20 years on: Self funded retirement still a challenge

PERENNIAL INVESTMENT PARTNERS

Perennial Growth Management

- Headed by: Lee Mickelburough.
- Eight investment professionals with an average of 19 years industry experience.
- $2.8 billion in funds under management as at 30 September 2012.

Australian Super System

- As a percentage of GDP, Australia has the fifth largest pension market in the world (Towers Watson Global Pension Survey, February 2012).
- Forecast to grow to $6 trillion by 2030 (Deloitte, Dynamics of the Australian Super System: The next 20 years).
- 65% of Australia's super assets are controlled by people aged between 45 to 66 years[1].

Challenger in brief

- Established 1985 and listed on the Australian Securities Exchange in 1987.
- Sector: Financials.
- Our valuation is $5.04, which is more than a 55% upside to the current share price.
- Based on earnings per share forecasts, Challenger is trading on an attractive 5.5x FY13.

Perennial Growth values companies for the long term and we are particularly interested in when, and if, structural changes in a market sector will affect the outlook and price for the companies we are modelling and ultimately invest in or exit from. When the research on the first 20 years of compulsory superannuation in Australia started to hit my desk, it reinforced the views we hold on our investment in Challenger Limited (Challenger).

In 1992, when the Keating Labor government introduced the compulsory superannuation guarantee levy (SGC) it was designed to be just one of the three pillars (age pension, SGC and voluntary contributions) of an integrated approach for an aging population to fundamentally, and permanently, move away from the traditional reliance on government funded pensions to a predominantly self funded retirement, with a much higher standard of living in our twilight years.

20 years on, Australians have close to $1.4 trillion in superannuation savings[1] and over 90% of adults aged between 15 and 64 have some form of superannuation. While we have one of the biggest superannuation schemes in the world, and one that has boosted productivity and activities across the economy, including infrastructure investment and employment, for most people the path to self funded retirement is not quite as planned in 1992. No one counted on what I like to call the "fourth pillar" of conspicuous consumption. Research shows that people have treated, and look set to continue to do so, lump payments on retirement like a windfall to pay off debt from their increased consumption during their working life. According to a number of research reports, a significant proportion of people will outlive their retirement savings and their lifestyle in retirement will be dictated by the level of the age pension.

Over the last two decades, there have been a number of changes to the operation of the SGC designed to encourage all of us to cost and tax effectively save more for our retirement. But these changes in concessional tax rates, rebates and contribution thresholds and the calls for increased percentages, well beyond the 9% we pay today and the 12% that we will be paying by 2019/20, have not addressed the problems created by the fourth pillar and the "windfall" mentality.

There is a school of thought that our system needs to move away from the concept of lump sum payments to one which is more suited to the original intention of the SGC. The introduction of a combination of a lump sum arrangement with compulsory income products, such as annuities, is increasingly gaining support. Challenger, a market leading provider of retirement income products, is well placed to benefit from this mooted change.

While most of us have seen the Challenger advertisements on TV, online and in magazines and would not be surprised to learn that the company has enjoyed a significant growth in brand recognition, you may not realise that since 2008 Challenger's retail annuity sales have grown by a compound annual growth rate of 26%. Based on our assessment of the market for retirement income products and the financial sector in general, we believe that there is further scope for continued growth in this key part of Challenger's business.

Our assessment of the research on superannuation and the trends for retirement income products is a key component in our valuation of the stock and reinforces our conviction that our position in Challenger is a good investment for our clients.

Lee Mickelburough
Head of Perennial Growth Management

1. Source: The Australian Prudential Regulation Authority (APRA).