Back to the future

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We need to learn from the past. This will help us increase the probabilities of success and limit the risk elements for retirees drawing an income.

SA had a strong bull market from 2003–2007 and again from 2009–2013. Added together, that gave investors almost ten years of extremely strong markets, leading to high expectations that this would continue. However, the returns of the last five years have been sub-optimal. Many of the factors that caused this are out of our control. But what we can, and do, know is that these events happen and try to plan for them.

Research shows that 51% of South African retirees can't make ends meet, 61% are unable to save for a rainy day, 33% still have debt, 53% still have adult dependants and one-third don't have enough funds to cover medical expenses – their second biggest expense.

Savings are too low, and drawdowns too high

The reality is that people aren't saving enough. This becomes even more problematic as the average life expectancy increases.

Added to this, figures from ASISA show that income withdrawal rates in SA – averaging between 6.5% and 7% - are still significantly too high, especially in an environment with almost no returns.

Over the long term we know that equity assets provide the best protection against inflation as historical evidence backs this up. With the level of returns received in 2003-2007, a living annuity was a good option, but in the low return environment of the last five years, many retirees would have done well to select a guaranteed annuity.

A new way of thinking around retirement income is required

Markets do go through cycles – the challenge is how best to take advantage of this. Retirees who experience a significant market drawdown just before, or just after, retiring (known as sequence risk) will find it very difficult to recover from this, as they'll be drawing an income from a lower capital base. If we can negate sequence risk, we can increase their chances of achieving a better longevity outcome.

Example:

Let's consider an average client drawing 7% p.a. and who needs to increase this by inflation each year to meet their needs. Assume that the inflation rate is 5% and total fees are 2%. This translates into a total required return of 14% (or CPI +9%). There isn't a single traditional asset class today that will deliver that return for the client over the long term. Historically, equities, which have been the best performing traditional asset class, have delivered 6-7% above inflation. We therefore need to broaden our thinking and include other non-traditional asset classes into our portfolios which are capable of generating better returns and can assist in controlling risk – particularly for retirees needing their income to last for the rest of their life.

As an example, private equity, a form of alternative investment, is able to return 9% - 10% above inflation because of the illiquidity premium. This means that investors are compensated – in the form of the extra return – because of the time their capital is locked-in.

By including non-traditional assets in the portfolio as well we can further reduce volatility while still keeping growth assets in the portfolio. As a result, we're able to address both longevity (risk of running out of money) and sequence (risk of a drawdown at the wrong time) risks.

By using the 67/33 principle, or asymmetry of returns, we aim to capture less of the downside so that we don't have to capture as much of the upside. Clients can also reduce volatility in their portfolios by combining a living and a life annuity.

Ultimately, we want to make sure that the client has some certainty and comfort that the outcome is reasonably certain, no matter what the markets deliver in the future.

To conclude

- New thinking is required to solve the retirement problem.
- It is time to change the paradigm and use all tools at our disposal.
- Solving sequence risk can improve the odds of making the client's money last longer.
- Combining a living and a life annuity can serve the client well and should be considered.

Together we can solve the retirement conundrum for clients.