Will you outlive your retirement capital?

Solving the Retirement Riddle

For many years investors have enjoyed the benefits of local investment markets which have delivered returns far in excess of more conservative and 'normalised' financial planning budgets. Money market – the lowest risk asset class - has beaten inflation by 4% per year, for 25 years! Local equities have delivered almost 9% in excess of inflation, property more than 12%! Which makes the more recent market returns somewhat sobering: negative real returns in 2016 for the average balanced fund, and only inflation matching returns for the past three years.

For investors in retirement these lower returns have started to cause real concern: will their retirement capital be sufficient to last their lifetime?

The boom years made it relatively easy to sustain higher lifestyles and levels of drawings from portfolios, typically out of a living annuity (where the investor takes the risk on the longevity of their capital). High returns hid the fact that the majority of retirees were under saved, overdrawing, or both. As it stands the average living annuity drawing rate in SA is about 6.5% per year, in excess of the recommended guidelines.

While the bust years were short (1998, 2000, 2008), the more troubling times have come recently in sideways moving markets, driven by a strong currency, expensive equity markets and a depressed global economy. Quite quickly, the income drawdown equation looks something like this:

	Low risk in-retirement portfolio		
	Past 'Outsized returns'	Current 'Low Returns'	Future 'Normal Returns'
% of capital drawn per year	(6.0%)	(6.0%)	(6.0%)
Nominal Investment Returns	14.0%	6.0%	9.0%
Investment Costs	(2.0%)	(2.0%)	(2.0%)
Inflation	(6.0%)	(6.0%)	(6.0%)
Real Capital growth/erosion per year	(0.0%)	(8.0%)	(5.0%)
Result	Capital Preservation in real terms	Capital Exhausted	Capital Exhausted

Table 1: Illustration of the impact on real investment capital

It is clear to see that this combination of income drawings and investment returns is not sustainable. This highlights the need for an investment plan in retirement which balances the competing forces of income generation, with the capital growth required to offset costs and inflation.

Identifying the common problems of investing in retirement

Problem # 1 is the income vs growth conundrum. These are diametrically opposed objectives. High income = lower capital growth in most cases, and vice versa. Solving this balance is a critical aspect of a retirement income plan.

Problem # 2 is referred to as sequencing risk. This is the risk that arises because investment returns are not earned in a straight line. Two similar investors, one retiring just prior to the financial crisis in 2008, the other just 12 months later at the start of the bull market, will have experienced materially different outcomes with respect to the longevity of their capital, simply because they retired at different times. The first investor would be drawing income into a falling market, forcing them to lock in capital losses. The second investor would be receiving capital gains in addition to income generated with the result that their capital longevity was substantially longer.

Sequencing risk is potentially the most unnerving for investors – the fear of retirement capital being scuppered through a local or global investment crisis. This risk causes retirement portfolios to be too conservative, ironically locking in the capital erosion the investor is so aware of.

Problem # 3 is human psychology. For the past 25 years investors, have taken relatively little risk to enjoy outsized returns. Looking forward – with more normal assumptions of market returns - this conservative strategy is highly likely to expedite the erosion and permanent loss of retirement capital due to the high level of drawings and associated investment costs. Investors simply are not built to take higher levels of investment risk in retirement, evidenced by the recent Sanlam survey indicating over 80% of investors would prefer certainty of income in retirement.

Problem # 4 is the relatively high level of drawings prevalent in the industry. This is also a symptom of a poor savings culture in general, and is also tied to Problem # 3 above.

What are the potential solutions?

Investors essentially have three options to mitigate these problems and to align their in-retirement investment portfolio with a sustainable lifestyle.

The first is the old-school life or guaranteed annuity. Interestingly these are making a comeback as investors reach for certainty amidst poor market returns. Secondly you have a 'total return' strategy, which balances the competing requirements of income and growth in a single investment solution; and thirdly you have an income based strategy designed to link capital drawings in retirement to portfolio income generated, with limited capital reliance.

Each of these options have strengths and weaknesses, and it may be that a combination of all three is the most suitable for certain investors. A comparison of options is shown below.

Annuity Type	What is it?	Who takes the risk?	Pro's	Con's
Life / Guaranteed Annuity	Income stream until death provided by an insurance policy.	Life Company/ Insurer	Guaranteed; no market risk	Capital dies with you and is not passed on to your beneficiaries; no growth upside
Total Return based Living Annuity	Balanced portfolio designed for investors in retirement.	Investor	Diversified across a wide range of instruments and asset classes	Broad, poor market returns for sustained periods.
Income based Living annuity	Equity, property or balanced portfolio optimised for higher levels of income generation	Investor	Growing income stream generated which covers a substantial part of the income drawdown	Investments concentrated in a narrow range of assets = less diversification

Table 2: Comparison of annuity options in retirement

In theory it is difficult to grasp when each of these may be appropriate solutions, so it helps to illustrate by way of practical examples.

	Risk / Scenario					
Annuity Type	High Future Inflation	Strong Market Returns	Weak Market Returns	Elevated Market Valuations	Market crash!	Under saved
Life / Guaranteed Annuity	Poor solution unless the annuity is CPI linked	Poor solution no market participation	Good solution no exposure to market returns	Good solution no exposure to market returns	Good solution no exposure to market returns	Poor solution potential to enhance real capital value over time is limited
Total Return based Living Annuity	Good solution diversified asset classes indirectly inflation linked	Good solution moderate exposure to growth assets	Poor solution mitigated via diversity and fund mix	Poor solution mitigated via diversity and fund mix	Poor solution mitigated via diversity and fund mix	Good solution potential for enhancement of real capital value
Income based Living annuity	Good solution income linked to inflation	Good solution moderate to high exposure to growth assets	Poor solution mitigated via income coverage	Poor solution mitigated via income coverage	Poor solution mitigated via income coverage	Good solution potential for enhancement of real capital value

Table 3: Illustration of suitability of annuity options

What is clear is that the old school life annuity has a place – particularly where market risks are currently high, or where prospective returns are low. Total return strategies offer the best diversified mix of assets, but rely more heavily on capital returns to come through over time which exposes the investor to sequence risk (which can be mitigated in various ways); and the Income approach hedges much of the sequencing risk but exposes the investor to the fact that the underlying investment portfolio is less diversified and exposed to acute capital losses.

The more recent industry products which combine these options appear therefore to make intuitive sense, but it remains up to the adviser and the investor to decide how and where to allocate between the options.

The only option within the investors control is the level of income they draw. For investors pre-retirement, the focus on building retirement capital needs to be a priority, and given future expectations, will be harder to come by than it has been for the past 25 years. Best start saving then…

31 March 2017

Sector		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol[1]	10yr Vol[1]
LOCAL MARKET INDICES (In Rands)									
FTSE/JSE All Share Index (ALSI)	ZAR	3.8%	3.8%	2.5%	6.0%	12.5%	9.8%	10.5%	15.1%
FTSE/JSE SA Listed Property	ZAR	1.4%	1.4%	1.5%	14.5%	15.8%	14.2%	14.4%	15.4%
SA All Bond Index (ALBI)	ZAR	2.5%	2.5%	11.0%	7.5%	7.4%	8.1%	7.9%	7.5%
SA Cash Index (SteFI)	ZAR	1.9%	1.9%	7.6%	6.8%	6.2%	7.3%	0.3%	0.6%
Balanced Benchmark [2]	ZAR	3.1%	3.1%	3.5%	8.1%	12.9%	10.4%	6.2%	6.2%
SA Inflation (1 month lag)	ZAR	2.1%	1.7%	6.3%	5.7%	5.8%	6.3%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	6.4%	6.4%	14.8%	5.5%	9.4%	4.2%	11.0%	16.5%
Emerging Markets Equity (MSCI EM)	USD	11.4%	11.4%	17.2%	1.2%	0.8%	2.7%	15.3%	23.5%
Global Bonds (Barclays Global Bond Index)	USD	1.8%	1.8%	-1.9%	-0.4%	0.4%	3.3%	4.6%	5.9%
Global Cash	USD	0.2%	0.2%	0.7%	0.3%	0.3%	1.0%	0.1%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	3.8%	3.8%	2.5%	6.0%	12.5%	9.8%	10.5%	15.1%
Global Equity (MSCI World)	ZAR	4.3%	4.3%	4.6%	14.4%	22.3%	10.8%	13.3%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	9.3%	9.3%	6.9%	9.7%	12.7%	9.2%	12.1%	15.8%
SA All Bond Index (ALBI)	ZAR	2.5%	2.5%	11.0%	7.5%	7.4%	8.1%	7.9%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	-0.2%	-0.2%	-10.6%	8.0%	12.2%	9.9%	12.5%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	7.2%	7.2%	1.3%	-1.2%	-5.5%	6.5%	17.0%	19.3%
Gold (Rands)	ZAR	1.2%	1.2%	-11.1%	5.7%	4.8%	12.8%	18.6%	21.8%
Currencies (positive return = Rand weakening)									
Rand / Dollar	ZAR	-2.4%	-2.4%	-9.2%	8.4%	11.8%	6.3%	14.1%	16.5%
Rand / GBP Pound	ZAR	-0.9%	-0.9%	-20.8%	-1.4%	6.5%	1.7%	14.2%	15.3%
Rand / Euro	ZAR	-1.0%	-1.0%	-14.6%	-0.4%	7.0%	4.0%	12.9%	13.8%

Spot Rates

			31-Mar-17	4-Apr-17 Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
Currencies	Rand/US$	Rand	13.53	13.68	15.50	8.07	7.05	4.68
	Rand/GBP	Rand	16.84	16.88	23.11	12.52	13.80	8.01
	Rand/EUR	Rand	14.42	14.42	16.83	10.48	9.30	NA
	Rand/Aus $	Rand	10.31	9.92	11.27	8.27	5.53	3.72
Rates	Libor 6m $	US$	1.43	1.32	0.85	0.81	5.37	5.60
	Repo Rate	Rand	7.00	7.00	6.25	5.50	9.00	NA
	Prime	Rand	10.50	10.50	9.75	9.00	12.50	20.25
	All Bond Index Yield	Rand	9.44	9.39	10.11	8.12	NA	NA
Commodities	Gold ($/oz)	US$	1,256.81	1,157.49	1,062.38	1,574.57	634.50	369.65
	Palladium	US$	806.00	670.00	555.00	630.00	324.00	116.50
	Platinum	US$	958.00	898.00	868.00	1,354.00	1,117.00	369.50
	Oil (Brent Crude) $	US$	54.13	56.71	35.70	108.28	59.44	23.99
Inflation	SA Inflation	Rand	NA	6.72	5.28	6.15	NA	NA

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