WHITE PAPER

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MARTIN CURRIE

2019

SOLVING FOR THE RETIREE PROBLEM WITH INNOVATION

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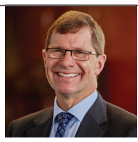

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Australia has a serious problem. Many retirees do not have enough income to fund a comfortable retirement because of an over-reliance by the industry on recommending low yield / low growth or so-called "low risk" asset allocations. In particular, term deposit rates are close to negative in real rates of return following successive rate cuts.

In May 2014, Martin Currie launched a multi-asset allocation solution that looked at the problem very differently to these traditional retirement options.

On its five-year anniversary, we take the opportunity to examine traditional retirement strategies and the issues surrounding them. In addition, we reflect on the Martin Currie approach and it's focus on providing **'a sufficent income for life'**.

CONTENTS

PART 1: THE KEY ATTRIBUTES FOR A SUFFICIENT INCOME FOR LIFE

PART 2: A DEEP DIVE INTO OUR PHILOSOPHY AND RESEARCH FOR RETIREMENT INCOME ASSETS

PART 3: MEETING RETIREMENT OBJECTIVES

"We believe that a retirement income strategy and asset mix should be very different to a typical balanced fund strategy for people in the accumulation phase of their investments."

PART 1: THE KEY ATTRIBUTES FOR A SUFFICIENT INCOME FOR LIFE

WE THINK ABOUT THE PROBLEM DIFFERENTLY

Most existing multi-asset retirement products assume that when retirees get to 65, they automatically become more risk adverse and should move away from growth-style assets (i.e. equities, or growth-tilted balance funds) and more towards defensive assets (i.e. term deposits, fixed income or more defensive balanced funds).

Back in 2010, the high nominal income yields generated by low risk fixed income and term deposit strategies meant that a defensive asset allocation for retirees was relatively easy. But we knew that this was not going to be sustainable as yields began to fall. This has proved to be true, with the cash rate steadily falling since then, and the RBA now lowering the cash rate to its lowest level ever seen in July 2019.

Based on feedback from investors, institutional clients, financial advisers, and even our own retirement-age parents, we have found that the solution to Australia's retirement problem requires a focus on providing for a **'sufficient income for life'**.

The key characteristics of a strategy that can provide a 'sufficient income for life' are:

- A high and stable franked dollar income stream to support annual expenses
- Income growth for inflation protection
- Capital growth with lower to moderate capital volatility to manage longevity risk
- Diversified growth exposures to reduce sequencing risk

WHAT OUR RESEARCH FOUND

Our hypothesis was that, going forward, retirement solutions would need to move away from the traditional industry solution of so-called "low risk" defensive assets which are in fact low yielding, low growth and have high income volatility, and into higher growth-style allocations.

Our research showed us that the characteristics of a **'sufficient income for life'** can be achieved by combining more of the right type of growth-style assets with the right type of defensive assets, and focusing on income volatility as a better risk proxy, rather than solely on capital or total volatility as a measure of risk.

Summary of our findings

To meet the above characteristics at a total portfolio level, retirees need more growth-style assets, in the order of ~70%, growing at least 2-3% per year to offset inflation. This is almost a complete reversal of the traditional approach for retirement of a 30% growth / 70% defensive strategy.

We do not agree that all growth assets are high risk and that all defensive assets are low risk, because this concept of risk is focused solely on capital volatility. Income volatility, a proxy for the risk of impaired living standards is a bigger problem than capital volatility.

But not all growth equities are appropriate, and the sustainability of income and future income growth must be considered. Our research shows that with the right growth allocation, a retirement portfolio can not only exhibit lower income risk, better protection against inflation, but also offer higher dollar income and provide valuable franking credits to maximise after-tax income for 0% tax payers as well as long-term capital and income growth.

We have found that even today, eight years later, the industry is still not focused on what retirees really need.

In this section we show the conclusions of our analysis of various retirement products such as **term deposits** & fixed annuities, traditional 'low risk' **30/70 balanced funds**, and rules-based **high yield index approach**.

Do Australians need global assets in retirement? Challenging the traditional asset mix

Another interesting outcome of our analysis is that global equities might not be appropriate for all retirees, even though they have been traditionally included in conservative balanced funds.

However, for retirees, the cost of living is largely domestically driven, i.e. inflation is mostly Australian, therefore the risk to the investor Australian in nature.

For example, a fall in consumer prices in, say, New York or London will not boost your spending power as a retiree in Melbourne or Sydney.

Additionally, yields on global equities and bonds are at all-time lows and franking credits are not available. Foreign-exchange risk, rather than adding diversification, has introduced an additional unintended risk in volatility of the income stream.

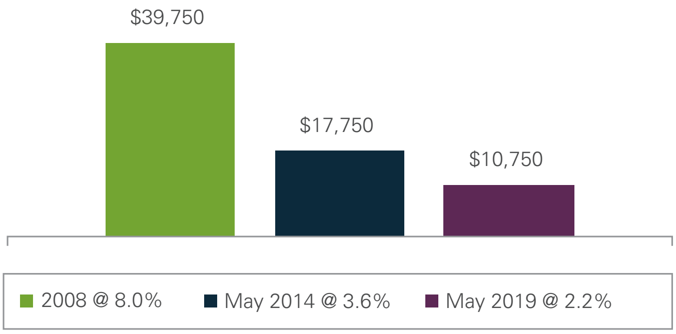
As such, we discuss only strategies that invest in Australian assets/AUD in this paper.

A HIGH AND STABLE FRANKED DOLLAR INCOME STREAM TO SUPPORT LIVING STANDARD

For retirees who require a reliable income stream to replace the wages that they received when working, it is important to focus on a stable dollar income generated over time, rather than targeting a stable headline yield.

Why is this important? Think back prior to the global financial crisis (GFC), when **term deposit** rates of almost 8% were readily available, it would have been possible to annuitize a retirement balance of say $500,000 and live comfortably off that.

Falling term deposit income



However, since the GFC, there has been a general fall in official interest rates, both here and overseas, with the current yield on best-rate term deposits falling to just 2.2%[5]. This dollar income is not stable.

Fixed annuities face the same falling dollar income problem as term deposits, albeit delayed as their characteristics are similar to a 3-5 year duration term deposit, as does the **30/70 balanced fund** due to the larger weighting towards fixed income.

The lower dollar income available today from term deposits requires an investment of more than three times as much as the peak in 2008 to generate the same dollar of income. Consequently, retirees have had to either take a massive hit to their standard of living, or significantly draw down their capital assets to meet their cost of living.

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Source: Martin Currie, FactSet, Morningstar Direct; as of 31 May 2019. Data calculated as per assumptions below in A$ gross of management fees unless otherwise noted. Inception date for performance: 31 May 2014.

Please refer to disclaimer on page 4.

[5] Source: Martin Currie, FactSet, RBA; as of 31 May 2019.

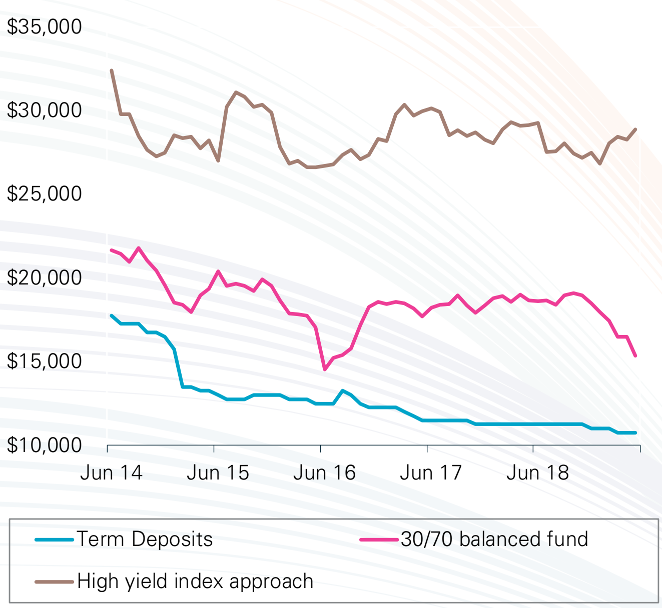
Drawing down on capital creates a downward spiral: the risk of running out of capital, the inability to fund a 30+ year retirement, and the impairment of the future dollar income generation of assets.

As a consequence, investors have turned to rules-based tilts towards high yielding stock - for example, a high yield ETF index. Such strategies generally do not consider the sustainability of such high dividends.

When a company is forced to cut an unsustainable dividend, it can create an income and capital shock. Moreover, if sold automatically after the cut, can result in an impaired capital value, as well.

A focus on franking can help retirees get more of their return from the dividend income stream and rely less on the capital growth component. Income from franked equities can be significant. We have found over time that the additional tax refund is over 2% p.a., and the current expected franking boost for the S&P/ASX 200 is 1.5%[6]. Significant weighting to fixed income or term deposits in retirement forfeits this retirement 'free lunch'.

NTM expected income from $500k investment on 31 May 2014 (after paying distributions)



INCOME GROWTH FOR INFLATION PROTECTION

ASFA's current standard for a comfortable retirement for a couple assumes an income of over $60k a year[6]. But income growth is required every year to offset inflation and longevity risk.

Income needs over potential 30 year retirement

While lower than long term assumptions, actual consumer price index (CPI) inflation has still averaged 1.6% p.a. over the last five years[7].

After taking inflation, and also the falling dollar income mentioned earlier into consideration, **term deposits** and fixed annuities now provide only half the expected next 12-month income today versus what was expected five years earlier.

Their income has been shrinking, not growing. The chart on the previous page highlights that **30/70 balanced funds** are suffering the same fate. Poor yields, and negative income growth rates, mean that income paid may not keep up with inflation.

Equity based income strategies such as those based on a **high yield index**, should fare better with inflation protection because of the ability to invest in companies that can grow their dividends along with or ahead of inflation.

However, the impaired capital issue described earlier also stifles the ability to grow income. Furthermore, the dividends of many high yield equities are correlated to the economic cycle and can be volatile.

"Retirees need to have reliable income growth, so they can have certainty in their ongoing inflation protection."

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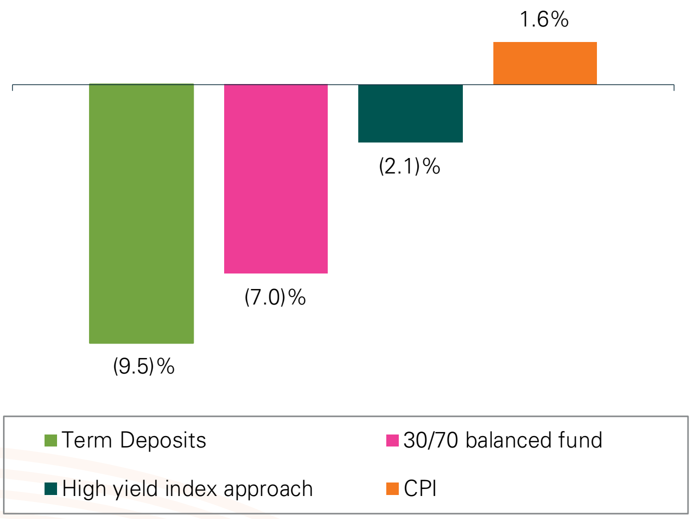
[6] Source: Martin Currie, ASFA; as at March quarter 2019; 2.5% p.a. long term inflation assumption.

[7] Source: Martin Currie, FactSet: as at 31 May 2019.

Expected NTM income stream growth (%p.a.)



CAPITAL GROWTH TO MANAGE LONGEVITY RISK

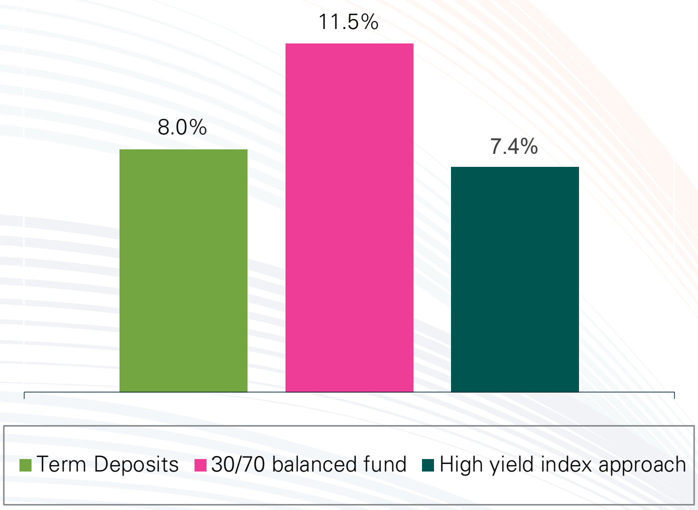
We are all aware that equities can be a volatile place to invest. However, younger retirees who have a long life-expectancy and 30+ year time horizon can tolerate capital volatility for a long period. They cannot, however, be short of regular income, or drawdown that capital too soon.

Capital growth is required to grow the asset base to ensure the future dollar income generating ability of their assets, and this requires investment growth assets.

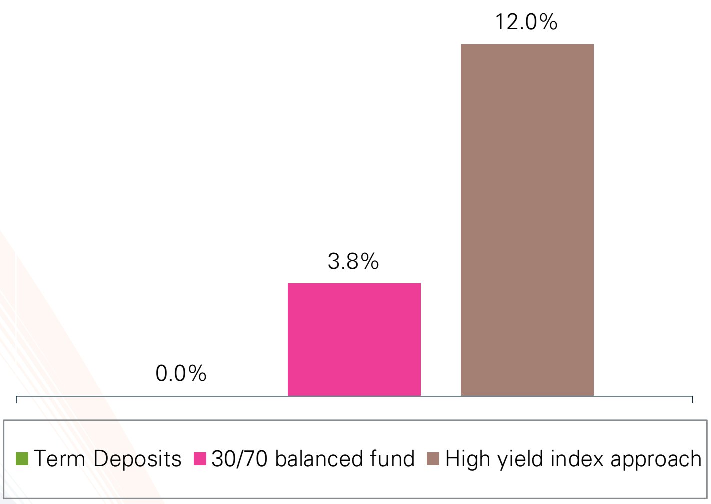
Term deposits and fixed annuities have no capital growth, and the **30/70 balance fund's** tilt to fixed income creates lower capital volatility, but very low growth. The **high yield index**, as discussed earlier, has impaired its capital base.

Remember, however, that not all equities are created equal. When combined with a disciplined investment process, high-quality companies may be able to provide both capital growth and income with less volatility than the broader equity universe.

Volatility in expected NTM income stream growth (%p.a.)



Capital volatility (%p.a.)



A side note, strategies using derivatives to provide income enhancements or capital protection may be potentially detrimental to long-run income growth as the cost is borne from impaired capital.

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DIVERSIFIED GROWTH EXPOSURES TO REDUCE SEQUENCING RISK

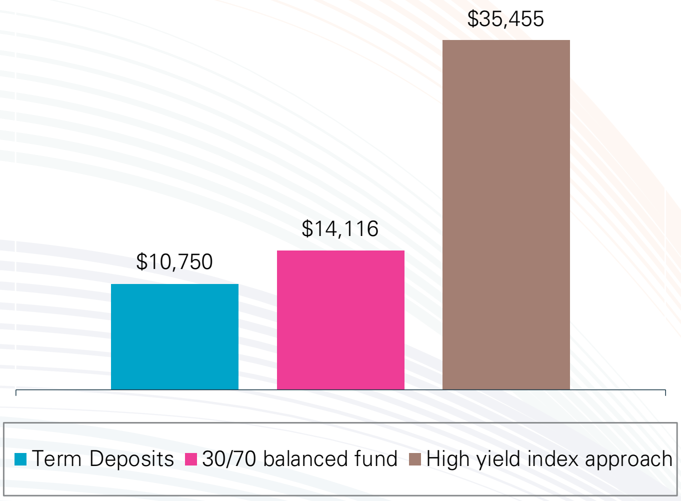
Sequencing risk is often discussed in terms of the order that capital returns occur and their impact on future portfolio values; E.g. shifting to an investment allocation at an arbitrary date (i.e. your date of retirement), when the equity market has fallen and locking in an impaired capital value.

While we recognize that the issue of impaired capital is a problem for future income growth, an equally important and often neglected risk is that of locking in impaired yields.

If you look at the expected next 12-month income available across the various options we have mentioned above, you will see that for a retirement balance of $500,000, **term deposits** or a **30/70 fund** will fall significantly short. Compare this with those who happened to retire in 2008 and could get that 8% term deposit.

Poor income early in retirement can be a significant income sequencing risk and have a long-lasting impact on the income available in future years.

Expected NTM income for $500k in assets invested today



A 30-year time horizon in retirement can allow for capital returns to improve, but only if the capital and income growth ability hasn't been permanently impaired as maybe the case with the **high yield index.**

By maintaining diversified exposures in our strategies, we believe you can avoid locking in a very low yield or crystallising capital losses, and defer the growth/defensive asset allocation question until a time when longevity is less of a risk.

"We see the risk to income from moving into defensive assets at low yields, such as they are today, as a more significant concern than capital returns near the point of retirement."

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A DYNAMIC ASSET ALLOCATION FOR RETIREMENT LIVING STANDARDS

The last five years reinforce why retirement products need to be built to specifically provide retirees with the characteristics of a **'sufficient income for life'**.

The Legg Mason Martin Currie Diversified Income strategy brings together Martin Curire's deep understanding of the income needs of retirees, and a 40+ year pedigree in asset allocation and managing balanced funds.

Based on our research, we developed a truly unique retirement offering when compared to the traditional industry solutions. The dynamically managed MCA Diversified Income strategy is made up of three building blocks that have each been specifically designed or selected to meet the characteristics of a **'sufficient income for life'**:

Australian Equities

For high and stable franked dollar income and capital growth, in the form of the Legg Mason Martin Currie Equity Income Fund

Australian Listed Real Assets
(A-REITS, utilities, infrastructure)

For lower volatility income growth, in the form of the Legg Mason Martin Currie Real Income Fund

Australian Cash and Fixed Income

To provide lower capital volatility and liquidity, using the capabilities of fellow Legg Mason-affiliate, Western Asset Management

Legg Mason Martin Currie Equity Income Fund:

- Focuses on the quality of businesses, and sustainability of dividend payments to enhance dividend security
- Avoids only considering high dividends without considering quality
- Avoids income enhancements or capital protection that could be detrimental to long-run income and returns
- Recognises the benefit of franking credits for retirees and is low turnover

Legg Mason Martin Currie Real Income Fund :

- Invests in listed real assets such as real estate investment trusts (REITs), utilities and infrastructure
- To provide good inflation protection because of the non-discretionary nature of real assets
- Invests in assets with growth drivers outside of the business cycle such as population growth
- Can provide a high, stable income stream that grows above the cost of living and exhibit less volatility than the wider market

Legg Mason Western Asset Australian Bond Fund & Legg Mason Martin Currie Cash Plus Fund:

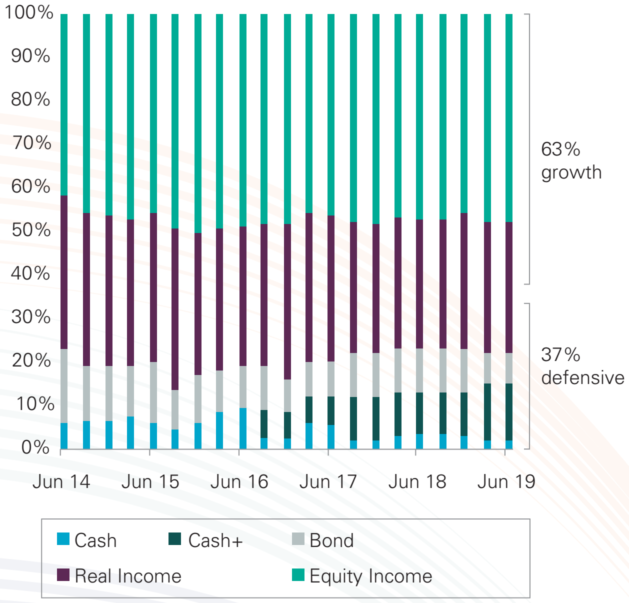
- Ensures that the overall risk return for the portfolio is conservative
- Aims to protect and promote the defensive attributes that fixed income offers; and
- Provides a high level of liquidity

DYNAMICALLY MANAGED SOLUTION

In order to maximise **'sufficient income for life'** characteristics, Martin Currie continually assesses Australian equities, real assets, bonds and cash, and tilts the strategy toward the most attractive asset classes.

The diversified asset allocation across both growth assets with attractive yields and growing dollar income, and lower volatility defensive assets, helps manage sequencing risk at the point of retirement, and it ensures lower capital volatility than a broad-based equity portfolio.

Asset Allocation[1]



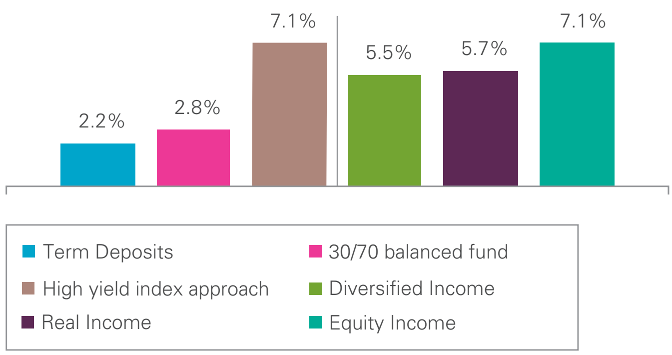
However, should bond rates normalise in-line with nominal GDP, our asset allocation will adjust accordingly, maintaining our income, income growth and lower capital volatility objectives.

ATTRACTIVE FORWARD LOOKING YIELD

Martin Currie's range of retirement solutions are specifically built to provide retirees with the characteristics of a **'sufficient income for life'.**

The current expected income yields of the Legg Mason Martin Currie Diversified Income strategy, and also its component strategies, Legg Mason Martin Currie Equity Income and Legg Mason Martin Currie Real Income, are attractive, especially when compared to the alternative retirement solutions such as lower yielding **term deposits** & fixed annuities, traditional 'low risk' **30/70 balanced funds**, or a rules-based **high yield index approach**, which as we show later, has a high headline yield, but a significantly higher risk to its income stream.

NTM expected income yield



Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate.

Source: Martin Currie, FactSet, Morningstar Direct; as of 31 May 2019. Data calculated as per assumptions below in A$ gross of management fees unless otherwise noted. Inception date for performance: 31 May 2014.

Term deposit: Average 'special' rate (all terms). 30/70 balanced funds: Based on 30% invested in S&P/ASX 200 Index, and 70% in the Vanguard Australian Fixed Interest ETF as a proxy for the Bloomberg Ausbond Composite Bond index. High yield index approach: Based on the iShares S&P/ASX Dividend Opportunities ETF as a proxy for rules-based tilts towards high-yielding stocks. Diversified Income, Equity Income and Real Income: Data calculated for representative Martin Currie accounts.

NTM - Next 12 Months Income is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return.

[1] For the purpose of the growth/defensive split, Real Assets are allocated equally between growth and defensive assets.

PRODUCTS THROUGH A RETIRMENT OBJECTIVE LENS

In the below table, we summarise our reserach into the features of various retirement products:

	Term deposits/ fixed annuities	'Low risk' balanced funds	High yield index approach	Legg Mason Martin Currie Diversified Income Fund	Legg Mason Martin Currie Equity Income fund	Legg Mason Martin Currie Real Income Fund
• A high and stable franked dollar income stream to support annual living expenses in retirement						
– High dollar income	X	X	✓	✓	✓	✓
– Focus on franking	X	X	✓	✓	✓	✓
– Stable income delivery	X	X	X	✓	✓	✓
• Income growth for inflation protection						
– Income growth greater than CPI	X	X	X	✓	✓	✓
– Low volatility income growth	X	X	X	✓	✓	✓
• Capital growth with lower capital volatility to manage longevity risk						
– Growing capital	X	X	X	✓	✓	✓
– Low to moderate capital volatility	✓	✓	X	✓	✓	✓
• Diversified growth exposures to reduce sequencing risk						
– Attractive dollar income today	X	X	✓	✓	✓	✓

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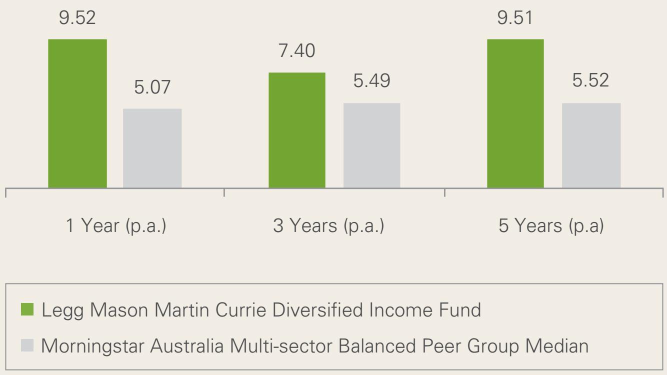
FUND OFFERING IN FRONT OF THE PACK

Since inception, the Legg Mason Martin Currie Diversified Income Fund has also delivered a 9.5% p.a. total return (net of fees), ranking 1st out of 116 funds in Morningstar's Multi-Sector Balanced peer universe over 5 years[3].

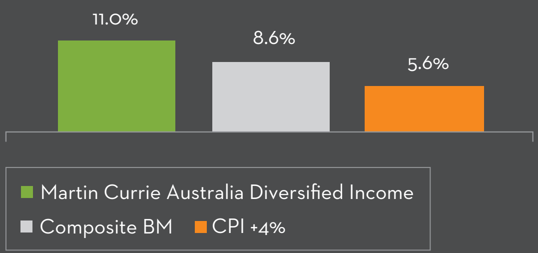
Performance versus peers (% p.a.)



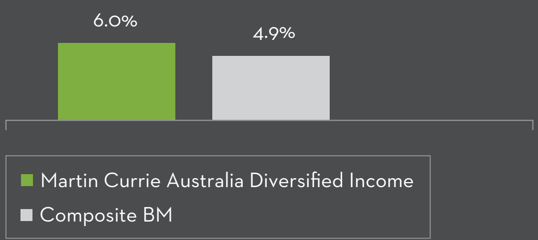
DELIVERING ON INVESTMENT OBJECTIVES SINCE INCEPTION

Pleasingly, in the five years since inception, the Legg Mason Martin Currie Diversified Income Fund has exceeded its objectives to provide an after-tax total return of CPI +4%, and a total return & income return that is greater than that of the Composite Benchmark[2].

Total returns (% p.a.)

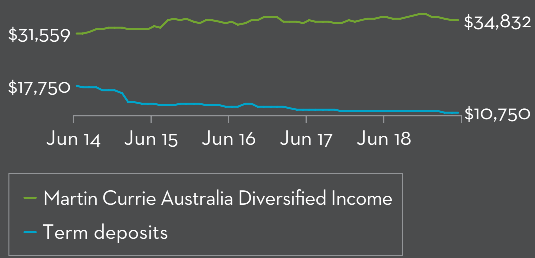


Franked income returns (% p.a.)

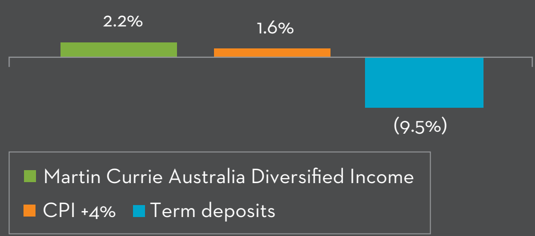


The expected next twelve month (NTM) franked income stream has also grown steadily since inception, at a level ahead of the rate of inflation and term deposits[3].

NTM expected income from $500k investment on 31 May 2014 (after paying distributions)



Expected NTM franked income stream growth (% p.a.)



Past performance is not a guide to future returns. The investment vehicles shown may have different risk profiles and a direct comparison may not be appropriate. Source: Martin Currie, FactSet, Morningstar Direct; as of 31 May 2019. Data calculated for a representative Legg Mason Martin Currie Diversified Income Fund in A$ gross of management fees unless otherwise noted. Inception date for performance: 31 May 2014. Next 12 Months (NTM) Income is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Assumes zero percent tax rate and full franking benefits realised in tax return. Composite benchmark: S&P/ASX 200 Accumulation (30%), 50% S&P/ ASX A-REIT 300 Index / 50% S&P/ASX Infrastructure Index (30%), Bloomberg Ausbond Composite Bond (30%), Bloomberg Ausbond Bank Bill (10%). Term deposit: Average 'special' rate (all terms).
Please refer to disclaimer on page 12.

MARTIN CURRIE PLATFORM OF RETIREMENT SOLUTIONS

The table below summarises our research conclusions for the various retirement products:

	MCA Diversified Income	MCA Equity Income	MCA Ethical Income	MCA Real Income
Long-term objectives	The strategy aims to provide an after-tax total return of CPI +4% and to provide income stream growth above inflation. The strategy also aims to provide a total return and annual income that is greater than that of the Composite Benchmark.	The strategy aims to provide an after-tax yield above the S&P/ ASX 200 Index and to provide income stream growth above inflation.	The strategy aims to provide an after-tax yield above the S&P/ ASX 200 Index and to provide income stream growth above inflation.	The strategy aims to provide a pre-tax yield above the S&P/ASX 200 Index and provide income stream growth above inflation.
Universe	Australian listed securities, Australian listed real assets, Australian fixed income, Cash	Australian listed securities	Ethically screened Australian listed securities	Australian listed real assets
Inception date	30 May 2014	22 May 2010	8 December 2015	17 November 2010
How to access/ wrapper	• Segregated account • Legg Mason Martin Currie Diversified Income Fund – APIR: SSB0061AU – mFund: LMA05	• Segregated account • Legg Mason Martin Currie Equity Income Fund – APIR: SSB0043AU – mFund: LMA01 • Betashares Legg Mason Equity Income Fund (managed fund) – ASX: EINC	• Segregated account • Legg Mason Martin Currie Ethical Income Fund – APIR: SSB4946AU – mFund: LMA13 • Legg Mason Martin Currie Ethical Values with Income Fund – APIR: SSB0064AU – mFund: LMA14	• Segregated account • Legg Mason Martin Currie Real Income Fund – APIR: SSB0026AU – mFund: LMA02 • Betashares Legg Mason Real Income Fund (managed fund) – ASX: RINC
Fund ratings	4 Recommended Lonsec Research	5 Highly Recommended Lonsec Research	5 Highly Recommended Lonsec Research	4 Recommended Lonsec Research

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WINNER
Retirement and Income

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- Legg Mason Martin Currie Real Income Fund (ARSN 146 910 349).
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