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Retirement Income Covenant – Exposure Draft Legislation

As a global leader in implementing 'next generation' retirement solutions, Dimensional Fund Advisors welcomes the opportunity to comment on the Australian Treasury's draft legislation for introducing a retirement income covenant for superannuation trustees.

In describing an effective retirement income strategy, we believe the draft bill rightly focuses on an outcomes-based approach – maximising expected retirement income, managing risks and maintaining flexible access to savings - rather than being overly prescriptive.

In terms of outcomes, Nobel laureate Robert Merton, a resident scientist at Dimensional, has defined a good retirement goal as an inflation-protected income for life that allows individuals to sustain the standard of living that they enjoyed in the latter part of their working lives.

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With that in mind, we see the main challenge of retirement planning as managing the uncertainty of future income. A good solution should take account of the investment risks that affect retirement income, such as rising inflation and changes in interest rates.

We also agree with the draft bill that trustees' role in helping members with a retirement income strategy can start in the accumulation phase. Indeed, this is what we have done with pension funds in other markets, including the US – creating vehicles, spanning both the accumulation and decumulation phases, that provide members with greater certainty about how much retirement income they can afford long *before* they retire.

Generally, we define successful retirement savings and investment approaches as those that allow members to move from working life to retired life without large shocks to their consumption. Such approaches should lead to steady retirement income and provide the flexibility people require to meet the costs of unexpected life events.

We believe that encouraging members to take appropriate actions in accumulation phase is the primary way to meet the first objective of the retirement income strategy – maximising retirement income by ensuring members are ready for retirement and are less likely to have to rely mainly on the age pension. By managing an accumulation-phase solution with the goal of integrating seamlessly to a decumulation-phase solution, members are more likely to be adequately positioned for retirement.

By providing people with retirement income-based reporting before they retire, members can more
easily assess their retirement readiness at a time in their lives when their actions, such as by saving
more, have the potential to make a meaningful change to their retirement outcomes. Our experience is that providing meaningful information about projected retirement income *prior* to retirement and ongoing estimates *in* retirement builds engagement with members.

To be meaningful, retirement income estimates must be communicated in an intuitive way and the
estimates should be tied to the investment solution. Retirement income estimates are reliable only if
the member's solution robustly manages retirement income volatility in both the accumulation and
decumulation phases. To be meaningful, income estimates need to communicate intuitively the expected retirement income volatility in addition to any retirement income estimate, enabling members to draw correct conclusions on the stability of projected retirement income streams.

Aside from maximising retirement income, the draft bill mentions as a second objective "managing expected risks to the sustainability and stability of expected retirement income". This includes longevity risks, investment risks and inflation risks. Again, our view is that managing income volatility in drawdown is easier if this task begins in the accumulation phase and is supported by an investment solution that deliberately seeks to reduce income volatility.

We also support the draft bill's requirement that the strategy be subject to a regular review, with outcomes reviewed every year and the strategy itself every three years.

Regular reviews and a seamless integration between the accumulation and retirement phases helps meet the third objective of the draft bill's definition of an acceptable strategy – that it delivers flexible access to expected funds during retirement. Unexpected life events are part of living. Members would receive great utility from solutions that provide steady retirement income but that allow them to retain control of their capital to deal with such events.

Against that background, Dimensional has developed an approach centred on a more complete risk management framework, focused on the right goal in retirement income, as defined above by Professor Merton, and managing investment risks that may affect that goal such as rising inflation or changes in interest rates.

We believe this approach, when combined with meaningful reporting for members, can bring more transparency to their preparedness for retirement, and help them better understand what choices can be made today in an effort to improve their chances for a successful retirement.

Overall, Dimensional welcomes the draft legislation for a retirement income covenant and stands ready to support the superannuation industry as it makes the transition to the new regime in 2022.