CPF investments: Too much choice may end badly

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Although there are areas in which Singapore's retirement financing system may need to be improved, the CPF system already offers more than sufficient flexibility to members who wish to take on more investment risk, says the writer. -- PHOTO: BLOOMBERG

LAST September, the CPF Advisory Panel was commissioned by the Ministry of Manpower to consider, among other things, whether or not to provide more flexibility for Central Provident Fund (CPF) members who are prepared to take on more risk.

In a recently-published working paper, Investment Risks in Singapore's Retirement Financing System, which I co-authored, we concluded that the returns available from the CPF Board are broadly equivalent to a portfolio invested 60:40 in global equities and bonds, but with considerably less downside risk. We noted that the returns from the CPF are more financially efficient, and that these returns therefore represent an attractive benefit to CPF members, compared to other available investment opportunities.

I would go further and argue that the default return-risk balance provided by the CPF Board is good enough for most members. Adding more choice and flexibility may add complexity to the system. A lack of adequate financial literacy among CPF members and potential retirees may result in sub-optimal decision-making. Taken together, this will result in underperformance and poorer outcomes for retirees' financial adequacy. The array of investment options - from Singapore Government Bonds and Treasury Bills, to equities and gold - available to CPF members under the CPF Investment Scheme (CPFIS) already creates what American psychologist Barry Schwartz calls the Paradox of Choice. He says that while having some choice may be good, more choice is not necessarily always better. There are psychological and decision-making costs resulting from an overload of choice that may reduce one's well-being.

Finance professor Benedict Koh, writing in The Straits Times last year, noted that 47 per cent of CPF members who had withdrawn their Ordinary Account (OA) savings to invest in the CPFIS had incurred losses on their investments between 2004 and 2013, while 35 per cent realised net profits equal to or less than the default 2.5 per cent per annum OA interest rate that prevailed during that period. Only 18 per cent generated net profits in excess of the OA interest rate.

Value of the status quo

THE CPF system does well in shielding its members from sequence risk, in addition to many other investment risks that we examined in our working paper. Sequence risk in retirement financial planning is the risk that a saver experiences lower or negative returns towards the end of their savings accumulation phase. This would affect the size of the CPF member's accumulated retirement savings, or impact a retiree early on in the decumulation phase, when he begins drawing down on his nest egg. While the magnitude of long-term average returns has a significant impact on a retiree's accumulated savings, the timing of those returns also matters.

We can illustrate the effects of sequence risk with a case study of three workers. For purposes of this case study, we will assume that the CPF scheme allows more flexibility and, hence, two of the workers have made private arrangements for their pension savings, with the third remaining on the CPF Scheme. All three have identical starting annual incomes ($39,000) and wage growth (3 per cent per annum), enter the workforce at age 26 in 2015, and work until their 65th year.

Worker A invests in an exchange-traded fund that generates annual returns in a sequence that is that of the Straits Times Index in the 20-year period from 1991-2010 and repeated in the subsequent 20 years. Worker B invests in another exchange-traded fund that generates a similar 5.2 per cent compound annual return as worker A's, but with the sequence of annual returns adjusted such that the average annual returns in the first 20 years is 23.3 per cent and, for the second 20-year period of savings accumulation, is -4.6 per cent per annum. Worker C contributes to the CPF scheme throughout his working lifetime at prevailing rates of contribution and interest, and does not withdraw funds to finance housing or other investments.

While the average annual returns and the distribution of these returns over the 40-year accumulation phase for both A and B are the same, the different sequence of returns has a significant impact on the retirement adequacy of these two workers. In his 65th year, A would begin retirement with $2.53 million of savings, equivalent to 20.5x his last-drawn income. B would have only $590,693, or 4.8x his last-drawn income in his 65th year. C would have generated an average annual return of 3.4 per cent during his accumulation phase, with his CPF balance increasing steadily over the years to $1.71 million, or 13.8x his last-drawn income.

Intergenerational equity

ONE could imagine A and B in our case study as being members of two different generations (a father and son, perhaps) who enter the workforce 20 or so years apart. The father would be retiring at the tail end of a multi-year bull market, while the son would come to the end of his working life in a prolonged market downturn not dissimilar to Japan's lost decades. Such disparities in outcome over time could pose significant structural challenges to a country's social safety nets and fiscal position, and potentially result in rising political tensions across the generations.

A national pension system with the primary objective of ensuring Singaporeans have a secure retirement through lifetime income must take into account the impact of this risk factor on intergenerational equity. The current system transfers this sequence risk, together with most other investment risks, to the Government and its investment-management agencies, in exchange for a defined rate of interest subject to certain minimum levels. The Government can absorb these investment risks, given its perpetual nature and extremely long-range investment horizon, as well as pooling its unencumbered assets with CPF funds to shield its citizens from most of the investment risks that individuals would be exposed to in a do-it-yourself strategy.

Although there are a number of areas in which Singapore's retirement financing system may need to be improved, I believe the CPF system already offers more than sufficient flexibility to members who wish to take on more investment risk. The current set-up, with low-risk investment returns backed by a triple-A-rated sovereign credit, generally provides outcomes that are good enough for its citizens over successive generations.

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