



Sustainable income in retirement

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One of the toughest financial planning tradeoffs is ensuring that retirees' post-retirement income is sustainable over the full period of retirement, without compromising more than is necessary on living standards in the first half. A task that is further complicated by the prevailing expected low-return environment – local interest rates are at their lowest in 40 years and local growth assets are fairly fully priced. Added to this is the scarcity of capital available for the task as most South Africans did not save enough during their working life to comfortably sustain their living standard through retirement. This article focuses on the key risks facing retirees, looks at the current state of the retirement income market and proposes three strategies that can be used to manage the tradeoffs that many retirees need to make.

Key risks facing retirees

■ Inflation risk

If you assume that prices will increase by on average 6% per year, you will need R1 800 in 10 years' time and R3 200 in 20 years' time to buy the same basket of goods and services that R1 000 buys today. You therefore need to ensure that your future income stream can keep pace with inflation. In our view, one of the best ways to do this is to have adequate exposure to growth assets in your retirement funding portfolio.

■ Sequence-of-returns risk

If you draw an income from your portfolio, you need to avoid big market losses early in your planning horizon. If you were unlucky enough to retire at the start of 2008 and invested all your capital in the equity market, you would have lost 23% of your investment after just 12 months. When you add in an income withdrawal of 5% – 6% and 1% – 2% in fees,

your retirement income plan would have been impaired by a massive 30%, permanently reducing the level of sustainable income over your entire retirement. What this means is that you can't afford to have too much exposure to growth assets so as to minimise the risk of short-term losses.

These two risks can, to a large extent, be managed by investing in an appropriately constructed portfolio, one that has the right balance between income and growth assets to achieve the dual objectives of reasonable growth after inflation (over the longer term) and preserve capital (over the short term). Refer to the descriptions of the Coronation Capital Plus and Balanced Defensive funds on page 34 for examples of funds managed to meet these objectives.

■ Longevity risk

The average South African retiring in their early 60s can expect to live for another 20 years. It follows that half of retirees will live longer and half less than the 20-year average. The problem, in a planning context, is that most people do not know in which half they will fall. Consequently, if you want to fund your income from a market-linked portfolio, it is not prudent for the average retiree to assume a planning horizon of less than 30 years.

Current market preferences

Retirement savers currently have two main options to provide a post-retirement income: a market-linked income withdrawal plan (most often called a living annuity) or a guaranteed annuity underwritten by a life office. If the 30-year planning horizon justified above sounds unpalatable, guaranteed annuities provide an alternative approach to managing longevity risk. In these products you transfer the risk of living longer than average to a life office, where the

excess contributions made by those living less than the 20-year average funds the additional income needed by those who live longer. A key feature of guaranteed annuities is that the underlying investment portfolios are invested in income assets only. This renders them an unpopular choice at the moment.

Statistics recently released by the Association for Savings and Investment SA (ASISA) indicate that of the R31 billion of capital used to buy a retirement income in 2011, nearly R27 billion was invested in market-linked living annuities, while only slightly more than R4 billion was invested in guaranteed annuities. Although we believe that this preference is rational given the historically low levels of interest currently prevailing, it does mean that the majority of existing retirees are taking on longevity risk.

A more concerning aspect of the ASISA statistics is that just more than half of retirees under the age of 70 are currently drawing 7.5% (or more) of their capital as income. We believe that for these withdrawal rates to be sustainable you need to make some heroic assumptions about future returns, as it implies that net real rates of return in excess of 7% are expected to be earned. The table shows the number of years that a specific income level can be sustained at different initial withdrawal rates, given different rates of return after inflation and costs.

	Drawing 7.5% income	Drawing 5% income
If you earn a net real return (after inflation and costs) of...	... you can maintain purchasing power for	... you can maintain purchasing power for
2%	9 years	19 years
3%	11 years	24 years
4%	12 years	34 years
5%	15 years	40+ years
6%	20 years	40+ years
7%	23 years	40+ years

Source: ASISA Standard on Living Annuities.

Assumptions: Assumes constant annual inflation adjustments, an inflation rate of 6% and a maximum withdrawal rate of 17.5% of capital.

Given that we expect a more realistic net real return expectation range for an income and growth portfolio of 3% – 5%, we conclude that the maximum initial withdrawal rate that can be sustained over the full retirement horizon for a healthy 60-something retiree is 5%.

Strategies for managing the tradeoff between current lifestyle and income sustainability

Retirees with inadequate capital to prudently sustain their desired income level can optimise the tradeoffs between current and future lifestyle requirements by considering the applicability of the following strategies:

■ Using spending rules

This approach requires that you start with a conservative withdrawal rate (e.g. 5%) and only increase in any given future year if the actual return and inflation experience over the elapsed investment period was positive. If you are lucky enough to have experienced high returns and low inflation, this enables you to increase the rate of current income without compromising the sustainability of future income. This approach works well for timing large discretionary spending items (e.g. travel and capital acquisitions). If this approach is applied consistently during the first decade of retirement, studies show that a somewhat higher ($\pm 1\%$), albeit more variable, withdrawal rate can be sustained over retirement.

■ The benefit of delay

If you can delay retirement by three years, you are likely to increase your sustainable initial withdrawal rate by around 20% without contributing additional capital to your retirement pot. This can be achieved because you now have a slightly shorter planning horizon, and this is based on the assumption that you have earned a net real return of 4% p.a. over the period of delay while avoiding an annual withdrawal in the 5% – 7% range.

■ Planning for declining spend

A recent US study showed that the average 75 year old spends 40% less than the average 55 year old and 20% less than the average 65 year old. If you explicitly plan for declining expenditure through the different phases of retirement, you can justify increasing the initial withdrawal rate by 1% – 2%. This strategy has the potential to work well, particularly if adequate provision has been made for late-life medical costs.

Existing retirees with potentially unsustainable withdrawal rates should, together with their advisors, actively engage with the tradeoffs that they need to make to improve the likelihood of reasonable outcomes. It is highly unlikely that kicking the can down the road while hoping for the best will be an approach that will deliver good results.

National Treasury recently released four technical discussion papers expanding on the proposals contained in its May 2012 paper 'Strengthening Retirement Savings'. These papers are subject to public consultation through October and November 2012. One paper, 'Enabling a Better Income in Retirement', proposes far-reaching policy interventions to make the post-retirement income market more sustainable.

These proposals include:

■ More automation

Retirement fund trustees may in future be required to provide their retiring members with a default annuity option. The intention with this reform proposal is to ensure that the fiduciary duties of trustees are extended into the post-retirement period, reducing the necessity for fund members to obtain advice in the retail market. National Treasury's hope is that this will make retirement income outcomes more efficient and reduce costs for retirees.

■ Enforced longevity protection

Given the current market preference for market-linked income plans and the high withdrawal rates selected by investors in these plans, there is a significant risk for many pensioners that retirement income may not be sustained over the full retirement horizon as previously described. To address this, National Treasury proposes that the first R1.5 million of capital available to purchase a retirement income be invested in an income plan that provides some form of longevity protection. The nature of this longevity protection is still up for discussion.

■ Making existing market-linked income plans more efficient

The key proposed interventions affecting existing market-linked income plans are:

- introducing age-dependent income withdrawal limits (younger pensioners will be allowed lower withdrawals than older pensioners, compared to the current standard 17.5% cap applicable to all age groups);
- reducing investment choice, as National Treasury's belief is that this will reduce costs;
- limiting payments for advice that can be made from within the income plan.

While Coronation broadly agrees with National Treasury's diagnosis of the current challenges, we are not in total agreement with the treatment programme. We will therefore be using the public consultation process to ensure that the proposals are implemented in a manner that is consistent with current market infrastructure to reduce implementation risk, and to minimise unintended consequences. More information on the final shape of the reforms and implementation timetables will be provided as they become available. We do not expect any major changes to the structure of the market before 2014 at the earliest. 