LOW INTEREST RATES – WHAT YOU NEED TO KNOW?

What a year! The American economy is showing signs of stalling under President Trump, Boris Johnson's ambitious dream to be Prime Minister has been fulfilled which means we are now full steam ahead to a 31st October Brexit.

In that famous financial safe-haven Switzerland, deposit rates are negative and are set to remain this way until 2021. Back home in New Zealand interest rates are about to fall further with the Official Cash Rate (OCR) already at a record low of 1.00% and tipped to lower further.

And for our retired clients with no employment income and only NZ Super and investment savings to live on, the new norm of low interest rates creates real day to day living challenges. How can a retirement nest egg provide an adequate income in this low (near zero) interest environment?

What are the options for our retired community?

An investor could take on more risk with the hope of achieving a higher return.
We are already seeing evidence that investors are chasing higher interest rates and taking on higher risk. The difference in interest rate yield between low risk investment grade bonds and higher risk junk bonds has narrowed to its lowest levels since before the Global Financial Crisis. At these levels investors are not being rewarded for taking on extra risk. We are also seeing large movements of money out of conservative investment assets and flowing into unlisted property or share markets – sometimes with little knowledge of the risks these investment assets contain.

Another option is to cut spending, consume less, travel less, eat less, and live on half the income you lived on previously. Not a very desirable choice! We could add to this option living not as long. Dying sooner reduces the need to have a large retirement fund. Again, not a very desirable choice.

You could buy an annuity, or an annuity type product.
Annuities work simply on the basis of drawing a regular income consisting of interest and principal until death. Like all insurance products, annuities pool similar age people together and use average life tables to determine the income payments over the statistical lifetime of the purchaser. Those people dying too soon subsidise those people who live too long. This is therefore a less risky option, however like all low risk calculations, the rate of return is also low.

If you have enough capital an investor can create their own annuity.
You can invest into a portfolio of assets and draw a regular income which can exceed the actual income. Over time the balance of your portfolio falls until eventually it is exhausted. We call this option a "sinking lid" and it can provide the increased cashflow and flexibility that is required. There are risks, however. Firstly, the assumed rate of return may not be achieved, and your money runs out sooner than anticipated. Secondly you could live too long and again find yourself without sufficient income in those later years.

You could use the largest asset on most people's balance sheet – the family home.

For many baby boomers, the family home has been used as a "retirement superannuation fund" and has therefore tied up a significant portion of a retiree's total wealth. Although you can't "eat the letter box" there are options. The retiree could downsize the home freeing up capital to live on. This is not always successful as the smaller retirement home is often more expensive. There are several "reverse mortgage" providers who will be willing to advance a lump sum or even a regular drawdown using the home as security. This is a surprisingly acceptable option, especially for investors with little or no investment income. There is a risk however that the debt increases to a level where the equity in the home is exhausted. This is also not a good option if intergenerational wealth transfer to children is a priority. For some retirees, renting out the spare bedroom is also an option although sharing your living arrangements may not be what most retirees aspire to.

So what is the best option?

All the options have some merit. The primary concern is to ensure the option, or options, selected meet all your objectives – not just the need for income. An investor needs to examine the following:

- Do you understand the risks that a promise of higher returns generate?
- Can you sleep comfortably at night with a higher risk profile?
- If you are drawing capital to subsidise income, will your capital last as long as you do?
- Is the family home the correct "retirement home" for your remaining years?
- Do you understand the subtleties of risk and return, volatility in prices versus capital loss, and long-term future returns versus recent market performance?
- Do you know when you are going to die? Assuming you do not know that vital piece of information, do you know the statistics around morbidity and mortality for your age cohort?
- Do you wish to leave intergenerational wealth to family and if so, how much?

As you can see there is a lot to think about. This is exactly what a financial planner does. Your financial planning adviser crunches the numbers, analyses the options, and selects the best fit for each investor. It may be that two or more options are combined to give the best result. If there is one major lesson to be learnt in a low interest rate environment – it is to **seek professional advice**.

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