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Transcript of my interview with Tim Farrelly on the Finance Hour

(4 April 2018)

Reuben Zelwer: Welcome back to The Finance Hour. Whether you're listening live on J-Air or on a podcast, live on our podcast, well maybe not live ... But today our topic is "Will your investments last longer than you do?" To have a chat about that we've got Tim Farrelly. We've had Tim on before. He's a Principal of Farrelly's Investment Strategy, which was established in 2003. He guides financial planners such as myself on how to stretch investments for clients, particularly around asset allocation, so that's about how much we have in the different asset classes of shares, property, cash.

Reuben Zelwer: Tim likes to look at the big picture, doesn't worry too much about which particular share and he's also done a lot of work on retirees, people working out if their capital will last long enough for them to spend in retirement. Tim's just had a bit of drama getting to the airport. I think hopefully he's found a place to talk to us.

Reuben Zelwer: Tim do I have you on the line?

Tim Farrelly: Good day Reuben, how are you?

Reuben Zelwer: I'm good, I'm good. Thanks very much Tim. I know it's been a bit of an eventful morning for you and you're sitting at the airport somewhere? You're not in the Qantas land or anything like that?

Tim Farrelly: Well, I was going to the lounge but they make too many announcements so I'm outside and hopefully we don't get too much beeping and horns.

Reuben Zelwer: Okay, no worries. Well, I think I can hear you pretty well.

Reuben Zelwer: So Tim, what we're going to talk today about, will people's investments last longer than they do, last beyond their life expectancy? I know that's something you've done quite a bit of work on. So I want to just start the conversation with you. I was just having a look at the retirement stand. There's a group called ASFA. I can't remember what they stand for but they do a retirement standard for people that want to live a modest lifestyle or a comfortable lifestyle.

Reuben Zelwer: And what they've said, for a couple, a modest lifestyle is about 35,000 dollars per annum and for a comfortable lifestyle it's about 60,000 per annum. That obviously doesn't include first class trips anywhere.

Reuben Zelwer: My first question to you is, as a general rule, let's say people want a comfortable lifestyle. I mean this is a broad question, but as a general rule, are restraints set up to have a comfortable lifestyle in retirement?

Tim Farrelly: Well, I mean, everything is relative. I think many people are, some aren't and it's bit of the old Mr. [inaudible 00:11:51] rule. Anytime, what was the income? Two pounds, one shilling expenditure, 2 pounds a year of whatever, month or week. Happiness: expenditure 2 pounds, 2 shillings. Misery is having a budget, working out what you can afford and then making the most of it.

Reuben Zelwer: Yeah. What I want to talk to you initially about, and I did see that you'd done a video on this the other day. There's a concept of a safe withdrawal rate. Now, when I was first out in financial planning about 20 years ago, I remember I was taught to say, "Look, you can probably expect to get a 5 percent, roughly, return from your investments. And, say if you've got a million dollars, you can expect, if you're retiring with that, to generate an income of about 50,000 dollars per year and under most usual circumstances, you'd probably be able to keep your capital intact so you wouldn't even be eating into your capital. And you can expect to have a reasonable lifestyle, provided you keep your expenses in roughly that sort of category. Obviously if you go higher, you'll reduce your capital."

Reuben Zelwer: I know now that there's been some work in the States and they say that rate is more like 4 percent.

Reuben Zelwer: What's your view about the viability of those sorts of rates, or what's a reasonable rule of thumb for people?

Tim Farrelly: The first rule of thumb is, there is no rule of thumb.

Reuben Zelwer: Ah, you've just made my job a whole lot harder.

Tim Farrelly: Well, the 4 percent rule, as they describe it in the States, to say, from someone who is 65, doesn't get Social Security, has 60 percent in equities, 40 percent in bond and increases their expenditure, and lives a full life expectancy but no more.

Tim Farrelly: So in the real world, if I'm 70, my situation is different from when I was 60. If I'm very conservative, my situation would be different if I'm taking a bit more aggression with my investment.

Tim Farrelly: The pension makes a huge difference in Australia because it is a safety net, which means you can spend more, particularly with the panel right of the assets test.

Reuben Zelwer: Yes. Let's just pause on that for a second because I do want to come back to that. But I just want to touch on what you said there, that a lot of it depends on your allocation, because obviously we've got an issue now, if people want to be conservative. We've talked about it on this show a lot before, that from a term deposit rate, they're looking at around about only two to two and a half percent.

Reuben Zelwer: So surely that makes it exceptionally difficult to make your capital last.

Tim Farrelly: Your safe spending rate, if you're 100 percent in term deposits, it's going to be much, much lower than if you have a principal mix of equities, and term deposits and property. Now, what is sensible depends on every individual and their risk bonds. If they can't cope the volatility of say, being 50 or 60 percent in growth assets, and they're liable to panic on downturns, well, they just have to get used to spending less.

Tim Farrelly: But certainly, if you are prepared to take a little bit more volatility in your portfolio, if you're prepared to take a long-term approach to returns, then you can safely spend a lot more than if you're going to concentrate on term deposits. So, that's another piece of the puzzle that makes a huge difference. And the other thing to that is, it wasn't so long ago that you could buy term deposits, which were giving you 10 and 12 percent. [crosstalk 00:15:26] bond at one stage was giving a 16 percent return.

Reuben Zelwer: Yeah, well those days are a long way gone though, aren't they? And they're not likely to return.

Tim Farrelly: They are long gone, and they're not coming back. But the point is, really the underlying market conditions that exist at any particular time will dictate how much you can spend.

Reuben Zelwer: But the risk- [crosstalk 00:15:46]. Partially, the risk of what you're saying though is, okay, I look at my term deposit rates, they're really low, I can't spend much in retirement. So then what I just do say, "Well, the other alternative, well, I'll just go into high income earning franked dividend shares. I can get a much higher yield, but then I've taken on a whole lot more risk."

Reuben Zelwer: So isn't there a problem that the low interest rates can encourage people to take risks that they're really not prepared for?

Tim Farrelly: That is the key, it's how much risk are you prepared to take? How much volatility can you accept? That's a critical piece. If you can't accept the volatility, you're going to be in term deposits and you've gotta cut your spending back.

Tim Farrelly: So, yes it does push you to get out on the edge of your tolerance for risk, but a lot of that is also a fact of having a coach, someone who'll be with you and explain to you, during downturns and upturns, what's going on? Is it something we should really worry about? Is this loss permanent or it's just some short-term volatility?

Tim Farrelly: Typically what you'll find is people who ... And I'm sure this is the case with your clients, work with you, can quite happily take on more risk than someone who is trying to do it by themselves.

Reuben Zelwer: Right, yep.

Tim Farrelly: It's not purely, you know, it does help having that coaching along the way.

Reuben Zelwer: Absolutely. Okay, so I know also, Tim, you've done a theory of the work, and I use some of the spreadsheets you created around confidence levels in terms of ... You do believe it, that you can project or estimate long-term returns but you also acknowledge that when you do that, there's a very high probability you won't get it exactly right.

Reuben Zelwer: So, can you talk to me a little bit about how you would project things for people on a worst case scenario, because I know you believe that you want people to be able to cope with a worst case scenario. Tell me little bit about how that methodology works.

Tim Farrelly: How I forecast returns is I say, for example equities. How much dividends are we getting? And then add to that what kind of growth mark you're getting. Typically the growth counts on the increase in earning power of a company or a property which you typically rent or profit. And then how much people will pay for that.

Tim Farrelly: So, from time to time markets get very excited and they pay too much [inaudible 00:18:20]. Other times the markets get very depressed and things have changed. So you look and say, "Well, how might that change?" You put all that together and come with a reasonable forecast.

Tim Farrelly: That forecast typically, always is just your best and my best guess of what returns might look like over the next 10 years. I do 10 year forecasts. But I realise that my assumptions aren't going to be right. Things are, they're going to bit better or a bit worse or a lot better, a lot worse. And what I do is go to a process to try and think, "In different economic environments, what kind of growth aren't we're getting. Dividends or profits? How good could it be? How bad it be? What might people be prepared to pay for shares, if they think the terms are really good and terms are really bad?

Tim Farrelly: Today people are paying, in the United States, 24 dollars for a dollar of earning. During the GFC they're paying, I don't know, 10 dollars for a dollar of earning.

Reuben Zelwer: Yeah, it's a massive difference.

Tim Farrelly: On average normally ... Yeah, it's hugely different ... Normally it's sort of, I think, 16, 17, 18 terms is more of a normal term. So, you try and think about that. If at the end of the 10 year period people are only paying 11 or 12 dollars per earning, what does that mean to your overall return? If terms are buoyant, they're paying more. What will that mean? And then sift through all those scenarios, and I use a process called Monte Carlo Simulations, but basically it let you assess a thousand different scenarios. And then I take, let say, the bottom 100th of those and say, "Well, I've got a 90 percent chance, I'm going to do better than this."

Tim Farrelly: And what I'm then trying to do is to say, "How much confidence we're going to make it?" Now, when I think about my retirement, I say, "I want to be at least 95 percent confident my money's not going to run out." When I started out looking and saying, "What is the 5 percent worst case scenario and I'll use that to project how I might do in retirement and based on that, am I going to make it?"

Reuben Zelwer: Yep. So I mean, the old way of plotting some straight line and saying this is what the average we expect to be, you see that as really flawed. You'd see, if you're projecting your capital over a time and you've really got to look at almost the worst case scenario to see if you could cope with that.

Tim Farrelly: What I'm firstly absolutely saying, "Here's my best guess. And if I project that out and I make it, kind of just, what I'm really saying is there's about a 50 percent chance my money's going to run out early." That's a really bad plan.

Tim Farrelly: More recently I've ... There's a guy called Michael Kitchen, out of the States, who inspires the big thinkers in the area, and he's pointed out to me the flaw in my plan. And the flaw in my plan is, if I aim at something that I'm 95 percent confident that my money won't run out, it sort of says 19 times out of 20 I'm going to hit age 80, 85 and realise I can spend a lot more money.

Tim Farrelly: And I'm going to be sitting down and saying to you, "Reuben, why couldn't you have told me this when I was 60 or 65, when I really wanted to spend the money? Why did we have to wait this long?" And so-

Reuben Zelwer: Right, because we could have worked out earlier on if we were in a really good environment or really bad environment. And you've just assumed the worst environment from the beginning and never actually changed that assumption.

Tim Farrelly: And worse than that, I've assumed we could check this thing once and never review it. Now, what Kitchen says, and I absolutely think he's spot on is, you can actually set a much lower confidence, call up 75 percent or 70 percent and you're still more than two-thirds likely to get to where you want to get to. But in those one third of times, when things don't work out as well as you'd hoped, now you have to review and might get a cut to what you're spending.

Tim Farrelly: The essential thing is, if you're going to take this, apply a lower confidence level to make it, spend more money when you really want to spend it, you must review it regularly, at least once a year.

Reuben Zelwer: So, that's interesting Tim, because that's an approach which you're literally saying to people, depending on how the market's going, that's how much you can spend. I see that as being a difficult conversation, to be perfectly frank. I mean, people have got what they want to spend in retirement that, in a way they're coming to you to say, "I don't want to have to adjust my spending if Wall Street falls by 10 percent. All we need is set up a plan that means that I don't need to do that, and you're now telling me that I do need to reduce it every time I wake up and I see the market down by a couple of percent."

Tim Farrelly: Typically it doesn't work that way, which is good for all the reasons you say. Typically, if the market's down by 10 percent we should assume that our returns in future are going to be higher than they were if they hadn't fallen. The flip side of that is, if you have a great year, where the market's up 20 percent, you say, "Well great. How much more can I spend?" The answer is just normally, "None. Sorry, you're still on the same path because all we've done is taken some future returns and brought them forward."

Reuben Zelwer: Interesting. So you're saying it actually works exactly the opposite to what I've said?

Tim Farrelly: Well, not quite the opposite. It tends to be neutral about lack of movement. The things that are really critical is when interest rates went from being CDs for five and sixes to twos, that makes a massive difference because that's not [inaudible 00:24:30] everything that's ever been about facts. You never get the money back. And so that changes forecasts forever, and you now go, "Ah, if we were assuming we could get six for our CDs we could spend a hell of a lot more than if we think we can only spend two."

Tim Farrelly: Whereas a market downturn would you assume it's going to recover is not nearly as bad. But then you have all sorts of other things that come around. A classic example. Let's say you are in that area where you've got your money in pension funds, let's say if we get a Labour government, they say no more franking credits.

Reuben Zelwer: Yeah, we've talked about that on this show.

Tim Farrelly: That is a permanent change, and you need to cap your spending as a result of that. And that's a real thing and it's just huge.

Reuben Zelwer: Yep, yep. So let's just-

Tim Farrelly: You're saving inheritance, you can increase you're spending.

Reuben Zelwer: Yeah, true.

Tim Farrelly: You get a very large, unexpected bill. You have to reduce your spending. It's way more than just that.

Reuben Zelwer: So it needs to be a bit of a more dynamic approach in terms of what people can spend. It's interesting.

Tim Farrelly: I recommend, for critical pieces you need a plan. And the plan says I can spend "x" amount a year. At the end of the year I'm going to give myself a pay rise for inflation and I'm going to test it. And as long as I'm still fall at 70 percent confidence, I can keep on going ahead but if I get below, say, 60 percent, now I've gotta myself a pay cut.

Reuben Zelwer: Yep, yep. Interesting.

Tim Farrelly: And if I get above 75, I can now give myself a pay rise.

Reuben Zelwer: Yep, yep. So let's go back to, Tim, talking about the difference in retirement income streams because obviously we're talking about returns just from your investment portfolio. But as you've mentioned, the age pension in Australia is a really big factor here. Looking at the fees, if couple homeowner have less than 380 thousand dollars in assets, that actually can give them age pension combined of about 35 thousand dollars a year. You can get a partial pension up to assets of about 830 thousand.

Reuben Zelwer: So the age pension is really an ... Can be, if your assets are around that level, an enormous part of your retirement income.

Reuben Zelwer: How does that fit into the picture?

Tim Farrelly: It is absolutely crucial. When I do my modelling with and without the pension, it changes things enormously. And then, even for people who, say they've got a million dollars of assets, they don't get the pension, they're hoping not to get the pension. They can still spend more money because the pension's there, because if things don't go well, the pension kicks in.

Tim Farrelly: It's like being on the high-wire with a safety net. You can actually take more risk because you have that safety net. So it's a really important part of the Australian retirement system.

Reuben Zelwer: But it also leads to [inaudible 00:27:39] comes, from what I can see. Because for each, as I said the pension ratchets down as your assets are higher, but for each thousand dollars less you have of assets, you get 78 dollars more per year to pension for a couple. So that's an enormous amount. That's like a 7.8 percent return, so it's crazy. So you end up, you end up ... You can be in a better income position, having a lower level of assets. It's just averse.

Tim Farrelly: Absolutely. And furthermore, as other commentators have pointed out during the week, if is mad plan to stop refunds of franking credits comes in, if you are a couple hundred thousand dollars outside of the pension range, it's entirely in your interest to put an extension on the house, get yourself back into the pension range, and there you get the franking credits, and you're way better off.

Reuben Zelwer: It's just crazy, isn't it?

Tim Farrelly: It's not sensible. But that's what we're dealing with.

Reuben Zelwer: So it's just going to encourage more people to try and get into the age pension net, which is exactly what they don't want to do because that's the biggest pending hole in the budget.

Tim Farrelly: It's terrible policy, it's terrible, terrible policy.

Reuben Zelwer: But as you said, from an individual point of view, it's critically important, as you say, to model the age pension into it. The American style of just that four percent without any age pension is really not applicable here.

Tim Farrelly: And I find ... And it depends on lots of things, but on age, and how much risk people are prepared to take and so on. Often the amount you can spend is up more like seven or eight percent.

Reuben Zelwer: Really?

Tim Farrelly: And it does depend on what you spend. So you can't just say, "Oh, I'll spend seven or eight percent." It is different for everybody. Unfortunately, back to the first, what are the rules of thumb, there's only really one good rule of thumb, is you must get advice on it. Your own circumstances will dictate some very different outcomes.

Reuben Zelwer: Yep, yep. Because there's really a lot of factors at play here. Used to say it'd be great to be able to simplify it but you can't because it is, as you say, depends on what your starting point, your age is, it depends on what sort of risk you're comfortable to take with your investments.

Tim Farrelly: It depends on your health. How many assets you've got. If you've got a whole bunch of assets that are not income producing but still count for the pension. All of that makes a big difference.

Reuben Zelwer: Yep. So let's talk about another retirement income stream Tim, which has become more and more popular, which is annuities. Challenger for example, one of the biggest annuity, well the biggest annuity provider in Australia, and apparently they're doing exceptionally well. Annuities which, just for our listeners, basically allow you to ... You invest some money and you get a guaranteed income stream, either for life or for a certain period of time. You can have different features of it, whether or not it's indexed for inflation or it's not. It ends up with different calculations.

Reuben Zelwer: But an annuity, and to [inaudible 00:30:52] the market, it'll say, "Look, you use an annuity and that can help you lock in your core level of income." So even if markets do bad things, you've got this kind of guaranteed core base. How do you think something like an annuity fits into the overall retirement picture or retirement plan, because it kind of does take away, it eliminates some of that investment risk.

Tim Farrelly: I think annuities are a really important part of the mix. They won't work for everybody, but they'll work in a lot of circumstances where ... I mean, I get the sense that people ... A lot of advisors aren't looking really closely enough at those things. The government is very keen that people start using annuities for retirement, and as a result of that, in some cases it's a really attractive assets test ,,, Can I [inaudible 00:31:49] in there?

Reuben Zelwer: Yeah.

Tim Farrelly: That can produce quite dramatic outcomes, not in all cases but some cases, and they're certainly worth exploring. The other piece of it is, the annuities are really tightly regulated by the government. And the important thing to understand when you're thinking, "Well, what's the chance that a annuity provider can go broke?" It's the wrong question.

Tim Farrelly: The right question is, annuity providers run into these Statutory Funds, so pick an example, Challenger. If Challenger the organisation went broke, that may have zero impact on people who are holding annuities, because it's a Statutory Fund. Challenger are obliged to keep enough capital in there so that even if the underlying investments do poorly, there's still enough money to pay out the annuity.

Reuben Zelwer: Yeah, but one of the issues with annuities at the moment, that might turn people off is that because interest rates are so low, if you're locking in say, a very long-term product like that, you're locking in at low interest rates. Is that a turn-off for people?

Tim Farrelly: Clearly a turn-off. My sense is people have got the wrong concern. The right concern ought to be, what if interest rates never go up again, or even worse, actually go lower? Some of the rates you can lock in for long periods of time in those annuities are really quite attractive.

Tim Farrelly: Not attractive compared to what you could have got 10 years ago, but compared to ... I haven't looked at the rates recently, but you may be able to get three and a half percent for 10 years. And you say, "Well, that's not much." Well, government bonds only pay you two point seven for ten years. And so, how much are the interest rates going to go up? My expectation is, not very much.

Reuben Zelwer: Well that's actually a point to me, because you just say that, sort of a bit off the cuff there, but saying, "What if interest rates don't go up?" That seems like a pretty dramatic comment, because everything runs in cycles and people will always expect ... People still talk about the 80's and they'll talk about interest rates going up, how could you suggest that they may not?

Tim Farrelly: We'll find out. I think they're going to go up a little bit, but not nearly as much in the past. The whole interest rate structure in Australia starts with the Reserve Bank and [inaudible 00:34:32]. Typically they fix interest rates and they take inflation pricing out, lift interest rates and now to slow the economy down so inflation cools and everything goes on as usual.

Tim Farrelly: It used to be, to slow things down they had to pay cash rate to five or six. Four would be absolutely speeding everything up and the economy's going mad and inflation be [inaudible 00:34:57]. Today we've had interest rates at one and a half for the longest period without a change of cash rates. No signs of inflation whatsoever.

Reuben Zelwer: No.

Tim Farrelly: So something has definitely changed, something has definitely changed. Furthermore, one of the things that has changed is the amount of debt that Australians have taken on to finance housing purchases, has gone through the roof.

Reuben Zelwer: Yeah, that's for sure.

Tim Farrelly: So there's ... Compared to 10 or 15 years ago, there's three times as much household debt. So that means, when the RBA increases interest rates by one percent, it has three times the impact it used to have.

Reuben Zelwer: Right. So they've going to be very, very careful to do that.

Tim Farrelly: When they put their foot on the brakes, they don't have to press nearly as hard as they used to. And that means interest rates will never get to those terms. I don't think they'll get to those levels we've seen before until that debt has been paid off, and that's 20 or 30 years away.

Reuben Zelwer: I think that might be 20 or 30 generations away, that that debt's paid off, with the level of debt that people are taking on, I think 20 or 30 years is wildly optimistic, Tim.

Tim Farrelly: That's why I think the whole interest rate structure is much lower today than it has been in the past, and it's going to be there for a very, very long time.

Reuben Zelwer: That's interesting when you think about that. The fact that the Gen Xs and the Gen Ys are taking on more and more debt, is actually to the detriment of the baby boomers because it's going to keep interest rates low and it's going to keep the baby boomers' earnings on their term deposits low.

Tim Farrelly: Yeah, well now the baby boomers have made out with house pricing [inaudible 00:36:43]. I don't think we should feel too sorry-

Reuben Zelwer: Well, I'm just trying to think about it because the X, Ys are always blaming the baby boomers for all the trouble, so I'm just trying to see if there's a flip side to it.

Tim Farrelly: There is, a little bit, yeah.

Reuben Zelwer: Tim, well, we're coming towards the end of the show, but I always ask people for their top three tips. So I just want to ask you for your top three tips for people planning retirement to ensure that their capital lasts longer than they do. You've got a maximum of two minutes.

Tim Farrelly: Okay, firstly, try and get an accurate assessment of what your life expectancy is, and typically not found by looking at the life tables. Because that's where you're going to plan against. There's a website called mylongevity.com that I use. It takes looking at your health, family history, a whole bunch of things and I think that's a really good start.

Tim Farrelly: Second thing, based around that, go and talk to someone like yourself, who actually can make the calculations which are complicated and then develop a plan. And the plan should have in it, how much can I spend and how will I review that spending. If things go well or not so well, what sort of confidence do I need and then make sure you actually do review that every year. Because if you take a slightly lower level of confidence, you're going to make it. Spend more money upfront, which is the right thing to do. You then must review it.

Tim Farrelly: So your plans are try and get a rough idea of how long you might live, secondly develop a plan and then actually review that plan every year.

Reuben Zelwer: Perfect Tim. That's fantastic tips. Thank you very much for joining us today. I know it's been a challenge with your travel arrangements but it's always great to have you on the show. And safe travels, I think back to Sydney, if I'm not mistaken.

Tim Farrelly: Right. Thanks. Been a pleasure.