Today's Trustee
YOUR MONEY YOUR POWER

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Editorials

LIVING ANNUITIES

Inevitable trade-offs

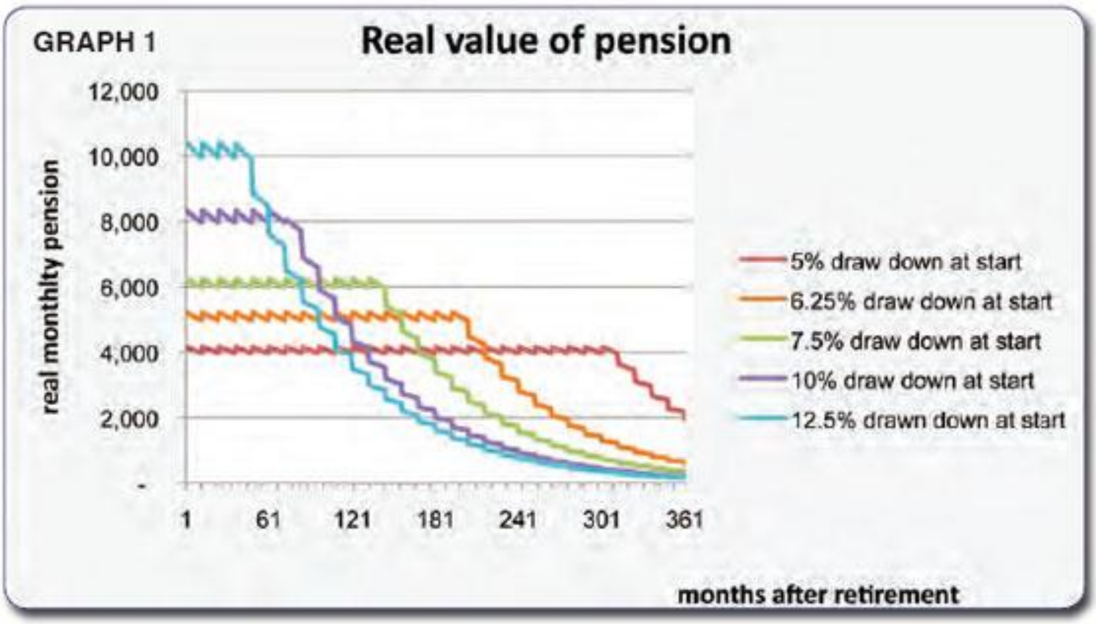
Such are the choices on retirement, and the potential pitfalls in making them, that trustees must at least ensure their fund members are properly advised. Brandon Furstenburg shows why.

Much debate about retirement centres on the "accumulation phase", the period of saving for retirement while one works up to the date of actual retirement. Less attention is paid to the period after, sometimes called the "decumulation phase".

Nobody wants to spend a lifetime saving and then commit an error at retirement by making a pension choice later regretted. On retiring, few people choose to purchase a conventional annuity from an insurer (a fixed or escalating annuity that ensures the retiree's monthly income until death). Most choose a "living annuity".

Here, in plain words, your money stays invested in the market. You choose how much you want your monthly pension to be by selecting an annual drawdown percentage between the regulated 2,5% and 17,5%. This article focuses on some straightforward things to be noted about living annuities.

First, retirees bear the longevity risk i.e. the risk that they effectively run out of money before they die. The maths behind a living annuity means that one can never actually run out of money, but for all intents and purposes your monthly pension could be reduced to virtually zero if you live to a ripe old age.



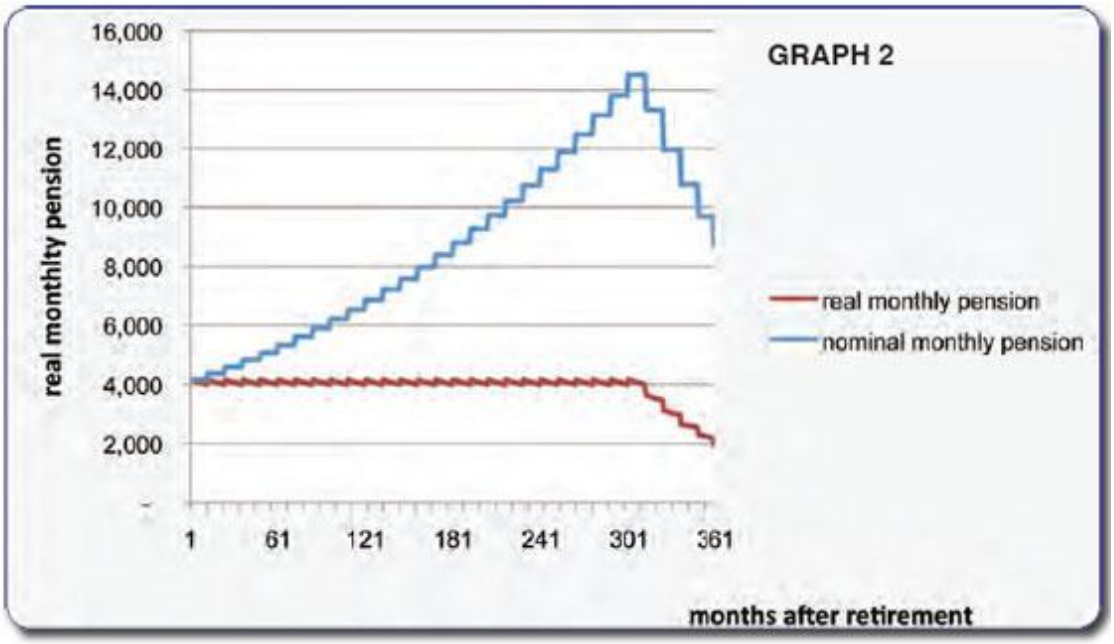
1 Assumptions: R1m initial investment at retirement, 8% annual return after expenses, inflation at 5% p.a. Drawn down rates can be varied only once annually. A less generous net annual return will reduce the monthly pension. The principles though remain the same.

Second, this directly links to the fact that a larger draw-down percentage selected by a retiree means that he'll get a bigger pension, but it doesn't last as long as if he selected a lower pension (draw-down) to begin with. Consider the example of one's monthly pension adjusted for inflation for the years after retiring at different living annuity draw-down rates (see Graph 1).

It applies to a person who selects a living annuity, invests R1m worth of capital and tries to keep his monthly pension in real terms the same for as long as possible before he is forced to reduce it (either because he is not allowed by law to draw down more than 17,5% a year or because the value remaining in his fund is too low).

If this person elects a 12,5% draw-down rate, he can get a monthly pension of R10 417. But he can only sustain this level for less than five years before he is rapidly forced to reduce it. By the tenth year after retirement, his pension will only be about R3 500. It represents a huge drop in living standards. If the person believes that he may still live a long time, barring accident, then such a drawn-down rate may be way too high.

However, if this person elects a draw-down rate of 5%, he can sustain his initial level of pension for much longer, albeit at a lower monthly level of R4 167. He will only be forced to reduce his real monthly pension from about the 25th year after retirement. The rate at which he is forced ultimately to reduce his monthly pension is also a lot more gradual than someone who had selected a much higher drawn-down rate.



Costs are critical. So too are the assumptions built into any analysis. The risk inherent in the assumptions -- for example, that investment returns are lower than assumed – implies that one's pension draw-down will be affected.

Third is the impact of inflation. The difference between the nominal monthly pension at a 5% draw-down versus its real value, adjusted for a 5% annual inflation rate, means that the pension must be increased each year for its purchasing power to remain the same (see Graph 2 where the blue line indicates the needed increase).

Inevitably, there will be trade-offs when thinking about choices at retirement. Retirement and annuity products offer different things. For fund trustees, the clear message is in the care they exercise during the accumulation.

They should also ask themselves whether their fund is doing enough for those retiring from it, at least in terms of providing information about choices, and not leaving them purely to their own devices.

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