M&G Investments

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Table Talk Q2 2024 Two-Pot Retirement System: An Investment Perspective

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Q: What are some of the key considerations from an investment perspective for factoring the two-pot system into a retirement portfolio?

Firstly, let's look at the background and context of these changes. The objective of the retirement fund industry is to ensure members can retire comfortably with adequate provision to retire in comfort. However, a small percentage of retirees can afford to maintain their pre-retirement standard of living due to a number of reasons, including inadequate savings and not preserving their retirement savings when changing employers.

The South African retirement landscape has evolved over the years with several regulatory changes coming into effect to bring about retirement reform. The most recent of these changes comes in the form of the two-pot system, following the signing of the Revenue Laws Amendment Bill into law on 1 June 2024. This move confirmed that the Pension Funds Amendment Bill will also soon be signed, cementing the two-pot system's rollout set for 1 September 2024.

With the implementation of the two-pot retirement system rapidly approaching, it's important that the changes, which affect all retirement fund members (in a pension fund, provident fund, retirement annuity, or a preservation fund) as well as the implications thereof is clearly understood. It's important to note that provident fund members who were 55 years old on 1 March 2021 can adopt the new two-pot system or maintain the previous system.

Let's unpack the two-pot retirement system from an investment perspective, highlighting key considerations for retirement fund members.

What is the two-pot system?

The two-pot retirement system in South Africa is a reform to the retirement savings framework. This system aims to balance the need for long-term retirement savings with the need for individuals to access their savings in times of financial hardship.

Essentially, the two-pot system is a strategy for managing retirement savings which involves dividing an individual's retirement funds into three separate pots, even though it is called the two-pot system.

The first component (called the savings pot) is set aside to be accessible during periods of financial difficulty. Retirement fund members are allowed one withdrawal (minimum of R2000) from the savings pot during a tax year.

The second component (called the retirement pot) has to remain invested for the purpose of targeting long-term growth for retirement provision.

The third component (called the vested pot) in the retirement savings system in South Africa is designed to ringfence members' accumulated retirement savings before the implementation of the two-pot system. This means that all accumulated retirement savings invested as at 31 August 2024 will form part of a ringfenced component of 'vested' funds. Access to the vested pot is governed by the retirement fund rules that were in place before the two-pot system was introduced. The vested pot ensures that the transition to the new system does not disadvantage individuals who already have significant retirement savings.

What will happen when the two-pot system is implemented?

The savings pot will be seeded from the retirement fund members' accumulated retirement savings via a once-off compulsory transfer of 10% but will be capped at R30 000. It's important to note that this will be a once-off transfer when the two-pot system is implemented and will not be repeated in the following years.

However, under the two-pot system, all future contributions will be allocated as one-third to the savings pot and two-thirds to the retirement pot. For example, a monthly retirement contribution of R1 200, will be split into: R800 allocated to the retirement pot and R400 to the savings pot.

Two-thirds of all future retirement contributions invested in the retirement pot can only be accessed at retirement date, while one-third of future retirement contributions that are invested in the savings pot can be accessed to cover unexpected financial needs before retirement. The withdrawal from the savings pot will be subject to a prescribed minimum of R2 000 and will be allowed once every tax year (1 March to 28/29 February). Keep in mind that marginal tax will be levied on every withdrawal. As always, we strongly encourage that you consult with your financial adviser to make informed financial decisions with full understanding of the implications thereof.

The intention driving the two-pot system is to provide retirement fund members with access to the savings pot (before retirement) in times of financial difficulty. The idea is to circumvent a trend where retirement fund members resign from their employer to get early access to retirement funds and forgo the opportunity to preserve their retirement savings. By splitting retirement funds through the two-pot system, it provides access to retirement funds for financial relief in the short-term and enables individuals to make more informed decisions about their long-term retirement funds.

In short, the long-term outcome will be greatly improved under the two-pot system because it will require members to preserve at least two-thirds of their retirement benefits when changing jobs.

Considerations of the two-pot system

Because there are three different 'pots' to keep track of, it's important to take a holistic view of your retirement portfolio and carefully assess the long-term impact of accessing retirement funds before reaching retirement.

There are implications of early access to retirement funding, such as tax implications for early withdrawals, missing out on the benefit of compounding and the risk of not reaching retirement goals. As always, it's critical to make informed decisions in close consultation with your financial adviser around your retirement planning and fund management.

Investment strategy

An investment strategy for a retirement fund should be aligned to the primary goal of retirement income provision, regardless of the two-pot system being implemented. The investment strategy of your holistic retirement portfolio should be focused on long-term growth, aiming to generate returns that outpace inflation. Due to the limited size of the savings pot in the context of your broader savings plan, liquidity concerns should theoretically not be a primary concern when making investment choices.

One approach you might consider is maintaining the current long-term investment strategy across both the savings and retirement pots. However, a potential drawback is that if you're looking to withdraw funds, you could realise losses if you're invested in an aggressive strategy suited for the long-term that may be in a period of underperformance.

Alternatively, you could opt for a strategy where the savings pot offers a lower-risk profile compared to the retirement pot. This choice could lead to lower overall returns over time. One could balance this by pursuing a more aggressive investment strategy for the retirement pot to compensate for the lower returns expected from the savings pot. Another tactic could involve adopting asymmetric strategies that promote capital growth while managing volatility.

What is important to focus on when investing for retirement is to ensure an adequate asset allocation and careful portfolio construction that ensures risk-adjusted returns suitable to meet your retirement goals in the timeframe available.

It's important to carefully balance your investment objectives, and assess liquidity risks. Equally crucial is your preservation preferences, contribution rates and risk appetite, as these factors will influence your decision.
One of the common pitfalls is to derisk at retirement by reducing growth asset exposure, such as equity or property, which can further erode your retirement investment. These investments come with a higher level of risk, but they offer the potential for long-term growth. Of course, asset exposure in retirement portfolios should comply with limitations set out in Regulation 28 of the Pension Funds Act.

Another key step is to regularly review and rebalance your investments to maintain an optimal asset allocation aligned to your circumstances, risk appetite, retirement goals and time horizon. Balancing risk, return expectations, and one's retirement needs will be pivotal in shaping effective investment strategies under the two-pot system.

Investing for long-term growth

Well-diversified multi-asset funds are a popular choice for longer-term investors, such as retirement portfolios, who are looking to grow their retirement capital faster than inflation with steady returns. Our flagship M&G Balanced Fund has proven to be an excellent example of a balanced fund having produced excellent risk-adjusted returns over time. The Fund has outperformed its benchmark, the ASISA SA Multi-Asset High Equity Category Average over the medium to long term, having returned 9.8% p.a. (A class, net of fees) versus the benchmark's 8.5% over three years and outperformed its benchmark by 1.5% p.a. since its inception in 1999 (up to 31 May 2024). The Fund's success is due to its strategic asset allocation, tactical asset allocation and stock selection, as well as the proven investment philosophy and process consistently applied during the Fund's successful 25-year history.

Proceed carefully with too many pots on the stove

While the two-pot retirement system offers a flexible approach to managing retirement savings in South Africa, it is intended to encourage preservation of retirement funds at resignation. Early access to ringfenced funds can offer much-needed financial relief in the short-term, but we strongly recommend that these funds are accessed only when absolutely necessary. Lest we become too focused on the short-term and forget about the reason for retirement fund savings: to secure a comfortable retirement during the years when you no longer earn a regular income.