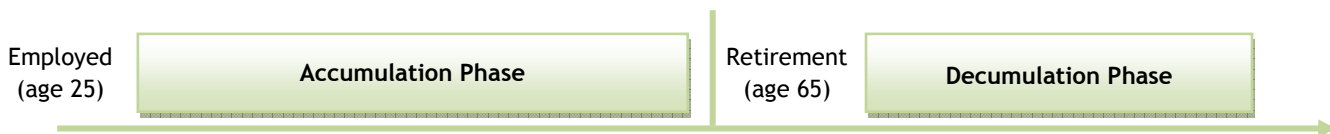


Planning for Retirement Part 2

Managing retirement income

We invest for various reasons but the one common investment objective shared by most is investing for retirement. This is an important issue as we spend a considerable portion of our lives in retirement.

The investment landscape for retirement can be divided into two broad phases:



In the previous article “Planning for retirement” we addressed the basic principles of optimising retirement capital. The key points were:

- Starting early
- Maintaining exposure to growth assets to ensure that returns are maximised
- Reducing the risk of the portfolio by diversifying across asset classes (equity, cash, property and bonds)
- Considering less aggressive funds closer to retirement

In this section, the focus will be on maximising your retirement investment during the **Decumulation Phase**, when using a living annuity. Decumulation is defined as the conversion of pension assets accumulated during an employee’s working life into pension income to be spent during retired life. At this stage, there are two main concerns - firstly, you need to outlive your retirement capital (longevity risk) and secondly, your monthly income should ideally keep ahead of inflation and be sufficient to maintain your lifestyle (investment risk).

Minimising Longevity Risk

Longevity risk can be more severe than many people think. At retirement there are probably no further pay checks or bonuses to supplement your income should your accumulated retirement capital prove insufficient. To minimise the risk of outliving your capital, consider the following guidelines:

I. Accumulate Sufficient Capital Prior to Retirement

If your capital base is not large enough at retirement, regardless of how conservative your spending is during retirement, or the investment vehicle used, it is unlikely that you will have enough money to support a comfortable lifestyle. The key points above address how to ensure that your capital accumulated at retirement is optimised. In the event that you do not have sufficient retirement capital when you plan to retire, you may want to consider deferring your retirement by a few years. This allows you to contribute further and allows compound interest to help you to grow your retirement capital. It also means that you will spend fewer years drawing an income from your retirement capital.

II. Select a reasonable Drawdown Rate

The drawdown rate directly affects how long your retirement capital will last. The rate at which retirees in a living annuity product draw an income from their accumulated savings is critical to the sustainability of their retirement capital. The allowable drawdown rate for retirees in a living annuity is between 2.5% to 17.5% of the retirement capital per year. The drawdown rate should be determined in consultation with your financial planner after the consideration of the following factors:

- The income required to sustain your standard of living
- Your lifestyle and hence how long you are likely to live for
- The nature of your investment vehicle.

Due to changing circumstances, including economic changes such as inflation, it is essential that the drawdown rate is reviewed regularly. If your drawdown rate is greater than the growth rate on your investment portfolio; you run the risk of outliving your capital and eroding your capital base.

In addition to the above mentioned points, the table below was compiled by the Association of Savings and Investments South Africa (ASISA) and can be used as a guide in selecting appropriate drawdown rates in conjunction with required investment rates.

Years before your income will start to reduce

		Investment Return per annum (before inflation and after all fees)				
		CPI - 3.5%	CPI - 1.0%	CPI + 1.5%	CPI + 4.0%	CPI + 6.5%
Annual Income rate selected at inception	2.50%	21	30	50+	50+	50+
	5.00%	11	14	19	33	50+
	7.50%	6	8	10	13	22
	10.00%	4	5	6	7	9
	12.50%	2	3	3	4	5
	15.00%	1	1	2	2	2
	17.50%	1	1	1	1	1

*Source: ASISA Standard on Living Annuities; 2009

The table shows that for a constant drawdown rate; the lower the investment return, the sooner your income will start to reduce. For a constant investment return; the higher the income drawdown rate, the sooner your income will start to reduce. In summary, it is your responsibility (in consultation with your financial advisor) to ensure that the income you select is sustainable during retirement. You need to carefully manage your income drawdown rate relative to the investment return on the capital in order to achieve this.

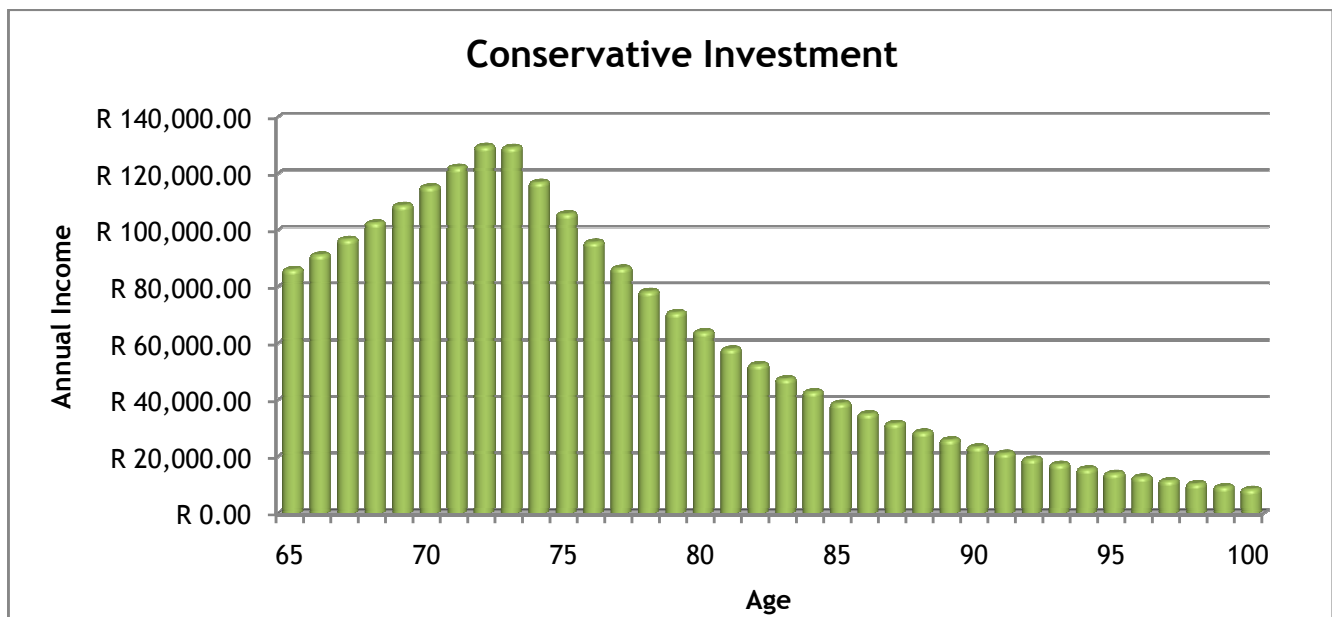
Minimising Investment Risk

If the markets fall or you invest too conservatively, you face the risk that your investments will not produce an income sufficient to beat inflation or that your capital may not last to provide a sustainable income for the duration of your retirement. To minimise your exposure to investment risk, consider the following guidelines:

I. The Downside to Conservatism

Investing your retirement savings too conservatively, may result in insufficient returns on your investment that will not generate a return large enough to sustain a reasonable drawdown rate. For example, a conservative portfolio with an annual return of CPI +2% is only able to sustain an 8% drawdown rate (increasing annually by inflation) for approximately 8 years before your income will start to reduce. A reduction in income will result in inadequate funds to maintain your lifestyle, thus reducing your standard of living. See the chart below.

To ensure that the capital will last longer, the drawdown rate needs to be reduced, or the investors need to invest in a fund(s) that have higher growth prospects. This typically means greater investment risk in the form of a balanced investment fund with exposure to growth asset such as equities and property.



Please note that while care has been taken to ensure that the information provided in this article is correct, it represents an overview of the topic under discussion and as such does not constitute advice. We suggest that you contact your professional adviser before taking any decisions based on the information herein. Fairbairn Capital is an elite service offering brought to you by Old Mutual Investment Services (Pty) Ltd and Old Mutual Life Assurance Company (South Africa), Licensed Financial Services Providers.

II. Minimise the impact of Volatility on retirement capital

The previous section highlighted that in order to sustain a reasonable drawdown rate; the retiree may have to assume a degree of risk that is commensurate with the desired drawdown rate by investing in a diversified portfolio. However, in doing so it is important to consider the volatility of the investment fund. Historically, the higher the desired return the more risk has to be assumed and hence the more volatile the series of yearly returns. It is important to bear in mind that the manner in which the return is generated can affect your financial wellbeing. The **sequence-of-returns risk** occurs when a series of poor returns at the outset substantially reduce your retirement capital.

Thus, with the help of your financial advisor you may want to consider one of the following options:

1. At retirement, estimate the amount of income required over the next few years and invest this amount into conservative solutions such as money market and fixed interest funds. This portion will be protected against a market fall. The remainder can be invested into more aggressive solutions to ensure your retirement capital keeps ahead of inflation.
2. Or alternatively, invest your full retirement capital in a balanced fund with measured exposure to equities (such as stable or defensive funds). These funds are moderately volatile in the short term; however they have historically produced inflation beating returns.

To ensure that your retirement capital will be sufficient to provide an income during retirement, it is important to remember the following:

- Accumulate sufficient capital prior to retirement or consider delaying your retirement by a few years.
- Select an appropriate drawdown rate. A high drawdown rate will increase the probability of you outliving your capital
- Overly conservative investments may not offer sufficient returns to provide a sustainable income
- At retirement consider placing the amount to be used to fund your income in the short term into conservative solutions and investing the rest more aggressively. Alternative, you can make use of balanced portfolios with a capital preservation focus (such as defensive and stable funds).

There are several appropriate balanced funds within the Fairbairn Capital range of funds which are available, to ensure that the returns are maximised.