The income and growth challenge

Executive summary from Conversations with Coronation held in August and September 2011

The current economic backdrop

The deep recession that followed the global financial crisis of 2008, has led to sharp drops in government revenues and the resultant massive fiscal deficits are now at the heart of the faltering global economic recovery. Research shows that following a deep financial crisis, economies take a long time to recover to the high growth rates experienced in the years leading up to the crisis. We believe that we are now in such a period of sluggish economic growth. The key question of how governments can get out of the fiscal mess is discussed in detail in our October issue of *Corospondent*. You can also listen to Charles de Kock's audiocast recording on www.coronation.com for an overview of the current global economic environment.

Below we focus on the implications of the global economic outlook for investors who are near or already in retirement. It is these investors who face the most challenging of investor needs: simultaneously investing for immediate income and long-term growth.

1) Plan for lower returns

After 10 years of outstanding financial market performance in South Africa, our reading of the current investment conditions is that investors should prepare for a lower return environment in the foreseeable future. This belief is primarily informed by the weak outlook for the global economy as mentioned above, resulting in continued very low interest rates and deteriorating fundamentals for local financial markets.

In **Figure 1** below, we show how handsomely investors have been rewarded by being invested in the local market over the past 10 years, compared to what we expect from these asset classes in the next decade. Assuming inflation of around 6% or more, we believe local equities will deliver a much more muted annualised real return of between 3% and 5% (compared to 11% achieved over the past decade), while we expect bonds to deliver an annualised real return of around 2% (versus 4% historically).

Given that the past decade's returns are far ahead of their long-term averages, we believe that using the past 10 years' performance as a guide for future returns offers a poor basis for prudent retirement planning. These muted expected returns also solidify why we believe it prudent for income and growth investors to have sufficient exposure to growth assets in their portfolios.

Figure 1: Asset class outlook

	Past 10 years*	10-year forecast**
Local equity	16.7%	9-11%
Global equity°	2.3%	13-15%
Local property	24.3%	8-10%
Local bonds	10.7%	8-9%
Global bonds°	5.8%	5-7%
Local cash	8.9%	7-8%
Inflation	6.0%	6%+

°Assume inflation differential of 3-4% per annum
*Past ten years to 31 August 2011
*Source: I-Net Bridge, Deutsche Bank, **Coronation Fund Mangers*

2) Be conservative with your initial drawdown

Given that investors who are near or already in retirement have very little opportunity left to earn an income through working, they need to make ends meet from an existing asset base that is unlikely to be replenished through further contributions.

The point is that a large part of the sustainability of your client's retirement capital hinges on the initial drawdown rate agreed upon. Drawing too high an income at the start of retirement and/or expecting too high a rate of return is as dangerous as investing too conservatively. Given the current economic backdrop and our muted return expectations, our plea is to rather err on the conservative side when you decide on an initial drawdown rate with your client. It is unlikely that an initial withdrawal rate much above 5% is appropriate given current conditions, compared to around 7% that would have been sustainable over a 30 year period based on historical returns.

In **Figure 2** we illustrate our point. Let's take a nominal net investment return of 15% per annum and an initial drawdown rate of 7.5% per annum. In this scenario an investor's retirement capital will provide a sustainable income over more than 50 years. However, look at what happens when the nominal net investment return drops to 12.5%. This lower return moves sustainability from 50 plus years, to just 22 years. If the average return drops further to 10%, sustainability declines to only 13 years.

Figure 2: Income rate and return analysis

		Nominal net investment return per annum					
Selected income rate per annum		2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
	2.5%	21	30	50+	50+	50+	50+
	5.0%	11	14	33	33	50+	50+
	7.5%	6	8	13	13	22	50+
	10.0%	4	5	7	7	9	20
	12.5%	2	3	4	4	5	7
	15.0%	1	1	2	2	2	3
	17.5%	1	1	1	1	1	1

Source: Asisa Standard of Living Annuities with additional calculations by Coronation Research

In **Figure 3**, we look at the same problem from a different angle, by calculating the probability that your client's living annuity will maintain its purchasing power at various drawdown rates and over different time periods. For this exercise, we used a portfolio with a risk budget consistent with that of the Coronation Capital Plus Fund (that can invest up to 60% in growth assets) and assuming a 7% p.a. real return from equities and 3% p.a. real return from bonds. Note that we deem this to be an optimistic forecast. At a drawdown rate of 6%, your client's portfolio has a two in three chance of maintaining purchasing power for up to 25 years if the return assumptions hold. By living 5 years longer, the probability of the portfolio maintaining purchasing power over the full retirement period declines to roughly one in two (46%). At a drawdown rate of 5%, things look to be reasonably fine up until 30 years, giving your client a three in four chance of being able to maintain their living standards.

Figure 3: Probability that your living annuity will maintain purchasing power

Years	Initial drawdown rate per annum				
	4%	5%	6%	7%	8%
20	99.9%	97.7%	86.8%	63.7%	36.6%
25	98.7%	88.8%	64.8%	36.2%	15.6%
30	95.7%	76.9%	46.4%	20.5%	7.2%
35	90.4%	64.8%	33.5%	12.8%	3.9%

Source: Coronation Research using a Monte Carlo simulation of a portfolio consistent with Capital Plus's risk budget.

However, if you reduce your asset class return assumptions - to what we would consider more prudent levels – from 7% p.a. real to 4% p.a. real from equities and from 3% p.a. real to 2% p.a. real from bonds, there is only a one in three chance that purchasing power will be sustained for 25 years at a 6% initial withdrawal rate. To achieve the same probability of maintaining purchasing power as in the optimistic assumption set, the initial drawdown rate needs to be reduced from 6% to 5% (see **Figure 4**).

Figure 4: Probability that your living annuity will maintain purchasing power

Years	Initial drawdown rate per annum				
	4%	5%	6%	7%	8%
20	99.1%	91.0%	67.5%	37.7%	16.2%
25	92.8%	68.6%	36.5%	14.1%	4.2%
30	80.7%	46.9%	18.5%	5.4%	1.2%
35	66.7%	31.2%	10.1%	2.5%	0.5%

Source: Coronation Research using a Monte Carlo simulation of a portfolio consistent with Capital Plus's risk budget.

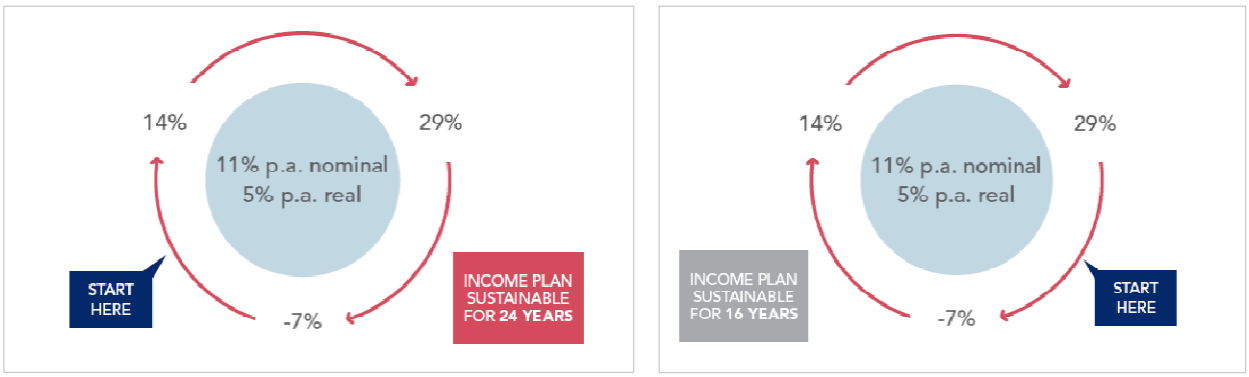
3) Investing in growth assets alone is not the answer

When we presented on the Income and Growth Challenge as part of our Conversations with Coronation series in August 2010, we argued the need for growth assets in an income and growth portfolio. But the problem is that you cannot optimise the outcome of your retirement capital by investing only in shares and property. This is due to the fact that returns on growth assets can vary significantly from year to year. Take for example a three-year investment cycle and assume returns of 14%, 29% and -7%. If you compound these returns you get a nominal return of 11% per annum, or 5% real if you assume inflation of 6%.

In the scenario (**Figure 5, below left**) where your client starts drawing an income of 7%, which adjusts annually by inflation, and the portfolio experiences two years of positive growth (14% and 29%) before suffering the 7% loss, your client's retirement plan will be sustainable for 24 years. If however he/she starts drawing down in the year that the portfolio suffers the 7% loss (**Figure 5, below right**), followed by the two years of positive growth, your client's plan will only be sustainable for 16 years before he/she starts eating into his/her capital.

The difference of eight years comes solely as a result of the negative return experienced in the first year of drawing an income; highlighting the need to moderate the volatility of returns in an income and growth portfolio and why too much exposure to growth assets may not be optimal.

Figure 5: Importance of the sequence of returns



Assumptions: Starting drawdown rate = 7% adjusting annually by inflation of 6%
Sustainability period measured to year when maximum annual drawdown rate = 17.5% (Max for an investment-linked living annuity)
Annual return series repeat in same order for full period of retirement.

Source: Coronation Research (Acknowledgement GAO; Milevsky &Macqueen)

4) Coronation's income and growth solutions

Coronation offers two funds that meet the needs of income and growth investors – Balanced Defensive and Capital Plus. These funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of real return over the long term with minimising the risk of capital loss over the short term.

The Balanced Defensive Fund can invest a maximum of 40% in growth assets and is managed to deliver positive returns over any 12-month period with a high degree of probability. The fund was launched in February 2007 and is consistently one of the top performers in the Asset Allocation – Prudential Low Equity Category, producing a nominal return of 9.6% p.a. (or 2.4% p.a. in real terms) since its inception at a standard deviation of 4.0%.

The Capital Plus portfolio has a unique risk budget and is optimised for income and growth investors with longer time horizons. Up to 60% of the portfolio can be invested in growth assets and despite its larger risk budget, the portfolio also aims to preserve capital over any 12-month period. It has produced a nominal return of 14.4% p.a. (or 8.1% p.a. in real terms) since its inception in 2001 at a standard deviation of 7.5%.