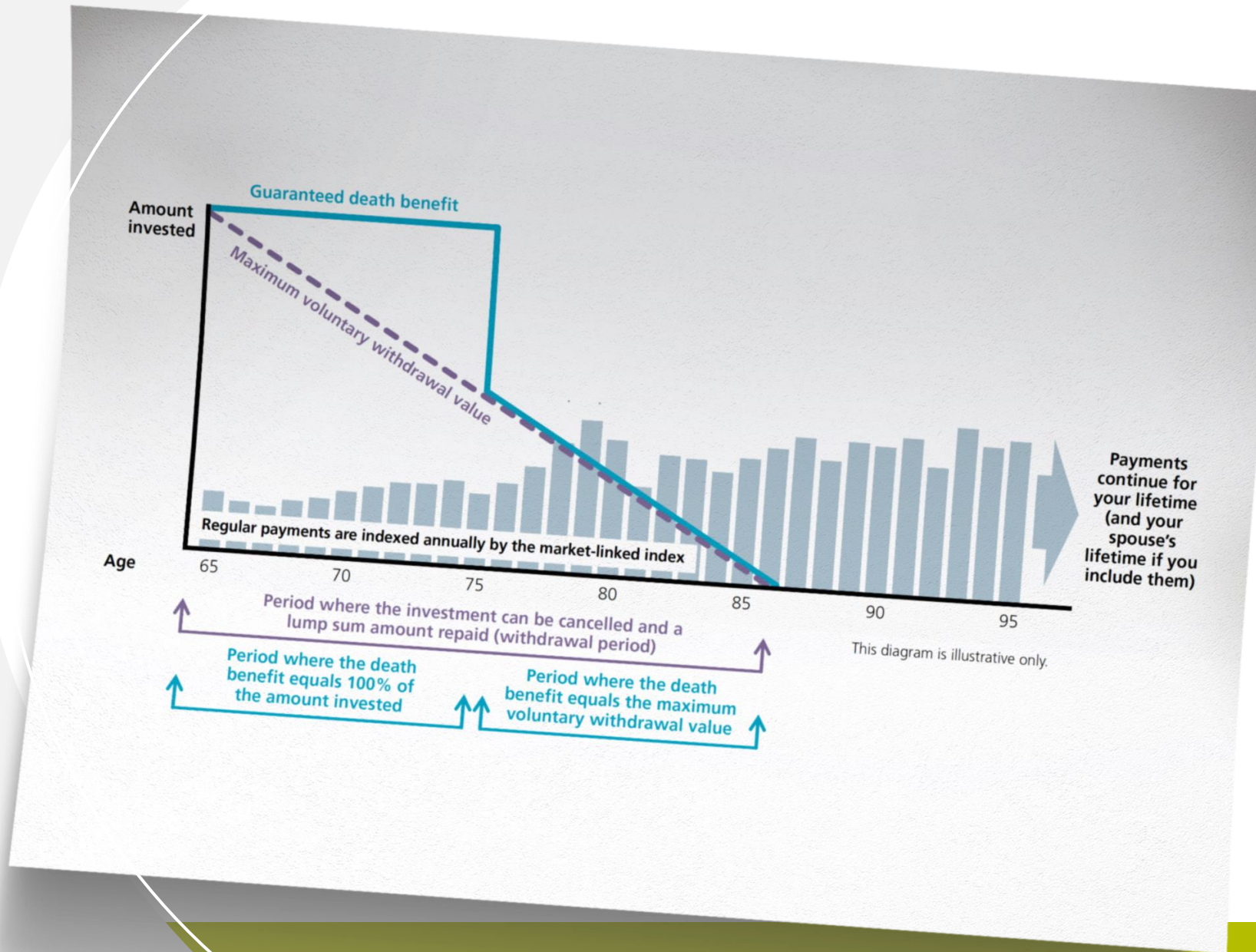
Emiko and Eric

But what about market-linked lifetime income?



Market-linked lifetime income

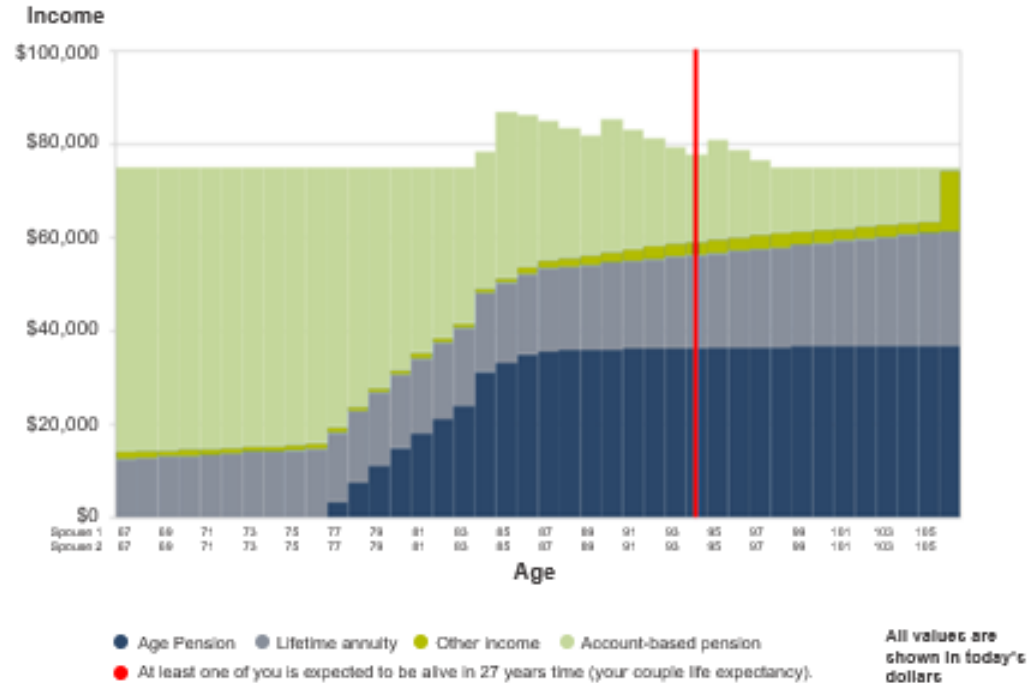
Regular payments guaranteed for life: Irrespective of how long a client lives



Based on a 65-year-old female client. Diagram is illustrative only.

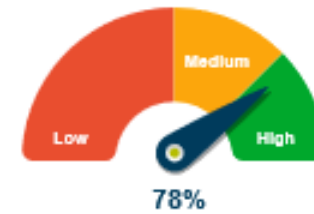
Emiko and Eric

20% allocation to market-linked (conservative-balanced) lifetime

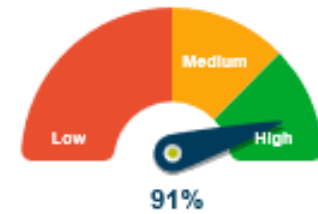


Chance of \$50,000 'needs' income being met

Account-based pension only

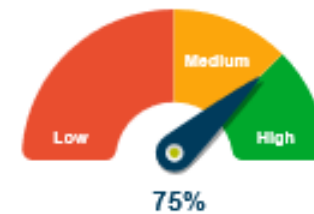


Comprehensive lifetime portfolio

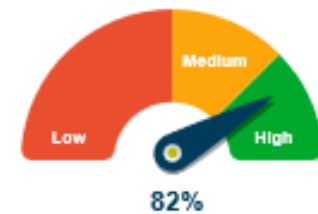


Chance of \$75,000 'needs' and 'wants' income being met

Account-based pension only



Comprehensive lifetime portfolio



Generating Reliable Retirement Income

Questions and answers

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