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Boosting retirement adequacy via a lifetime investment scheme

The yet-to-be-launched CPF Lifetime Retirement Investment Scheme will offer low-cost, passively managed funds. **BY JOELLE FONG AND BENEDICT KOH**

ENSURING retirement adequacy is a central policy goal of any pension system. While in no way prescriptive, the term "adequacy" conjures up several definitions to policymakers. While some may tie the term to a social standard such as the poverty line, others define adequacy as a subsistence-level of retirement income. However, adequacy to retirees may imply maintaining their current standard of living, or perhaps, being able to meet a specific income replacement target such as 40 per cent or 60 per cent of pre-retirement income. Regardless of the adequacy threshold, most Singaporeans will want to ensure as large a nest egg as possible at retirement.

One of the objectives of the CPF scheme is to help Singaporeans accumulate savings to finance retirement needs. From a financial planning perspective, the CPF nest egg at the point of retirement depends on three key drivers: the amount saved, the rate of return, and the time horizon. CPF members' savings can be greatly enhanced if they commit sizeable investments into high-yielding assets over an extended investment horizon.

By design, the CPF enforces a disciplined savings mechanism where members start building their nest egg early and take advantage of compound interest to accumulate wealth. If members started contributing to their CPF accounts at age 22, they would have a long horizon of 40 odd years for the magic of compounding to take effect and grow their savings for retirement.

For most Singaporeans, the amount of CPF savings is rather sizeable. The current contribution rate enforced by CPF Board is 37 per cent of wages for individuals 55 and below. Even among older adults, the contribution rates range from 12.5 per cent to 26 per cent. As at Sept 2017, the total amount of CPF savings accumulated in all members accounts amounts to a grand S$353 billion. This is more than double the total balance of S$137 billion accumulated as at 2007.

RATES OF RETURN

Of the three drivers of wealth creation, the one that presents the most challenge for Singaporeans is the rate of return. Financial instruments that offer higher rates of return tend to be more risky and complex. It requires financial literacy to understand the return-risk profiles of these instruments before one feels comfortable enough to commit hard-earned savings to them. Accessing these high yielding instruments is something that ordinary CPF members need help in.

Today, CPF members grow their CPF savings primarily through the interest paid by the CPF Board. Of the S$353 billion sitting with the CPF today, less than 10 per cent is invested through the CPF Investment Scheme (CPFIS) where members can choose to invest in instruments such as stocks, bonds, endowment policies, unit trusts and exchange-traded funds. The bulk of retirement savings is defaulted into CPF earning a guaranteed 2.5 per cent return on the Ordinary Account and 4 per cent on the Special Account.

For those with no risk appetite, keeping their savings in the default CPF accounts is sensible. Since the prime investment objective of a nest egg is generally to preserve capital, the safest option may be a suitable option. Nonetheless, for those Singaporeans who are able to tolerate more risk, a 100 per cent allocation to the CPF fund may seem over-conservative. This is especially so for younger and financially secure persons whose priority is capital growth rather than capital preservation.

There are also some individuals who wish to achieve a more diversified pension portfolio but are unsure where to start. Determining the appropriate asset allocation for your CPF monies is not an easy task. Basically, you must pick a mix of assets that has the highest probability of meeting your retirement goal at a level of risk you can live with. You will need to understand your time horizon and risk tolerance. After establishing an asset allocation strategy, you need to be able to periodically adjust the mix of assets so as to rebalance your portfolio.

For those with no risk appetite, keeping their savings in the default CPF accounts is sensible. Since the prime investment objective of a nest egg is generally to preserve capital, the safest option may be the best one.

A recent study by the Singapore Management University showed that while the majority of elderly Singaporeans understand interest compounding and inflation, less than half understand the concept of risk diversification. Clearly, investing in risky security markets requires a higher level of financial literacy.

LIFETIME RETIREMENT INVESTMENT SCHEME

Currently, the CPF Investment Scheme offers more than 200 investment funds and an assortment of stocks and bonds for CPF members to create their own unique pension portfolio. While more choices are a boon to the financially sophisticated, it can paralyse decision-making for those less financially savvy. As noted in the 2016 CPF Advisory Panel report, there is a portion of CPF members who may be prepared to take on investment risk to seek higher expected returns but are not "sufficiently confident of making active investment decisions or navigating the wide range of investment offerings under the CPFIS". These individuals who have the desire and potential to invest may lack the financial expertise, as well as time and resources, to actively manage their investments. The policy solution – mooted by the Panel and which the government has accepted – is a new simplified investment option known as the "Lifetime Retirement Investment Scheme (LRIS)" which offers a few well-diversified funds that are low cost and passively managed for CPF members to choose from. The CPF Board is currently working on the design and implementation of the yet-to-be-launched LRIS.

From a policy perspective, the new LRIS option improves the investment of retirement savings in two main aspects. First, it simplifies investment decision-making. Instead of having to identify an asset allocation strategy and actively manage a diversified portfolio themselves, CPF members now need to only choose from a few professionally designed and passively managed funds. Pooling CPF savings to purchase investments in bulk helps achieve economies of scale and also keeps costs low. This streamlined investment approach offers an alternative to the traditional DIY-investing approach (via the CPFIS) and is likely to appeal to both novice and experienced investors. Second, it allows for dynamic asset allocation. The allocation between growth and conservative assets in the LRIS fund will shift as a CPF member ages. For example, the exposure to stocks will gradually reduce as individuals approach closer to retirement age.

POLICY DESIGN OF LRIS

One easy way of implementing the LRIS is to use Life-cycle or target date funds. These funds are well-diversified and reduce investments in risky assets as an investor ages. While the design of life-cycle funds are based on sound finance principles such as diversification, automatic rebalancing, and long-term investment horizon, several key policy issues need to be considered before they can be deployed as a mainstream vehicle for investment of CPF savings.

The first policy issue pertains to the risk-return trade-off. Policymakers need to ask whether they should be helping CPF members maximise their retirement wealth or protect and grow their retirement saving at a less than optimal rate but immunised against financial shocks particularly near retirement age. Life-cycle funds with conservative glide paths are clearly more appropriate if the latter is the primary objective. A glide path is the asset allocation path (percentage allocated to equity and fixed income securities) that a life-cycle fund adopts across ages, and this differs from fund to fund.

Generally, asset allocation is adjusted to have less equity exposure over time so that portfolio risk steadily decreases as the investor approaches retirement age. Nonetheless, life-cycle funds with an aggressive glide path may still expose investors to significant risk even near retirement age.

A related issue to risk exposure is how geographically diversified the fund should be. Creating a more geographically diversified fund could yield higher rates of return, but at the expense of exposing CPF members to additional risks such as political and currency risks. A domestic fund may resonate better with Singaporeans due to the greater familiarity with the companies and assets invested in but it may limit the returns earned. Limiting the life cycle funds to local investments has the added advantage of helping to grow our domestic equity market.

The second policy issue is to decide whether life-cycle funds should be managed in-house or outsourced to the private sector. While private investment companies generally incorporate best international pension fund management and governance practices as well as transparent performance, a concern is that outsourcing will inevitably change the public-private mix in the provision of old-age pension income and expose CPF members to higher fees and charges. Consequently, the development of guidelines as to what constitutes reasonable fees and charges is crucial. In contrast to outsourcing to a private operator, managing these passive funds in-house by the CPF board has the advantage that profits and fees – that would otherwise be charged by private operators – can be refunded to CPF members as additional returns.

Life-cycle funds generally help investors grow their savings if they adopt a long-term investment horizon to ride out the market cycles. A third policy issue pertains to rules governing the purchase and selling of funds under the LRIS scheme. Whether the LRIS funds should instil a lock-up period and limit opportunities for switching in the manner of commercial hedge funds is an aspect that needs careful calibration. A lock-up period is consistent with the long-term investing approach that the LRIS scheme seeks to establish but CPF members may resent the lack of control over their CPF investments. Striking a balance of having adequate flexibility and safeguarding CPF members from poor market timing by enrolling in LRIS at the peak of the market cycle and exiting at the trough would be a challenge for policymakers.

Prior to launching the LRIS, it is important to educate CPF members on the benefits and limitations of life-cycle funds. While they provide a low-cost means to invest in a diversified portfolio that is rebalanced dynamically, they do not guarantee high returns. They are still risky investments which can incur losses in black swan events such as a global financial crisis.

The introduction of the LRIS will be an improvement to the current CPF Scheme. Once the scheme is implemented, Singaporeans will have three options of growing their retirement savings. If they are risk-averse, they can leave their savings with the CPF to earn interest with the assurance that these savings are protected against loss. If they wish to take a risk, they can adopt the active approach of investing the savings themselves using CPFIS or alternatively adopt the passive approach of purchasing low-cost highly diversified life-cycle funds. The latter provides a convenient way for financially less savvy members to invest as it does not require much financial knowledge. In the near future, CPF members can look forward to setting their investment of their CPF savings on autopilot through the LRIS.

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