Pieter Hugo
Chief Client and Distribution Officer

Table Talk

Key take-aways

- The choice of retirement vehicles is largely guided by an investor's income needs: should you lock in a perpetual, guaranteed income that rises with inflation (but cannot be changed) with a guaranteed life annuity, or take a chance and hope for higher returns by accepting what the markets deliver with a living annuity?
- A guaranteed life annuity is typically more expensive and leaves no inheritance, but it avoids investment risk (should your market returns be inadequate), sequence risk (should market losses be timed inconveniently) and longevity risk (should you outlive your income). All of these are assumed by the life assurer, so you'll never have to worry about receiving a minimum income.
- The investor assumes all the above risks with a living annuity, but it is generally cheaper, offers upside to your income when markets rally, and any remaining value is passed to beneficiaries. It is also more flexible; you can adjust your underlying investments and your drawdown levels regularly.

Q **I'm about to retire and I'm concerned that my retirement savings won't be sufficient to draw a sustainable income for the rest of my life. I'm considering using my retirement benefit to purchase either a guaranteed life annuity or a living annuity. What are some of the main factors I should consider before deciding on which product to purchase?**

A

Introduction

Good question. Many South Africans find themselves facing a similar dilemma. In fact, a recent study found that 90% of South African retirees are unable to maintain their current standard of living when they retire. Unfortunately, it's often only at the point of retirement when investors realise that they have insufficient capital, which also happens to be a time in the lifecycle when there are fewer options available to recover from a capital deficiency.

The decisions you make today could therefore have a significant impact on the quality of the remainder of your life. For this reason, we strongly encourage seeking the advice of a good independent financial adviser to help you structure a sound retirement plan. To help facilitate this discussion and give you some insights into the main choices available to you at retirement, we've highlighted some key features of the two post-retirement vehicles you mentioned, as well as the various factors that you'll need to consider when deciding on which option to choose.

Option 1: A guaranteed life annuity

The main benefit of a guaranteed life annuity is that it offers longevity insurance. This means that when you retire you will receive a regular income that is guaranteed to continue for the rest of your life. When purchasing a guaranteed life annuity, you essentially "hand over" your retirement savings to the life insurer. The life insurer then carries the risk of you outliving your capital. Another major benefit is that the life insurer assumes all the investment risk, which includes the risk of low growth on your underlying assets, as well as sequence risk, both of which we explain in more detail below.

In terms of disadvantages, arguably the most notable drawback is that there is no capital payable to your beneficiaries in the event of your death. This can be mitigated by either taking out a joint-life annuity (which is payable until the death of the last joint-life) or by adding a guaranteed term to your annuity income, whereby if you die within a specific period your spouse or nominated beneficiary will receive a regular income for the remainder of that term. Adding these options increases the cost of the annuity, and they are effectively funded by reducing your monthly income.

Another disadvantage is that your income amount is fixed, which means you do not have the flexibility of changing it in the future if your financial situation changes. There is also the risk that pensioner inflation could increase above the annual increase option that you selected when purchasing your policy. This typically relates to costs associated with old age, such as unexpected medical expenses.

Option 2: A living annuity

A defining feature of a living annuity is its flexibility. You have full control in selecting the underlying assets that you invest in, and the value of your investment is directly linked to the performance of your chosen underlying assets. This is particularly beneficial if you're looking to grow your post-retirement capital over time. Unlike pre-retirement investments, your asset allocation is also not restricted by Regulation 28 of the Pension Funds Act, which means that your portfolio can hold more than 75% in equities or more than 45% offshore. In terms of your income rates, you also have the flexibility to draw an income of between 2.5% – 17.5% p.a., which you can change once a year on the anniversary of your investment. In the event of your death, the balance of your remaining capital can be paid to your nominated beneficiaries – which is especially attractive for those wanting to leave behind an inheritance for their loved ones.

Arguably, the main disadvantage of a living annuity is that you take full responsibility for all associated risks. Your ability to draw an income lasts for as long as you have sufficient capital (longevity risk). Because your investment is market-linked, the value could go down in periods of poor market performance (investment risk). Another risk is the possibility of drawing an income during a depressed market, which could potentially erode the value of your capital over time (sequence risk). If the rate at which you draw an income exceeds the growth of your underlying investment, you run the risk of eroding your capital and running out of money before you die. Your annual income might also not be able to keep up with inflation.

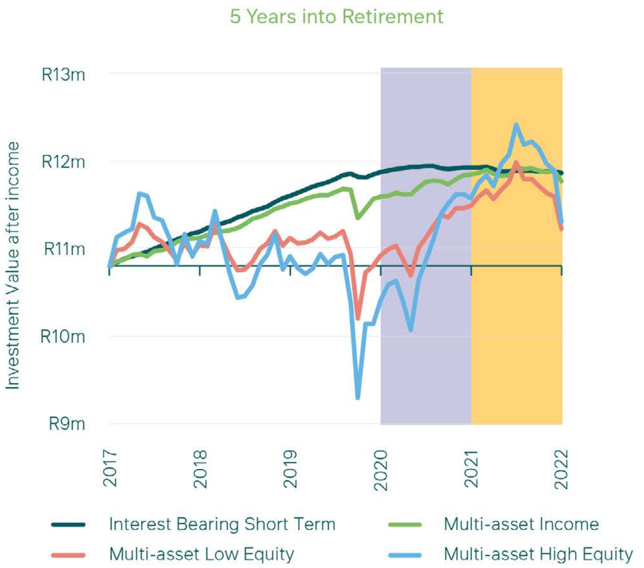
Choosing the right asset allocation for your living annuity investment

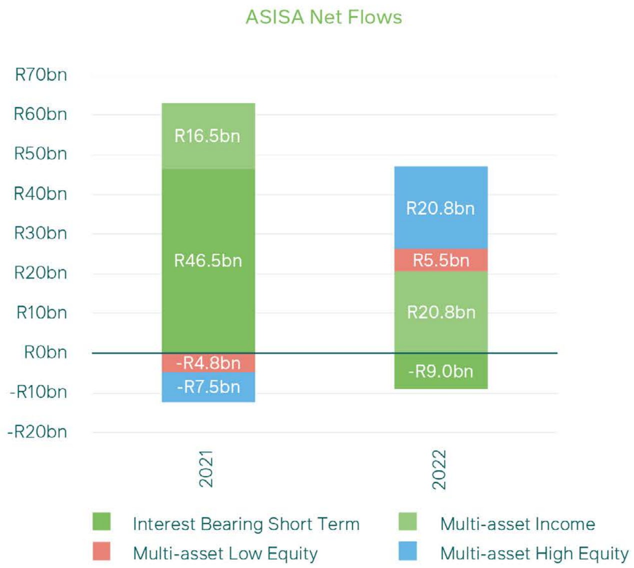
If you decide to incorporate a living annuity into your post-retirement plans, you'll need to ensure that you have sufficient exposure to growth assets (particularly equities) to help reduce longevity risk. When holding equities, it's important to understand exactly how this asset class works, particularly regarding short-term volatility. Being able to tolerate volatility is vital to mitigate the impact of poor investor behaviour, which involves buying and selling assets at the wrong time, thereby eroding future returns and negatively impacting your future income stream.

To demonstrate this, Graph 1 shows the average performance of multi-asset and interest-bearing funds over the past five years.

Graph 1: Investors chasing the best short-term performance

Investment value after income





Based on a 75% replacement ratio = 4.5% drawdown rate
Source: Morningstar and ASISA

From this, we can see that investments with a higher weighting to equities were significantly more volatile compared to other asset classes. When comparing the ASISA net flows into the various funds over this period (the bar graph on the right-hand side), a few observations become apparent:

- In the period after higher-equity investments **underperformed** (the purple-shaded area), investors switched out of their higher-equity investments in favour of fixed-income investments that had better short-term performance (the green shaded bars of the ASISA Net Flows graph on the right-hand side).

- In the period after higher-equity investments **outperformed** (the yellow-shaded area), investors switched out of their fixed-income investments in favour of higher-equity funds that had better short-term performance (the blue and pink shaded bars of the ASISA Net Flows graph).

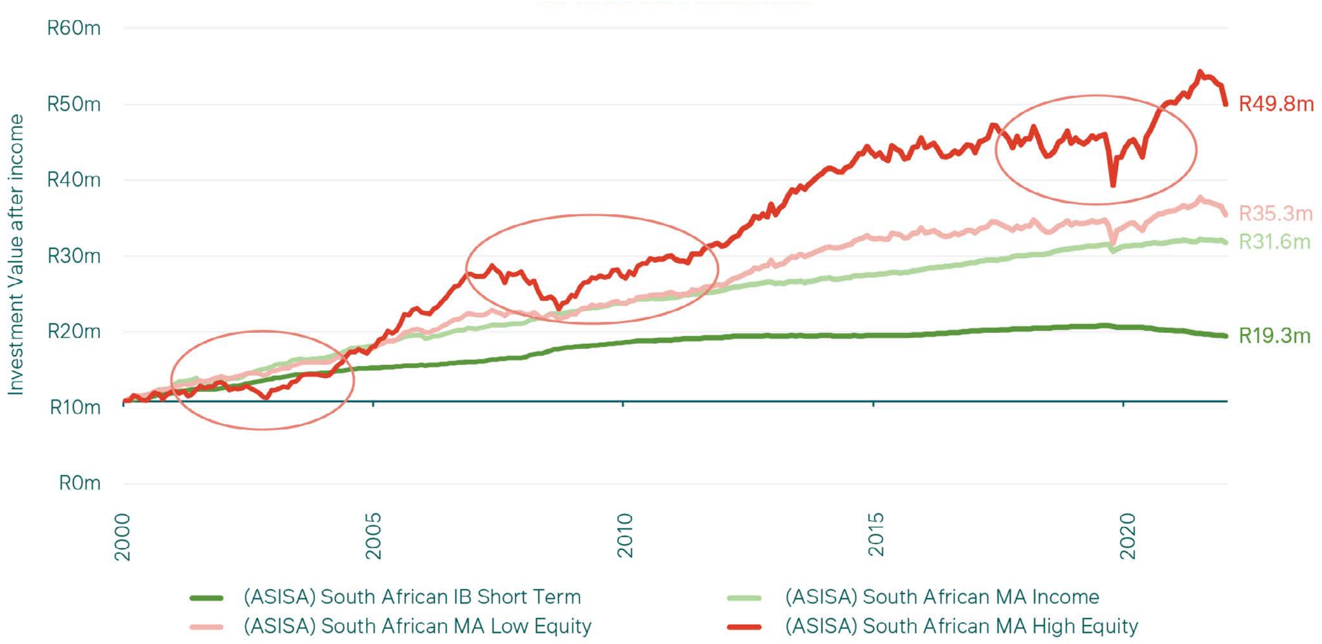
This shows how investors effectively chased short-term performance with the hope that it would continue into the future, instead of sticking to their long-term plans. This behaviour would have resulted in investors locking in their losses, missing out on the rebound that followed the sharp sell-off, and an increased risk of running out of money as a result of eroding capital.

What history has taught us

Graph 2 shows the same data as Graph 1, but extended over 22 years. What it demonstrates is that volatility is a natural part of investing, especially in high-equity funds. Over time this volatility is "smoothed out" and the performance line angled upwards. High-equity investors who rode out the sell-off would have been rewarded, while investors holding fixed-income assets would have experienced less volatility over the short term, but also significantly less inflation-beating growth over the long term.

Graph 2: Time "smooths out" volatility in high-equity investments

22 Years into retirement



Based on a 75% replacement ratio = 4.5% drawdown rate
Source: Morningstar

Deciding which option is right for you

If you're purely looking to mitigate longevity risk, you'll need to decide whether you want the security of a guaranteed income for the rest of your life, or if you're comfortable with market volatility and want to grow the value of your capital by purchasing a living annuity with sufficient exposure to growth assets, whereby you manage your own investment risks. Another option we often see involves the purchasing of a living annuity for the first few years of retirement, and then using the remaining benefit to purchase a guaranteed life annuity. However, research suggests that this latter option is typically a sub-optimal strategy.

Regardless of which post-retirement vehicle you choose, it's important to have a good understanding of the options available to you and the pros and cons of each. It's worth remembering that the decisions you make now will have a significant impact on the quality of your future. □

Pieter joined M&G Investments in 2015 as Managing Director of M&G Investments Unit Trusts and Head of Retail Business. In 2019 he was appointed as Chief Client & Distribution Officer. With 23 years of industry experience, Pieter previously worked for one of the country's largest financial services groups in a range of senior management positions. He holds a B.Comm (Maths) degree from Stellenbosch University, and is a Fellow of the Institute of Actuaries (UK) and the Actuarial Society of South Africa. He completed the General Management Program at Harvard Business School in 2010 and during 2020 completed a course in Behavioral Finance from Duke University.