



Pensions World

SOUTH AFRICA

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- What could a better benefits model look like? The challenge
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How to fund a Retirement Income for Life



When considering income products at retirement, members want:

- **Access to good returns** with some investment choice.
- **Protection against risk** and in particular, investment risk and longevity risk.
- **Access to capital**, before and after death.

Given the combination of needs that individuals will have and the risks that they will face throughout their retirement years, a single retirement product is unlikely to be appropriate.

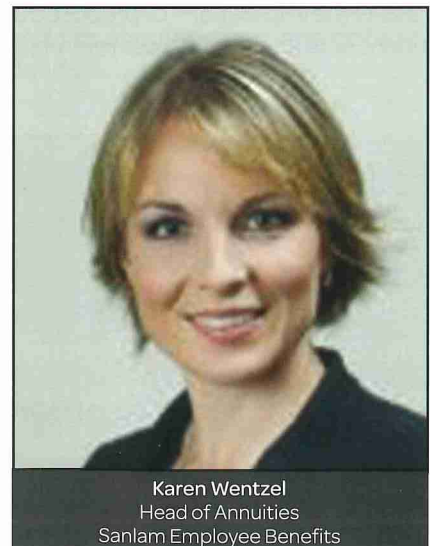
Every financial product has advantages and disadvantages, benefits and costs. Incorrect product advice and a misunderstanding about the features of annuities may lead to mixed emotions and different opinions.

Guaranteed life annuities

For all life annuities, pensioners carry no longevity or investment risk and some of the advantages of this cannot be understated:

- **Income for life.** Annuities provide an income stream that clients cannot outlive. This is more than just a marketing phrase; this is a promise for life. Insurers pool all annuity customers together. Although insurers do not know exactly when policyholders will die, they have a fairly good estimation of their lifespan by using mortality tables.

- **Annuities can be tailored** to meet specific family needs. For example, they can provide a benefit that equals 75% of the income of the main member to a surviving spouse or dependent child. Annuities give clients and their spouses the peace of mind that no matter how long they may live, their payment stream will continue.
- **Freedom from making investment decisions** for clients. Insurers can invest in a wide range of assets. Insurers offer products with attractive returns that annuity holders could not access on their own. They also release pensioners from the stress of having to make their own investment choices. This is especially important when cognitive ability starts to decrease during old age.



Karen Wentzel
Head of Annuities
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- The disadvantage is that guaranteed annuities offer clients an income for life, but **no remaining capital is left as an inheritance** or legacy after death. Further, a guaranteed annuity cannot be transferred to a living annuity.

Living annuities

Living annuities provide pensioners with an income from their retirement savings, offering flexible investment choice and withdrawal rates. In exchange for this flexibility, pensioners take on the risk that they may outlive their savings or experience poor investment returns (known as longevity and investment risk).

Pros:

- **Flexibility.** Pensioners can make investment choices regarding the underlying assets in their portfolios and can choose an annual withdrawal rate within a range of 2.5% to 17.5%.
- The remaining **capital is not lost in the event of death** after retirement and can be paid out to nominated beneficiaries.

Cons:

- Living annuities **do not guarantee an income for life.** People who live longer than average hold a significant risk that they may run out of cash. Statistics indicate that people are living longer and this leads to a rapid depletion of capital. This is currently the greatest risk for pensioners. Living annuities unfortunately offer no protection to those pensioners who may outlive their cash. Pensioners carry this risk, with no form of safety net.
- **Release from the ownership responsibility of retirement outcome.** Living annuities not only give pensioners more flexibility, but also more responsibility to make the correct investment decision and select an appropriate withdrawal rate. This may be fine when the pensioner is 65, but it is not something that they may want to worry about when they are 85 years old.

In the travel industry, premium economy class addresses more than one need for passengers by offering options for affordable, spacious way of travelling. In the same way, hybrid and composite annuities address retiree needs by way of access to good returns, protection of risks and access to capital.

Composite annuities are becoming a popular option in the market, with the following versions:

- Living annuity, phasing into a guaranteed annuity over time.

- Purchase of a living annuity together with a deferred annuity, at inception.
- Purchase of a term annuity for the first 5-10 years and thereafter affording income from a living annuity.

When commencing with a living annuity and switching into a guaranteed annuity later, the big question remains: When is the optimal time for this switch to take place?

Let's compare 2 options, namely:

1. Purchasing a 5% guaranteed escalation annuity at age 65.
2. Purchasing a living annuity at age 65 and then switching into a 5% guaranteed escalation annuity at age 70.

Option 1:

Our calculation shows that for a member retiring into a 5% guaranteed escalation annuity, with a capital value of R1 million, the starting annual pension amounts to R97 974 per annum.

Increasing this pension annually by 5%, the member will receive an annual income at age 70 of R119 088 each year.

Option 2:

This option involves purchasing a living annuity at age 65, then withdrawing the same level of income as that received from the guaranteed escalation annuity, but from the living annuity.

If a member buys a 5% guaranteed escalation annuity of R119 088 per year 5 years later (the same as the income in option 1 after 5 years), the member at age 70 requires R1.053 million to afford this. The question is what return is needed in the living annuity after fees, during the first 5 years to afford the guaranteed annuity after 5 years?

For those who are interested in the details of the actuarial models used, all the above calculations are based on the PA90 mortality table without mortality improvements.

With increasing age, the retiring member becomes a select life and a guaranteed annuity becomes relatively more expensive. The return needed to afford the same pension after 5 years is 13.9% per annum, which is a high return for a portfolio without investment in higher risk assets. Thus, if the retiring member wants to ultimately end up in a guaranteed annuity, the best time to do this is as soon as possible. □

"The secret to living well is to die without a cent in your pocket. But I miscalculated, and the money ran out too early". Jorge Guinle