INSIGHT

Investment perspectives from the Harvard House Group

LIVING ANNUITIES

Risks at Retirement

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HARVARD HOUSE GROUP

Agenda

- Pensions at Retirement: History & Trends
- What is a Living Annuity?
- General Retirement Income Risks
- Major risks with Living Annuities
- Questions

Pensions at Retirement

History & Trends

- South African Pension Fund legislation (including Retirement Annuities) requires that on retirement, members use the remaining portion after having drawn a lump sum cash portion to purchase a **Compulsory Purchase Annuity** or **Pension**.

- Prior to the early 90's nearly all pensions purchased were **Conventional Life Annuities**

- **Conventional Life Annuities** are the exclusive preserve of the **Life Assurance Industry**

- A **Conventional Life Annuity** is defined as:

  "In exchange for a lump sum, the insurance company promises the buyer a regular income stream guaranteed to continue for as long as the buyer lives"

Enabling a better income in retirement – National Treasury September 2012

Pensions at Retirement

History & Trends

- In the early 90's there was a significant a steady swing towards **Living Annuities** as the product of choice for compulsory purchase portions of Retirement Annuities and Pension Funds.

- A **Living Annuity** is defined as:

  "A post retirement,… tax protected phased withdrawal product"

  Enabling a better income in retirement – National Treasury September 2012

Pensions at Retirement

History & Trends

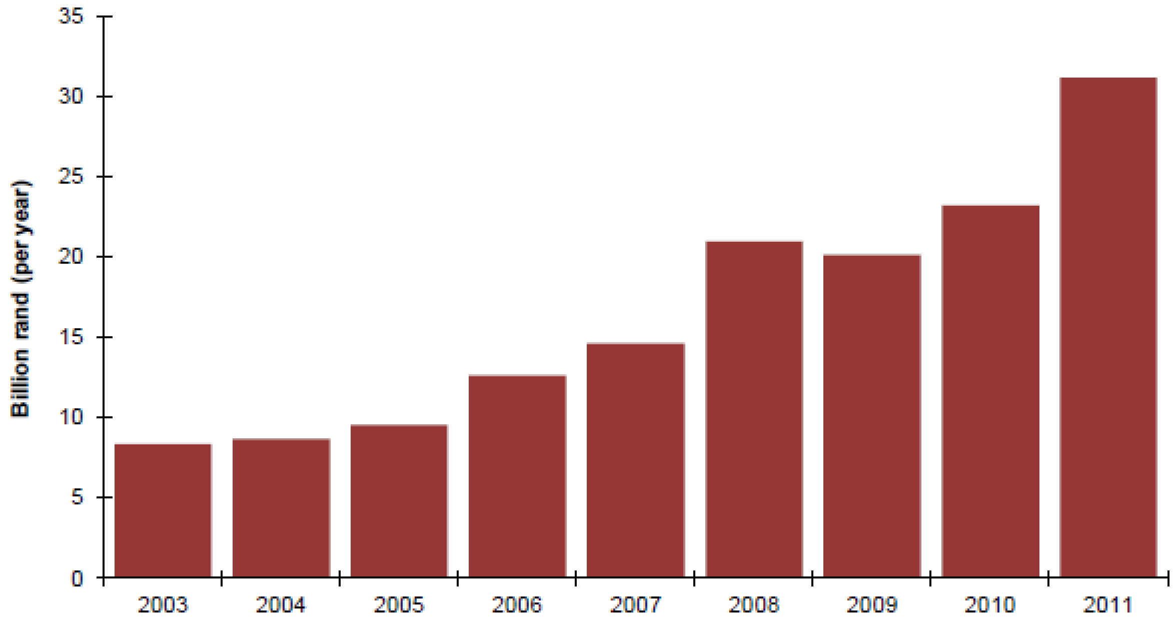
Proposed reasons for purchase of **Living Annuities** over **Conventional Annuities**

- Loss of liquidity on purchase of a **Conventional Annuity**, no opportunity to draw an occasional lump sum
- Loss of the ability to bequeath accumulated retirement funds to heirs
- Flexibility and Control
- Low interest rate environment
- Investor belief that they can ‘outperform’ insurance companies
- Loss of Trust in insurance establishment
- Commission Incentive

Pensions at Retirement

History & Trends

Figure 1: Volume of single premiums for compulsory purchase retirement annuities (including living annuities), 2003-2011

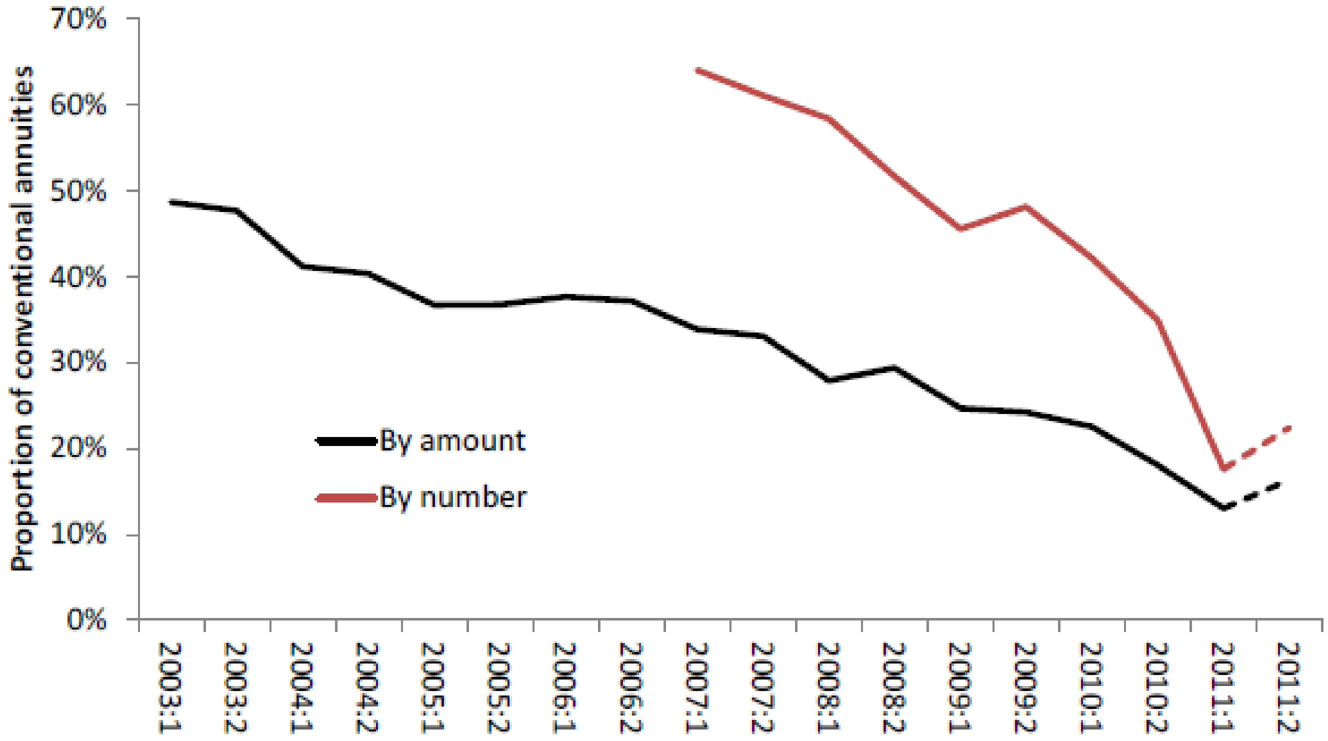


Source: ASISA

Pensions at Retirement

History & Trends

Figure 2: Proportion of compulsory purchase annuities that are conventional life annuities



Source: ASISA

What is a Living Annuity?

Contribution from **Pension Fund** or **Retirement Annuity**
(Placed by an *Advisory FSP* who charges an initial & ongoing fee)

Living Annuity – Administered by an *Administration FSP*
(Monthly Admin Fee Levied)

Investment Portfolio
Managed by a *Discretionary FSP*
(Asset Management Fee Charged)

Regular Income withdrawal, deemed taxable income, paid to client. Income Level may vary between **2.5%** and **17.5% per annum** based on the value of the underlying **investment portfolio** at **anniversary** date.

What is a Living Annuity?
The Midlands explanation…….

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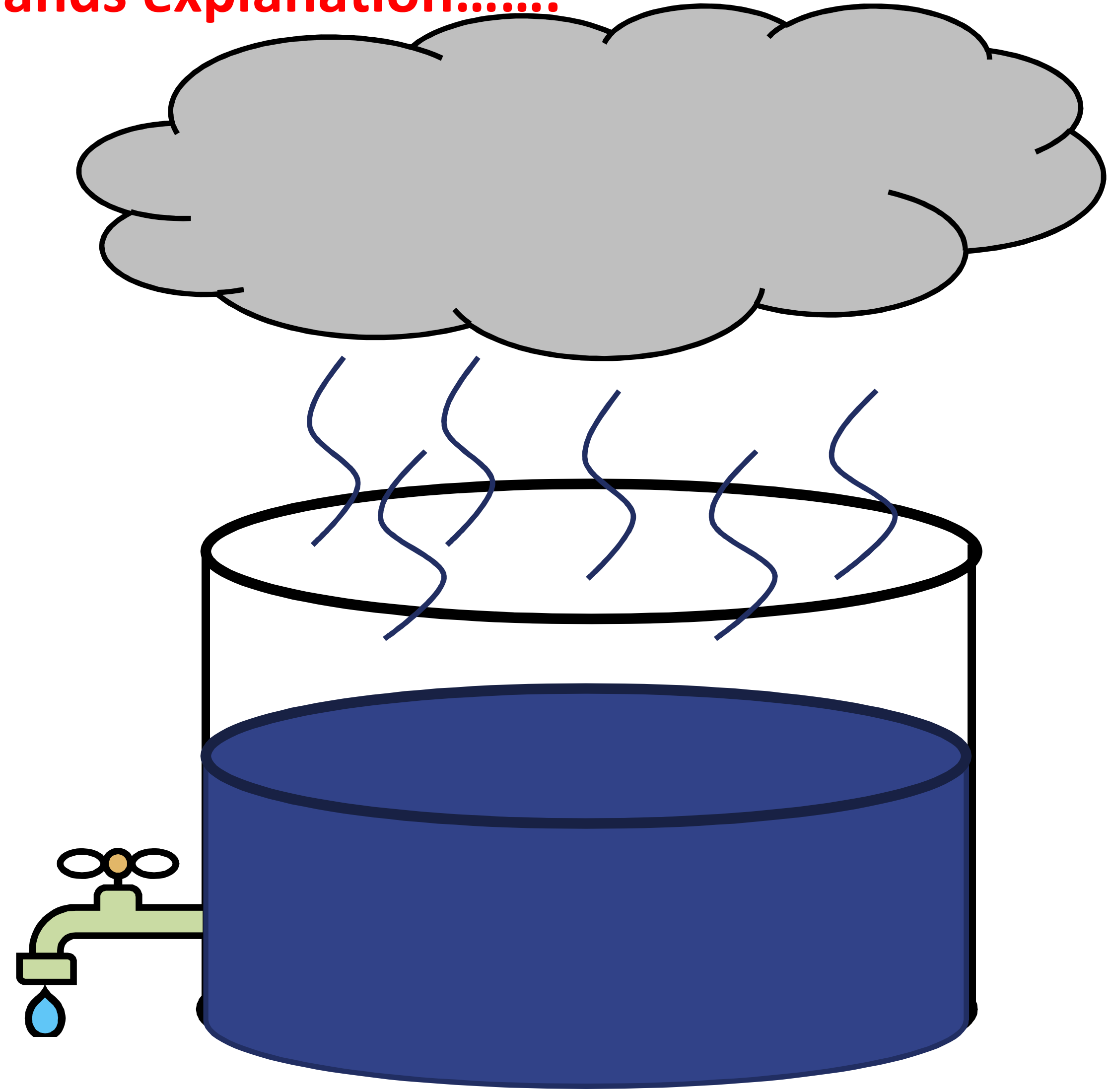

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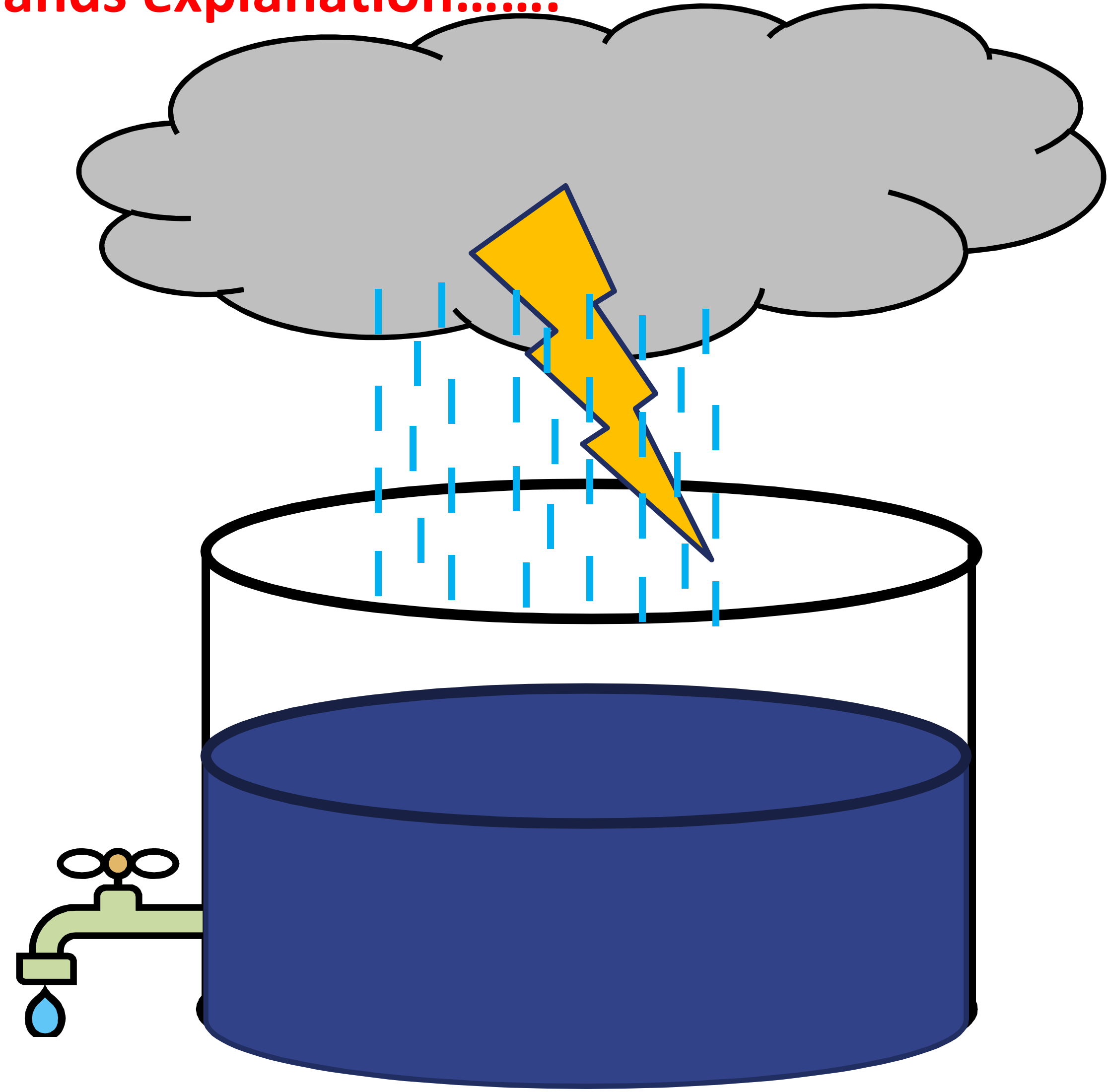
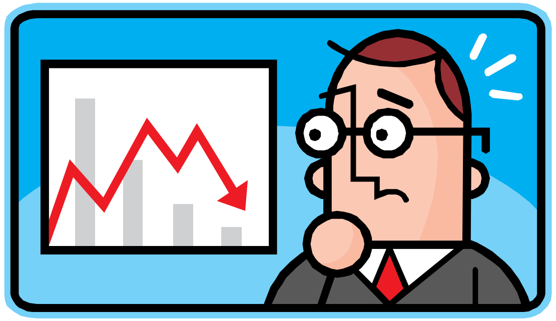


Key Retirement Risk Considerations

4 Major Risk Areas every Retiree Faces

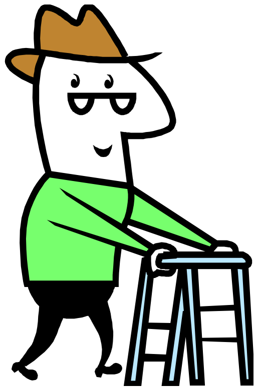
Inflation Risk

Market Risk



Income Risk

Longevity Risk



Specific Living Annuity Risk Considerations

Four key areas to being your own Pension provider

- Income Level
- Underlying Portfolio Selection
- Costs
- Income Increases

1. The effect of Income Choice

Looking at the consequences of choice

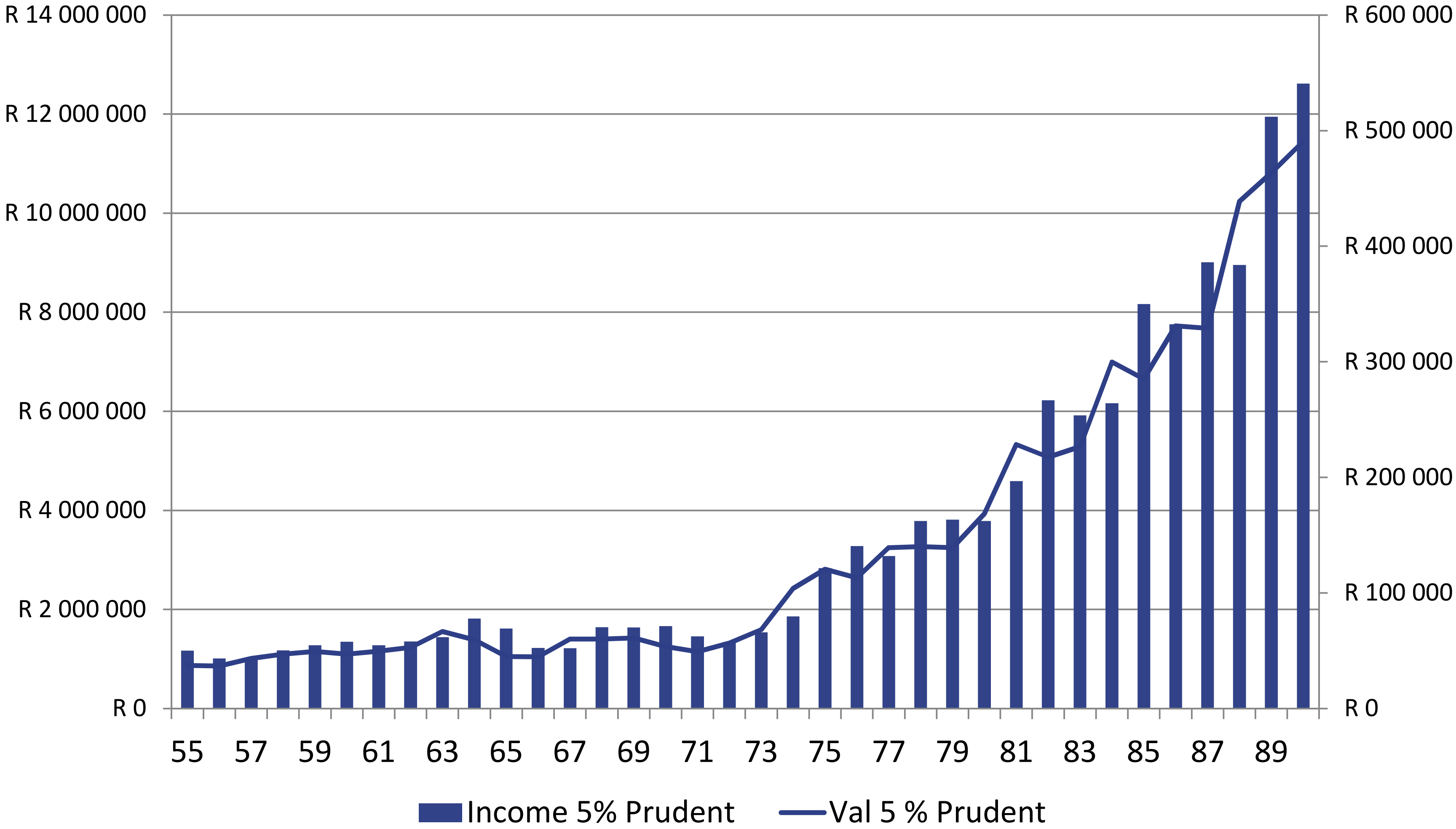
There are infinite numbers of illustrated choices

To illustrate effect of income selection on Living Annuities we have assumed the following:

- Male aged 55 @ Retirement
- R 1,000,000 capital
- "Prudential" Asset Mix
  - 65% ALSI
  - 25% ALBI
  - 10% Cash (Fixed Deposit)
- Period 1960 – 1995
  - Starts with an ALSI decline
  - Covers a period of increasing interest rates
- Annual all in cost (Adviser, Administrator, Asset Manager) = 2%

1. The effect of Income Choice

Value and Income at a steady percentage



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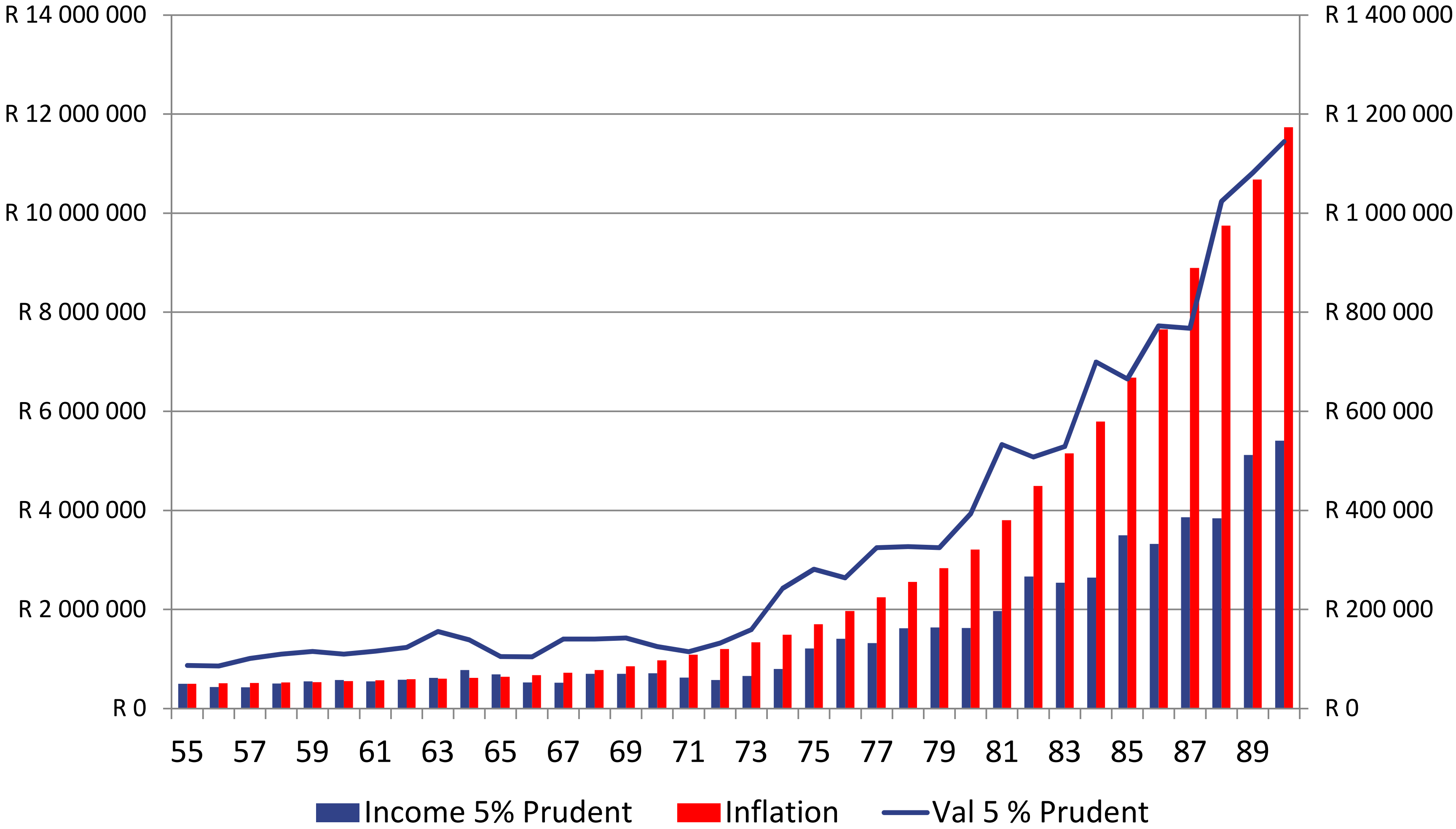
Value and Income at a steady percentage



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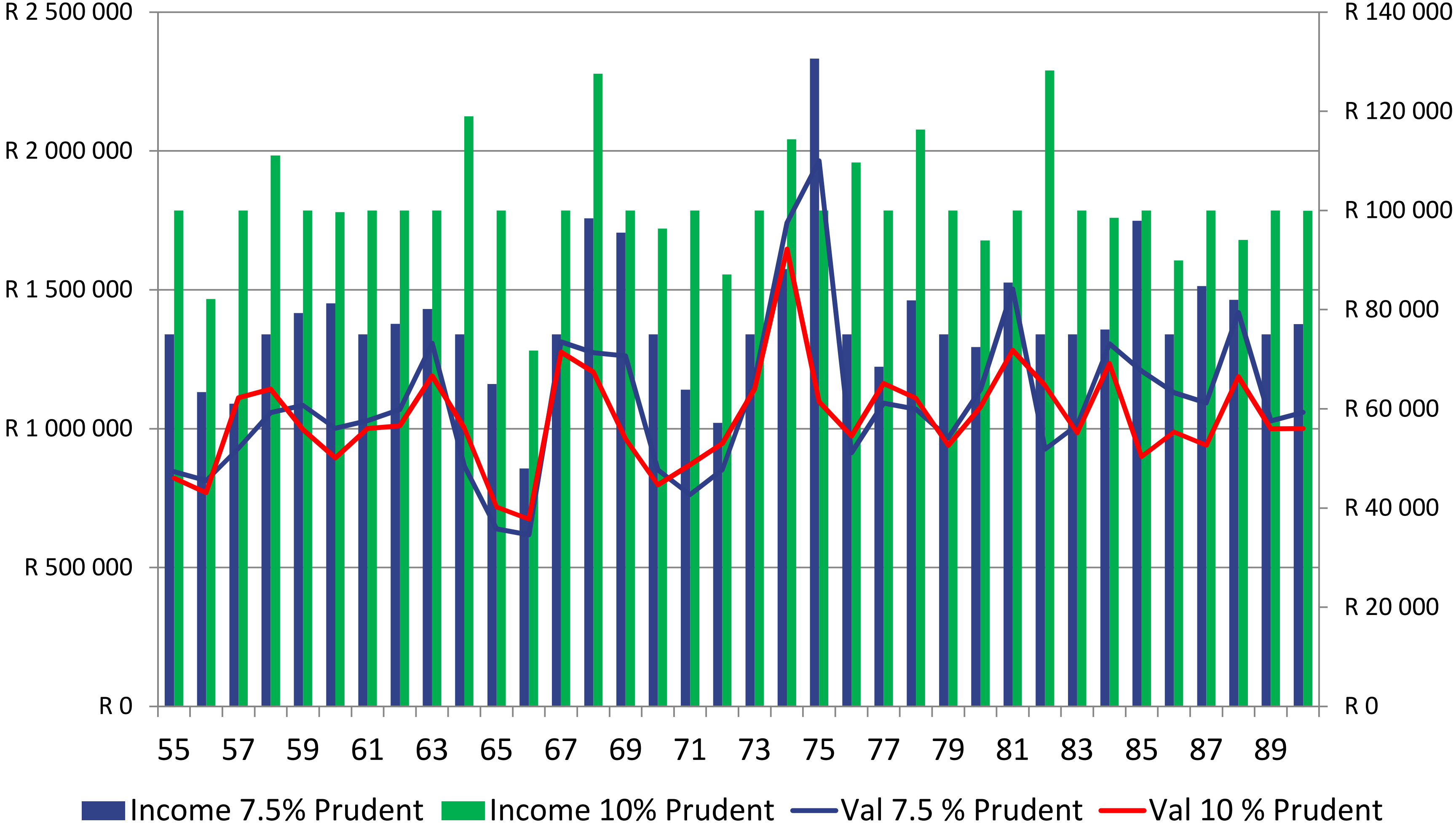


1. The effect of Income Choice

Conclusions

Income level is a defining factor.
As in all things, living for today affects tomorrow.

- Drawing at 7.5% or 10% shows little difference in the long term. Too high, is just too high!

- While it would appear that capital will not exhaust, inflation becomes the true enemy!

- Drawing too high almost guarantees either a reduction in real income or an increase of draw rate in the future.

How then does underlying investment portfolio choice affect the portfolio?

2. The effect of the Underlying Investments

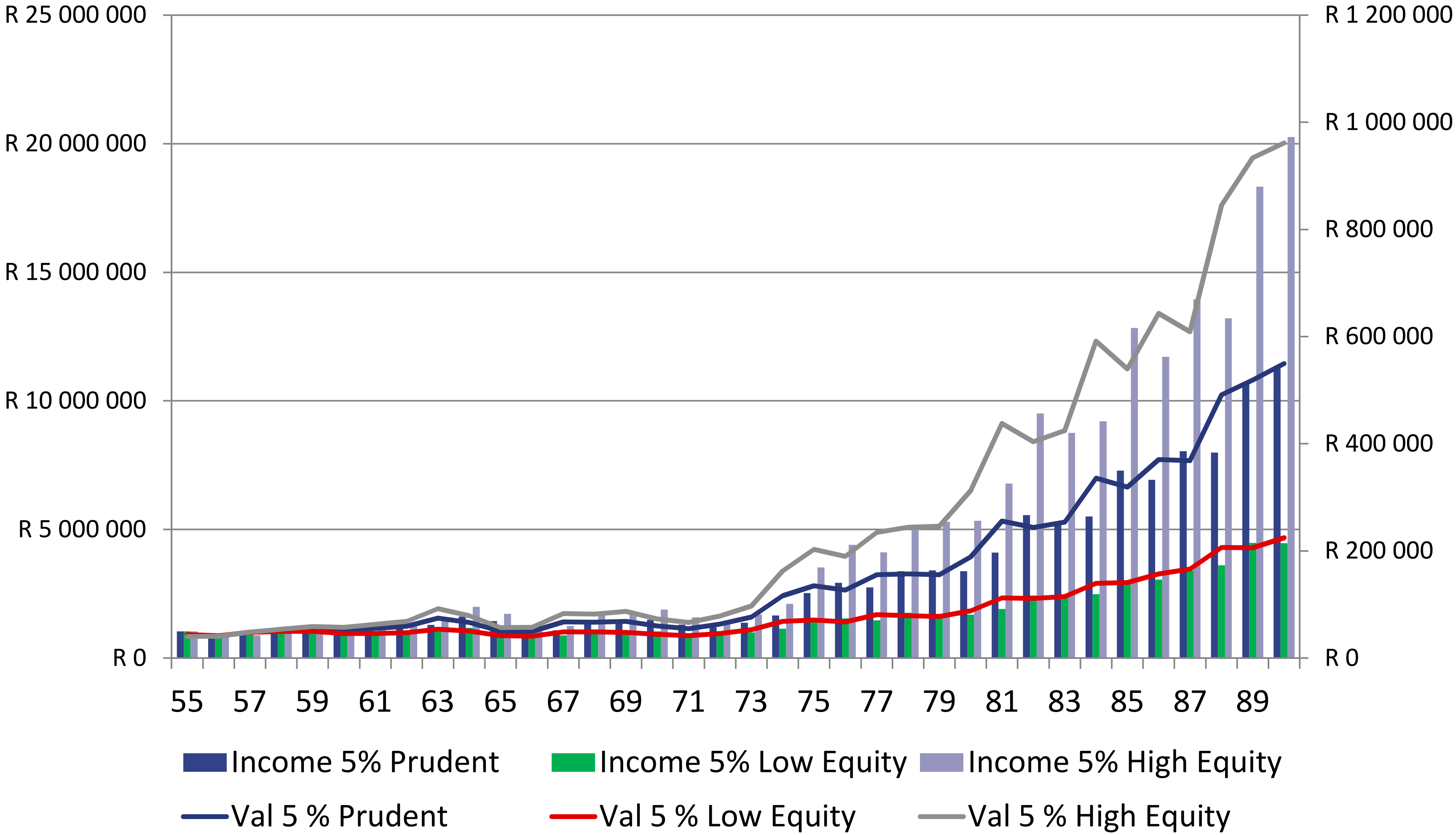
Portfolio choice consequences

To illustrate the effect of the underlying portfolio performance on Living Annuities we have considered a single income rate of 5% per annum and then 3 distinct investment portfolios (all other assumptions unchanged):

- "Prudential" Asset Mix
  - 65% ALSI
  - 25% ALBI
  - 10% Cash (Fixed Deposit)
- "High Equity" Asset Mix
  - 85% ALSI
  - 10% ALBI
  - 5% Cash (Fixed Deposit)
- "Low Equity" Asset Mix
  - 35% ALSI
  - 40% ALBI
  - 25% Cash (Fixed Deposit)

2. The effect of Underlying Investments

The Performance effect



3. The effect of Costs

Cost is really just income paid to someone else

Since costs are largely quoted in percentages, we are de-sensitized to their effect.

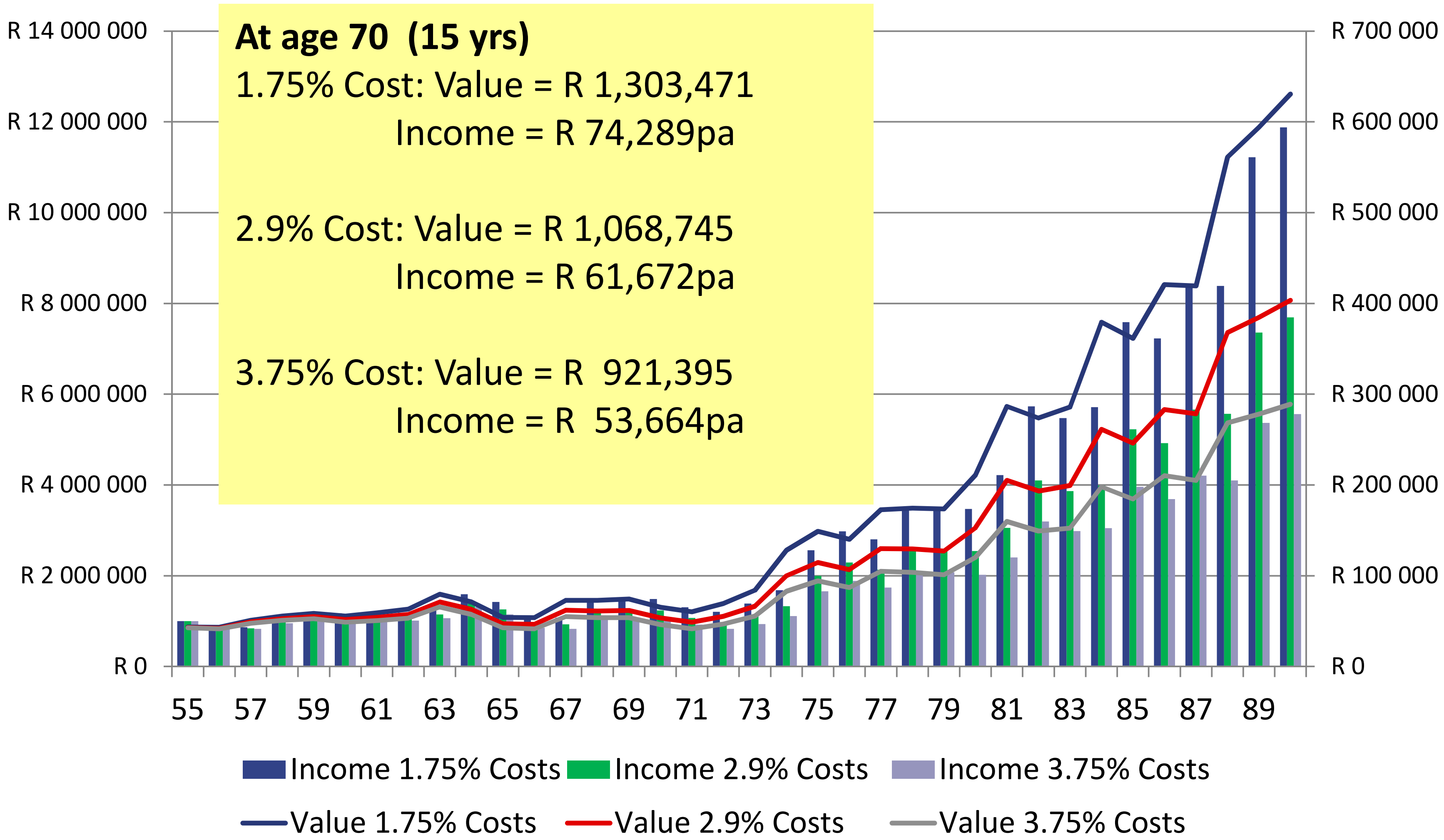
We have chosen 3 cost levels to illustrate the effect.

We have used a 5% income draw, prudential income portfolio as the base annuity.

	Option 1	Option 2	Option 3
Adviser Fee	0.0%	0.5%	0.75%
Product Admin Fee	0.5%	0.65%	0.75%
Asset Management Fee	1.25%	1.75%	2.25%
Total	**1.75%**	**2.9%**	**3.75%**

3. The effect of Costs

Who else are you feeding?



4. The Annual Income Review

Are your salary increases dangerous?

Annuitants are able to review their income draw annually. What is taken into account for these decisions?

- Market performance? The total return on the underlying portfolio.

- Income needs (inflation effect)? An external need unrelated to the annuity itself.

- Published inflation? Formal inflation levels.

4. The Annual Income Review

Are your salary increases dangerous?

In most cases, clients select their income based on their needs.

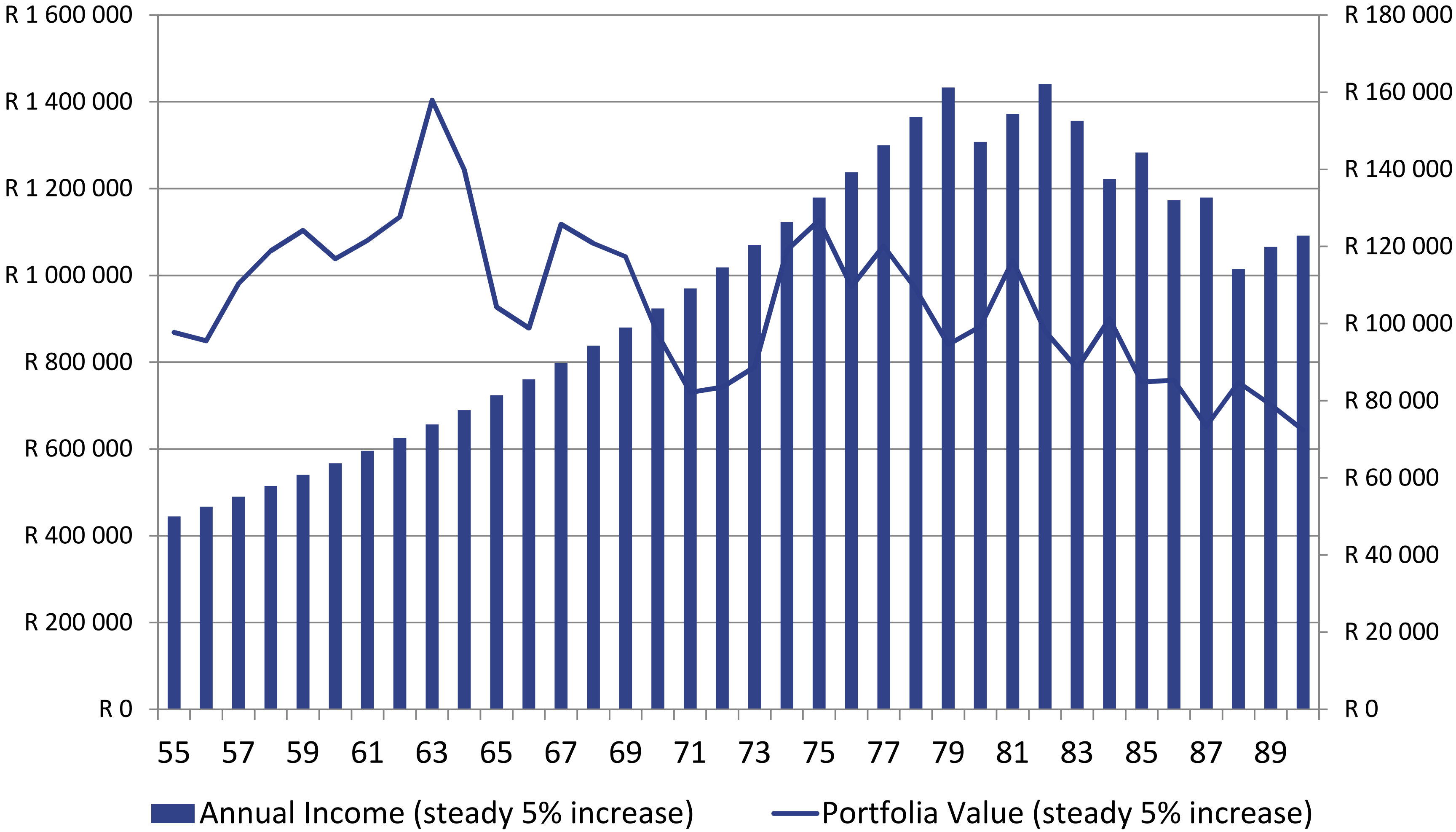
The pressure of inflation forces an increased draw, especially where the living annuity is the sole retirement investment.

Consider the following graph:

- Income increases are a level 5% irrespective of the performance of the fund.

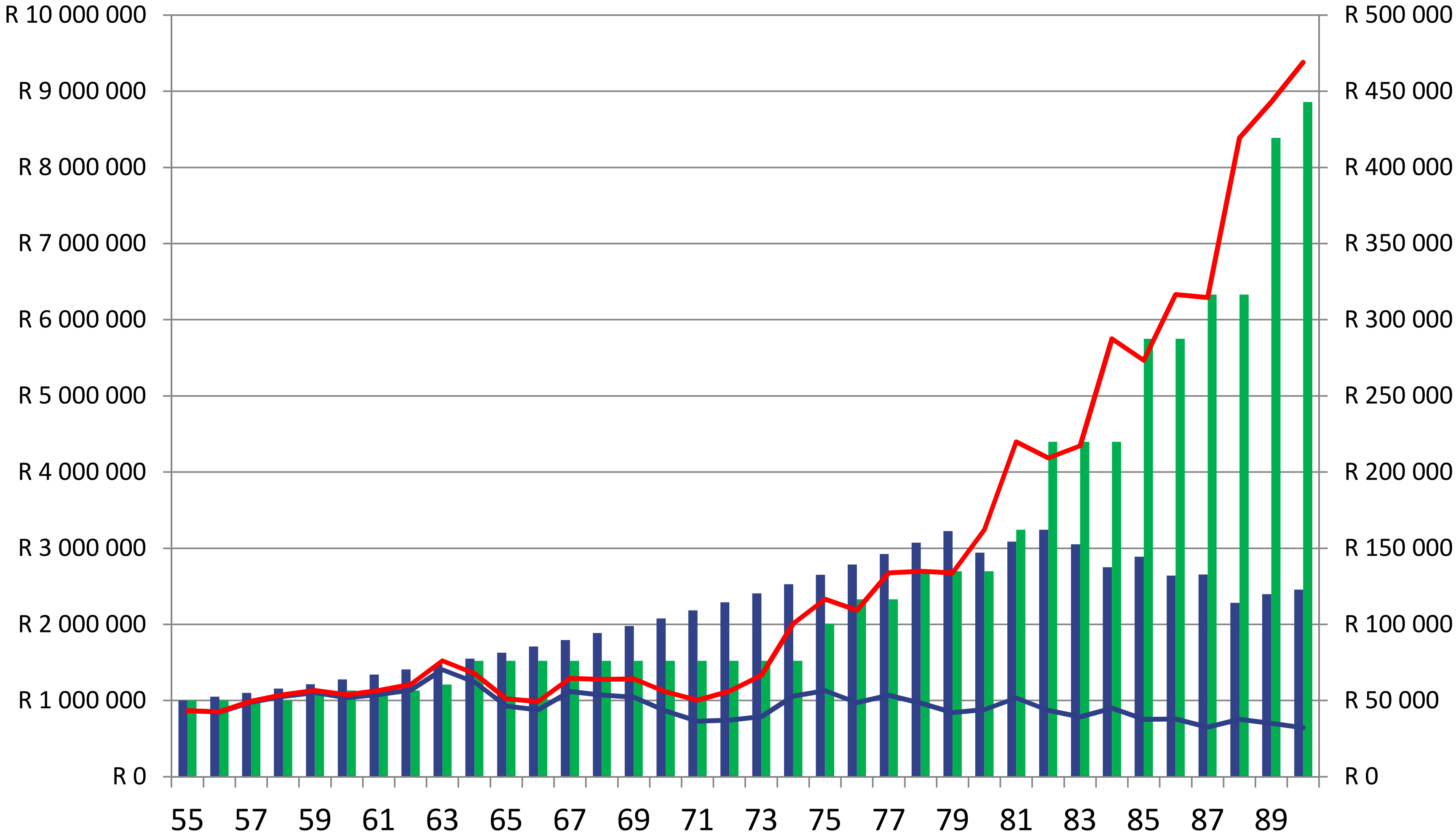
4. The Annual Income Review

Are your salary increases dangerous?



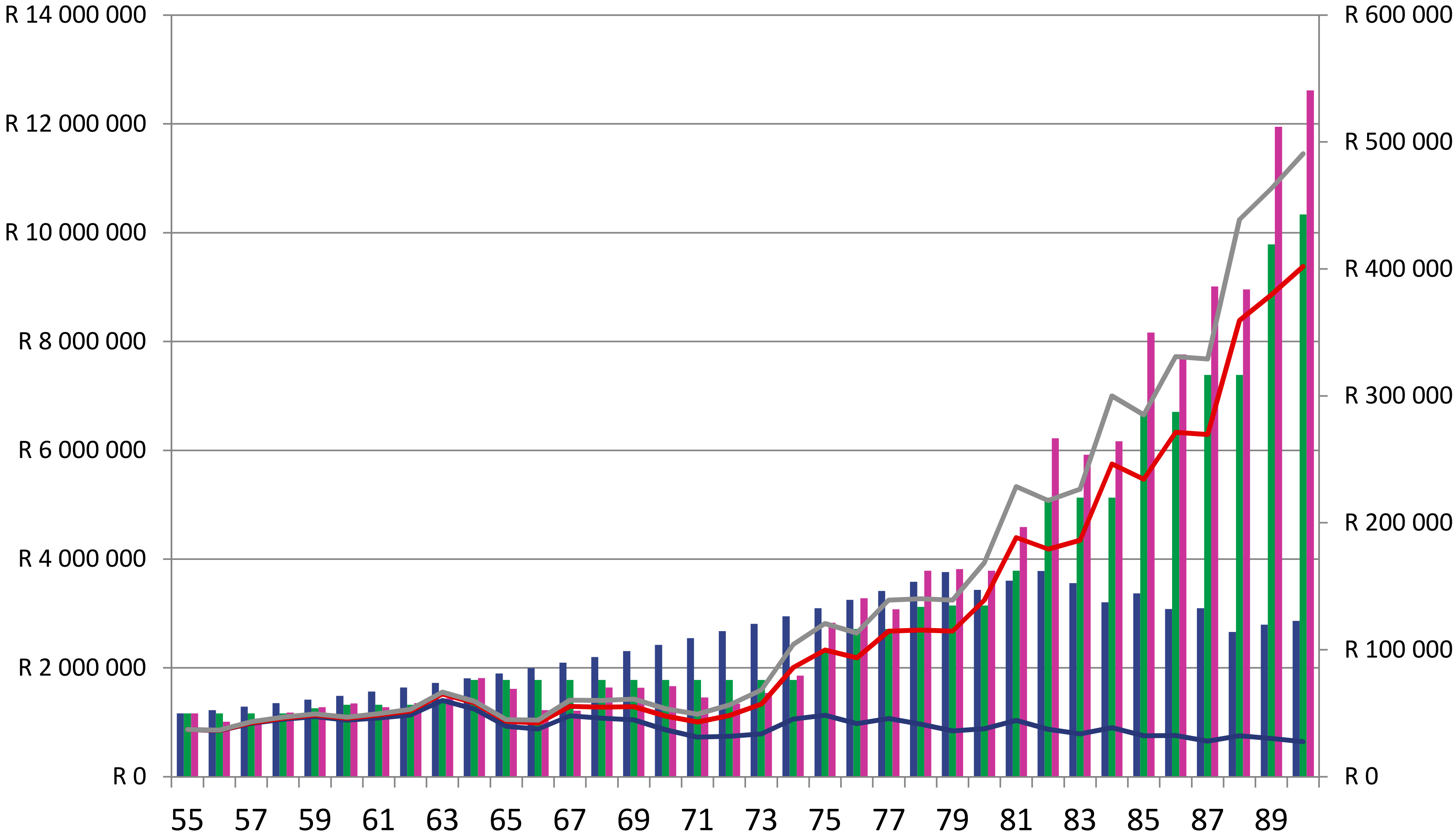
4. The Annual Income Review

A more healthy alternative – increase in up years, level in poor years



4. The Annual Income Review

Or the bolder move, decrease income in line with portfolio decline?



4. The Annual Income Review

Are your salary increases dangerous?

- You cannot choose your income based on your needs, it must be related to portfolio performance and inflation.

- Try to think like an employer, not an employee.

- Short term pain is better than long term regret.

Living Annuities Conclusion

Guidelines for Success

- Make sure you are drawing **income** at levels that allow you to **beat inflation** in the future. Inflation can derail you!
- While volatility may be higher the importance of being exposed to **growth assets** cannot be emphasized enough.
- Be **cost conscious**, even 0.5% per annum can make the long term difference.
- Try to **moderate your income increases** wherever possible.
- Do not just focus on one of these aspects, they all combine to make a dangerous retirement cocktail!

Warren Buffet on Living Annuities

Give it to Harvard House?

But when Mr Buffett described how he wanted his widow's retirement fund to be invested, he cut through all this complexity and came up with almost the simplest investment plan possible: "My advice to the trustee could not be more simple: **put 10pc of the cash in short-term government bonds and 90pc in a very low-cost S&P 500 index fund**."

Mr Buffett said of his suggested retirement portfolio: **"I believe the long-term results from this policy will be superior to those attained by most investors…….who employ high-fee managers."**

Q & A

Please feel free to ask questions

Thank you for listening