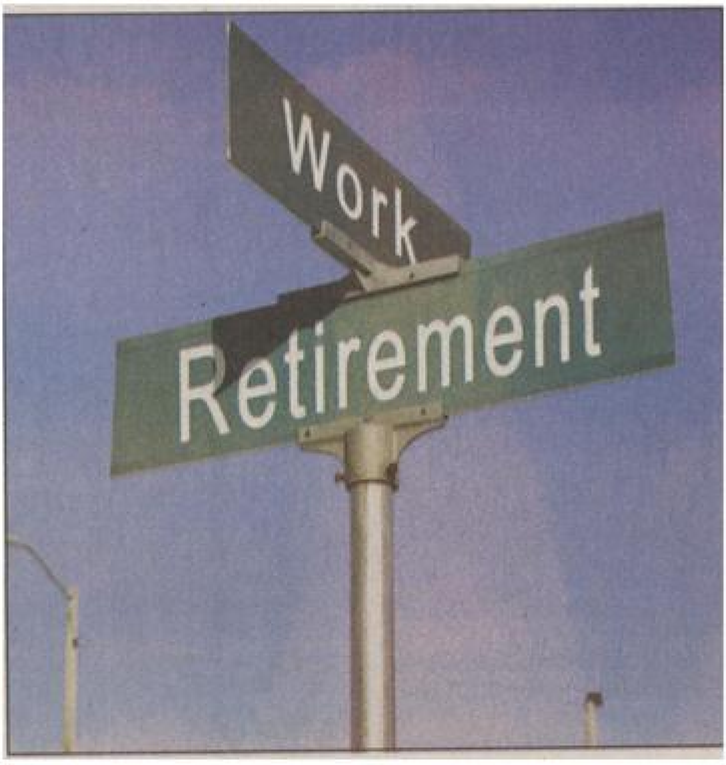
Pieter Koekemoer ... the risk appetite should be stepped up to secure a dignified lifestyle.



Twin challenges of retirement

You need a regular income to cover everyday living expenses but the capital must keep pace with inflation, writes DAVID JACKSON

INVESTORS who are near to — or who are already in — retirement face the most challenging of investors' needs, simultaneously investing for both immediate income and long-term growth.

Pieter Koekemoer, head of personal investments at Coronation Fund Managers, says: "While these investors need to draw a regular income from their retirement portfolios to cover their everyday living expenses, they also need their capital to continue to grow to keep pace with inflation."

Koekemoer says that one of the biggest risks investors face is the failure to provide for a comfortable standard of living in retirement, however long that may be. This risk is often overlooked by investors who seek the security of a product with low volatility and low risk for their retirement capital.

"In an attempt to sleep easier at night investors are moving down the risk spectrum — out of growth assets such as equities and property into income-generating assets such as bonds and cash — when in fact their risk appetite should be stepped up to secure an enjoyable and dignified retirement."

He says the main reason for making this potentially unpopular move is that the decision to move down the risk spectrum is being taken on future outcomes predicted by back-testing exercises using historic returns and correlations.

"While these are the only tools at one's disposal, the important hazard warning concerns the sustainability of historic returns in the future."

He says the past 10 years have been good to investors in local assets and many retirees who expect a repeat of this experience may find that they are not positioned to cope with the tougher investment environment that is unfolding.

Koekemoer says that drawing too high an income at the start of retirement, or expecting too high a rate of return, is as dangerous as investing too conservatively. "Given our expectation for lower returns we do not believe that initial income drawdown rates above 6% will be sustainable for most retirees — and then only from a portfolio with adequate exposure to growth assets."

He argues for the inclusion of growth assets in a post-retirement portfolio, but warns that a retiree's outcome will not be optimised by investing only in shares and property.

"This is because returns on growth assets can vary from year to year."

For example, the local equity market has achieved an average return of 16,7% a year over the past decade at a standard deviation of 20%.

The standard deviation reflects the range of calendar year returns, which in the case of the equity market has ranged from as high as 46% in 2005 to as low as -23% in 2008.

Koekemoer says that studies show that the sustainability of a retirement income plan is most often optimised with a standard deviation of 10% or less.

"The reason why the volatility of returns should be moderated is because the sequence of returns matter.

"If the value of your investment declines just after you start drawing an income from your portfolio the income drawn will represent a bigger portion of your capital than if you had experienced growth over the same period. It means that in future years you will need to draw a larger portion of the remaining capital to achieve the same level of income."

He says that these are important considerations that investors with both income and growth needs should take into account to ensure that their retirement planning is appropriately prudent.

Windall Bekker, head of investment consulting at OMAC Actuaries & Consultants, says trustees can protect themselves and their members from significant financial loss by paying close attention to the details of their particular fund.

"During times of extreme volatility and uncertainty it is helpful for trustees to understand every aspect of their funds. First of all, trustees should have a detailed understanding of the fund members they represent. This includes, but is not limited to, age, gender, accumulated credits and contribution rates."

Trustees also need to be clear on what the target replacement ratio is and understand the effect that changes in various factors, such as age to retirement, changing contribution rates and differing investment objectives, will have on the replacement ratio.

Bekker advises trustees to define their objectives clearly.

"Trustees need to be clear what the investment objective of the fund (return above inflation) is to achieve the target replacement ratio."