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Realistic ways to raise CPF returns

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The CPF Investment Scheme can be modified to help financially illiterate members make better investment decisions

Realistic ways to raise CPF returns

By BENEDICT KOH
FOR THE STRAITS TIMES

SINGAPORE is a fast-ageing nation due to declining fertility rates and the increasing life expectancy of its citizens. The impending ageing tsunami places a heavy burden on the Central Provident Fund (CPF) to be the primary vehicle to prepare citizens for retirement.

But is the system working in the best possible manner?

There have been gripes in social media recently about the inadequacy of CPF's compulsory savings scheme. From 2005 to 2012, the percentage of CPF members attaining the required minimum sum for old age ranged from 33.8 per cent to 48.7 per cent. In other words, less than half of CPF members have the minimum sum.

This minimum sum is essentially a retirement account. It is created by transferring savings from other accounts (often used for housing and education of children) held by CPF members when a citizen or permanent resident turns 55. Intended to be sufficient to support a subsistence level of living in old age, this minimum sum can only be accessed at age 65. Increased regularly to keep pace with inflation, it currently stands at $148,000. In July, it will be raised to $155,000.

The key reason many do not have the minimum sum in their retirement accounts is that Singaporeans have committed the bulk of their retirement savings to housing. A study by the author and others, published in the Journal of Pension Economics and Finance in 2008, found that 44 per cent of cumulative CPF savings has been invested in properties.

Little wonder that home ownership in Singapore was remarkably high at 90.5 per cent in 2013, much higher than developed nations such as the United States (66 per cent), the United Kingdom (64 per cent) and Germany (44 per cent).

If these CPF patterns are indicative, it is little wonder Singaporeans feel asset-rich but cash-poor.

A key solution to achieving retirement adequacy in Singapore is therefore to develop a market mechanism to unlock home equity. The announcement in March by the Ministry of National Development to look seriously at a reverse mortgage scheme is certainly the right direction to go.

Another solution is to help CPF members grow their cash savings more rapidly through higher-yielding investment instruments.

CPF Investment Scheme

CURRENTLY, CPF members who are willing to take risks to earn a higher return on the CPF savings can invest their money through the CPF Investment Scheme (CPFIS). This scheme allows them to invest part of their savings in a wide variety of financial instruments that could potentially earn a higher yield than the default CPF interest rates.

While the CPFIS is open to all members, the 2008 study found that only 12 per cent of Ordinary Account (OA) savings and 20 per cent of Special Account (SA) savings were committed to investment. These statistics indicate that the participation rate in CPFIS is low.

Possible reasons for leaving money in the SA include the relatively high guaranteed annual interest rate of 4 per cent, and an unwillingness to risk retirement savings. However, these may not be the only reasons. The research indicated that the reasons for the low investment in professionally managed unit trusts also include poor investment performance, the high fees and transaction costs charged by funds, and a lack of financial literacy on the part of CPF members.

So far, those CPF members who have risked their savings have not done very well. Almost half of CPFIS-OA investors (47 per cent) incurred losses on their investments between 2004 and 2013, while 35 per cent obtained net profits equal to or less than the default OA rate of 2.5 per cent. Only 18 per cent made net profits in excess of the OA interest rate.

Allowing a free rein for CPF members to invest their savings may therefore not help those who lack financial literacy and investment skills. What would help them is professional advice and easy access to financial instruments such as indexed portfolios, life-cycle funds and inflation-protection instruments that do not require much specialised knowledge.

Vulnerable groups

THE 2008 study also used aggregated CPF data to look at the asset allocation decisions of CPF investors. It found that men were more proactive in investing their savings compared to women.

They also tend to invest more in shares and unit trusts than women, who tend to put the bulk of savings in insurance products.

Contrary to the conventional wisdom that investment in risky products should decrease with age, the more mature CPF members (aged 56 and above) tend to invest a higher proportion of their savings in individual stocks compared to those in younger age groups. In addition, younger working adults are more likely to delegate their investments to professional fund managers.

The study also revealed that lower-income earners were less likely to hold risky investments. At least 70 per cent of their investments were committed to insurance products. As salary levels rise, the fraction invested in risky instruments also rises.

The research identified three vulnerable groups of investors requiring special attention. They are women, the aged and low-income CPF members. Women and low-income members need more guidance to select the right financial products to grow their retirement savings. Older members need advice on portfolio rebalancing so that as they age, they reduce their exposure to risky financial instruments, thereby preserving their savings.

Of the numerous funds on offer in the CPFIS, very few are low-cost passively managed index-linked funds.

There are also no target maturity-date life-cycle funds or inflation-protected instruments. Life-cycle funds may appeal to financially less savvy members as these funds automatically rebalance asset allocations between investments such as bonds, shares and fixed deposits as an investor ages.

One possible reason for the low investment in actively managed unit trusts is that CPF members do not know how to evaluate funds for investment. Without guidance from the CPF Board, these members simply leave their savings in the OA or SA accounts.

Apart from CPF deposits, CPF members do not have access to default portfolios. The latter are diversified investments with low transaction costs in which CPF members can automatically invest their monthly contributions without the need for specific purchase instructions.

One reform that the CPF Board could consider is to invite a few large low-cost privately managed life-cycle funds to participate in the CPFIS.

Life-cycle funds are those which reduce investments in risky assets as an investor ages. Inexperienced investors can reap the benefits without having to master the intricacies of finance.

The introduction of diversified low-cost life-cycle funds as well as inflation-protected investment instruments may appeal to many financially illiterate members, thus helping them grow their savings more rapidly.

By pooling members' savings for investments, the CPF board can also help them enjoy lower institutional transaction costs.

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Irrational to expect both low risk and high returns

THE low interest paid on Central Provident Fund (CPF) balances when compared with the relatively high returns earned by government investment entities such as Temasek Holdings and GIC is a common gripe.

CPF members currently have a choice of either investing the savings themselves or leaving them with the CPF Board.

For the former, they can invest in a rich menu of instruments from the CPF Investment Scheme. The latter earns guaranteed interest income.

Since the CPF has a duty to safeguard members' savings, it is prudent for it to purchase low-risk instruments that generate stable cash flows.

The safest instrument without an exchange-rate risk is Singapore government bonds which are rated "AAA". This allows the CPF Board to guarantee interest payments to its members.

When the Government issues bonds, it borrows from the CPF Board. The borrowed funds are then used to finance government expenditures such as building infrastructure, investing in financial markets or some other purpose.

As the Government has been generating budget surpluses over the years, it is assumed by detractors that CPF funds end up with GIC and Temasek which then "exploit" Singaporeans by paying them meagre interest while earning higher returns.

Those who espouse such views clearly do not understand the basics of finance and how financial intermediation works. CPF members' savings in the Ordinary Account (OA) and Special Account (SA) are akin to deposits in banks. Depositors who leave their savings in banks do not demand high returns. Instead, they are willing to settle for very low interest in exchange for security.

They cannot demand the returns earned by banks because they are not the ones putting capital at risk. Similarly, CPF members who leave savings in default accounts consciously choose not to take risk but rather receive tax-free guaranteed interest instead.

Even if it is possible for them to purchase equity shares in GIC and Temasek through the CPF Investment Scheme as postulated by some, they need to ask themselves if they are prepared to risk losing a substantial portion of their life-time savings in a market downturn.

For example, during the global financial crisis in 2008, almost all professionally managed funds and sovereign wealth funds lost money. Such an investment strategy is certainly not prudent for CPF members, especially when market crashes can occur in the year in which they retire.

What about those who insist on having guaranteed safety of CPF savings as well as the high returns that come with risk taking?

Well, they are simply being irrational. No financial investments can deliver what they desire.

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