

Adapting Living Annuity Drawdown rates in a low – return environment

After years of saving for retirement, investors and their financial advisers are faced with one of the most important retirement planning questions - “what is the maximum I can draw from my investment portfolio to ensure I do not run out of money?” Most of the research around this question states that the answer to this question lies in accurately determining your *initial withdrawal rate*, which is defined as the Rand amount withdrawn divided by your investment portfolio value, and how you increase your income year on year. In a high return environment, like we have seen in South Africa over the past 20 years, there has been less focus on the initial withdrawal rate as investment returns have generally been more than the income drawn. However, we currently find ourselves in a low return environment which has caused some anxiety amongst investors as they are starting to see their annual income exceeding the investment returns.

The challenge that needs to be resolved when selecting this initial rate is that we want to achieve three objectives; *select a sustainable rate that will allow us to grow or at least preserve our capital whilst also improving our standard of living over the years*. In South Africa, the average annual percentage draw is about 6.5%, however most of the research recommends 5% as a maximum.

In practice, there are several ways to determine this withdrawal rate however in this article, we will look at the most common methods seen in the market and show how introducing certain spending rules can benefit your retirement.

Most common practices seen in the market

As mentioned above there are several different methods when it comes to selecting your initial and ongoing withdrawal rate, however there are two strategies that are the most common in the market.

Inflation adjusted method

In this method, the financial adviser and client calculate a sustainable annual rand amount needed by the client in Year 1 of retirement, and use that as the initial withdrawal amount. This amount is then increased every year by inflation to ensure the purchasing power of the client’s income remains constant. For example, if a client retired with an amount of R5 million and the calculated rand amount needed in Year 1 of retirement was R250 000 per annum, assuming 6% inflation, the rand amount would increase by R15 000 ($R250\,000 \times 6\%$), for the following year the annual income would be R265 000. The advantage of this method is that the real level of income is maintained year on year, however because the annual income is only linked to inflation and not the underlying performance of the investment portfolio the capital value might be at risk in a consistent period of lower than inflation returns.

Fixed Percentage method

With this method, the annual withdrawal amount is determined by taking a fixed percentage of the value of the investment portfolio at the beginning of every year. If we use the same example as above, the client retires with R5 million, and the client and adviser decide to draw 5% of the value of the portfolio each year. This would mean in Year 1 the client would draw R250 000, however to determine the income in Year 2 we do not increase the income by inflation but take 5% of the value of the portfolio at the time of selecting the new income, the rand amount withdrawn will be affected by the underlying performance of the investment portfolio. This would mean that the level of income would be more variable than the *Inflation adjusted method*. This variability creates anxiety among retirees as they can never be sure what their next year’s income will be which makes planning and budgeting more difficult. For example, if the portfolio generated an 15% return in Year 1 the income in Year 2 would be R275 000, however if it generated -5% return you would have had a reduction as the income would be R225 000. As previously mentioned the South Africa market has seen strong performance for the last 20 years and investors have therefore not experienced many periods of negative returns.

So, which one then is the better method?

To answer this question, we have compared the two methods over the last 20 years. We have used the actual performance of a representative portfolio for a living annuity portfolio. In the example, the client retired 20 years ago with R1 million (R4.5 million in today's money). The annual income drawn in the first year was R50 000 or 5%. As we can see below, after 20 years a client that applied the 'Inflation adjusted' method would be in a better capital value position than the client that used the 'Fixed Percentage' method.

	INITIAL ANNUAL INCOME	CAPITAL VALUE AFTER 20 YEARS
INFLATION ADJUSTED	R 50 000	R 3 500 029
FIXED PERCENTAGE	R50 000 (5%)	R 3 213 598

The reason for the difference is that by selecting to increase your annual income by a fixed percentage every year you will end up increasing your annual income by more than you require (inflation) after a year of higher than inflation performance. Figure 1 illustrates this. This means that in these years you will be drawing an income that is above the real income you require (this is calculated as the initial rand amount needed increased by inflation). Therefore, any excess return generated which should have been used to supplement the years following weak performance has already been spent.

Annual Income Drawn

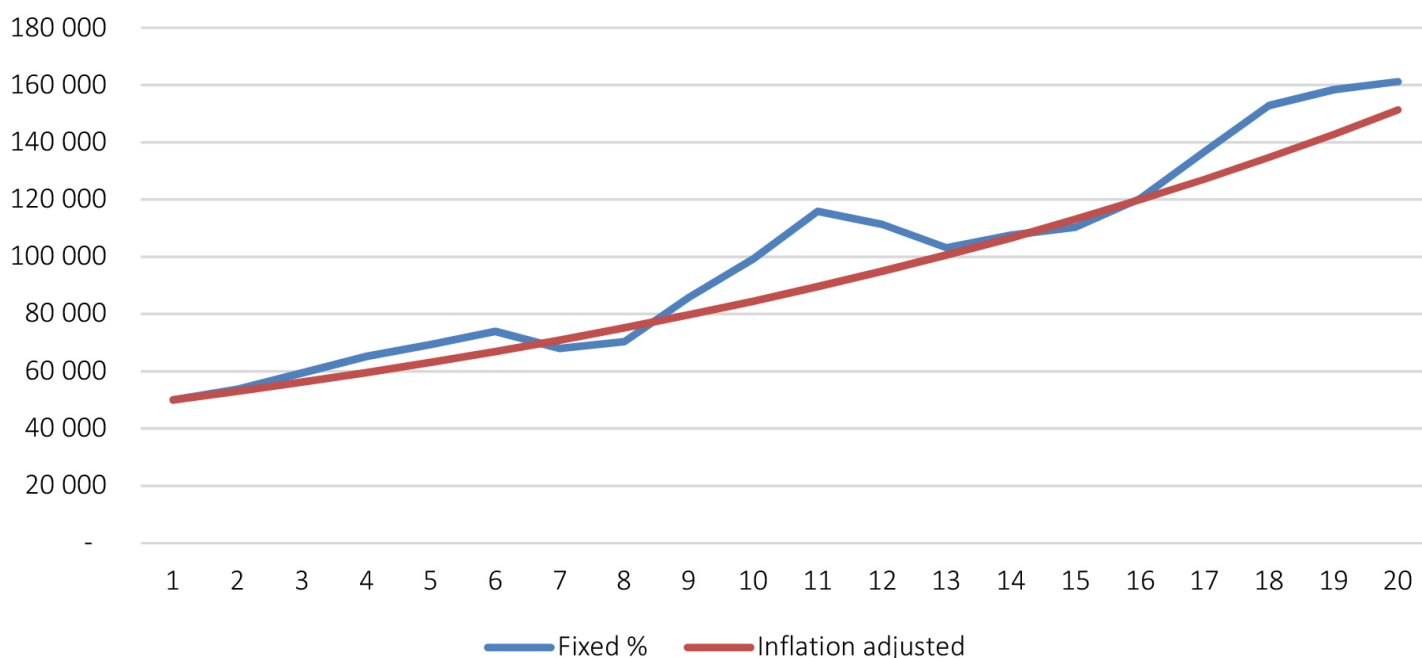


Figure 1: Annual income drawn

Modified inflation adjusted method

The above example clearly shows that the 'Inflation adjusted' method is the more favourable method when selecting the annual income drawn. Both in terms of capital value and the predictability of your annual income. However, because the increases are only linked to inflation every year and not the underlying performance of the portfolio you will never get an 'income raise'. Therefore, because one of the objectives we have is to improve your standard of living we have listed three additional spending rules that you can implement that consider the portfolio returns which will give you an above inflation increase when the portfolio returns allow for it:

1. If your previous year's return was negative you do not increase your annual income.
2. If the previous year's return was larger than 0% but less than inflation plus 4% you increase your income by inflation.
3. However, if your previous year's return was bigger than inflation plus 4% you increase your income by inflation plus 2%

Looking at how this method compares to the *inflation adjusted* method we can see that the returns for the past 20 years would have allowed the client to increase their income by more than inflation in certain years. This meant that although the capital value would have been less the total income drawn over the period was more and therefore allowing the client to improve their quality of life.

	TOTAL INCOME DRAWN	CAPITAL VALUE AFTER 20 YEARS
INFLATION ADJUSTED	R 1 839 280	R 3 500 029
MODIFIED INFLATION ADJUSTED	R 1 957 240	R 3 247 227

In summary, all three methods have their own advantages and disadvantages, and each method will have certain market conditions that will suit it. However, in a lower return environment, like we have seen over the past few years we feel that being prudent in terms of spending is crucial. We feel that the last method finds the balance between being prudent when drawing an income, allowing you to sustainably increase your income, and giving you a more predictable annual income.

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AUG INVESTMENT 2017 REVIEW

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data provided by Profile Data Analytics, Reuters and Datastream

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol ¹	10yr Vol ¹
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	6.0%	13.6%	10.1%	6.6%	13.1%	10.2%	10.8%	15.3%
FTSE/JSE SA Listed Property	ZAR	4.8%	6.9%	9.4%	13.0%	11.7%	14.6%	13.6%	15.2%
SA All Bond Index (ALBI)	ZAR	1.6%	6.7%	10.2%	6.7%	6.3%	8.6%	7.7%	7.5%
SA Cash Index (SteFI)	ZAR	1.9%	5.0%	7.7%	7.0%	6.4%	7.2%	0.3%	0.6%
Balanced Benchmark ²	ZAR	4.1%	10.0%	7.3%	8.1%	12.5%	10.7%	6.9%	6.9%
SA Inflation (1 month lag)	ZAR	0.8%	3.2%	4.5%	5.2%	5.6%	6.0%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	2.9%	13.5%	16.2%	5.9%	11.1%	4.5%	9.9%	16.5%
Emerging Markets Equity (MSCI EM)	USD	9.4%	28.3%	24.5%	2.4%	5.3%	2.4%	14.6%	23.4%
Global Bonds (Barclays Global Bond Index)	USD	2.6%	7.2%	0.2%	0.7%	0.9%	3.6%	4.7%	5.9%
Global Cash	USD	0.3%	0.7%	0.9%	0.5%	0.4%	0.8%	0.1%	0.4%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	6.0%	13.6%	10.1%	6.6%	13.1%	10.2%	10.8%	15.3%
Global Equity (MSCI World)	ZAR	1.5%	7.8%	2.6%	13.2%	21.2%	10.9%	13.3%	13.8%
Emerging Markets Equity (MSCI EM)	ZAR	7.8%	21.9%	10.0%	9.5%	14.8%	8.7%	12.2%	15.7%
SA All Bond Index (ALBI)	ZAR	1.6%	6.7%	10.2%	6.7%	6.3%	8.6%	7.7%	7.5%
Global Bonds (Barclays Global Bond Index)	ZAR	1.1%	1.9%	-11.5%	7.6%	10.0%	10.0%	11.7%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	3.6%	14.5%	0.2%	1.7%	1.0%	0.5%	10.7%	7.5%
Gold (Rands)	ZAR	2.1%	9.0%	-11.5%	8.7%	5.1%	2.5%	11.8%	8.3%
CURRENCIES									
Rand / Dollar	ZAR	1.1%	5.5%	12.6%	-6.5%	-8.3%	-5.8%	13.0%	15.9%
Rand / GBP Pound	ZAR	1.0%	6.2%	14.8%	1.7%	-4.4%	-1.5%	14.5%	15.5%
Rand / Euro	ZAR	-4.4%	-6.2%	5.9%	-3.2%	-7.2%	-4.5%	12.4%	13.7%
LOCAL UNIT TRUST SECTORS									
SA Equity - General	ZAR	3.1%	7.5%	4.4%	4.0%	10.2%	8.2%	9.2%	12.4%
SA Multi Asset - High Equity	ZAR	2.1%	6.4%	3.7%	5.7%	9.7%	8.2%	6.0%	7.1%
SA Multi Asset - Low equity	ZAR	1.8%	5.5%	4.8%	6.5%	8.2%	7.9%	3.3%	3.6%
SA Real Estate - General	ZAR	3.1%	5.6%	7.2%	11.6%	10.9%	13.0%	11.8%	13.2%
Global Equity - General	USD	2.6%	12.8%	14.3%	3.8%	8.7%	2.1%	10.0%	16.3%
Global Multi Asset - High equity	USD	2.5%	10.5%	10.8%	3.0%	6.8%	3.2%	7.7%	12.4%
Global Real Estate - General	USD	3.3%	7.7%	-0.5%	1.5%	4.4%	1.1%	10.9%	21.3%

Spot Rates		1-Sep-17	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US\$	Rand	12.9	13.1	14.6	8.2	7.1	4.5
Rand/GBP	Rand	16.7	17.0	19.7	12.8	14.2	7.5
Rand/EUR	Rand	15.3	14.9	16.3	10.4	9.5	NA
RATES							
Libor 6m \$	US\$	1.5	1.4	0.9	0.7	5.4	5.9
Repo Rate	Rand	6.8	7.0	7.0	5.5	9.5	NA
Prime	Rand	10.3	10.5	10.5	9.0	12.5	20.3
All Bond Index Yield	Rand	9.3	9.5	9.3	7.6	NA	NA
COMMODITIES							
Gold (\$/oz)	US\$	1,321.9	1,243.5	1,321.1	1,597.4	649.7	334.6
Platinum	US\$	999.0	922.0	999.0	1,428.0	1,279.0	430.0
Oil (Brent Crude) \$	US\$	52.8	47.8	49.6	95.4	71.0	18.6
INFLATION							
SA Inflation	%	NA	5.1	6.3	5.5	5.8	9.4

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