

PENSIONS

The death of retirement

HOW LONGEVITY, BETTER MEDICAL CARE, HIGH COSTS AND POOR RETURNS COULD SEE YOUR SAVINGS EXPIRE BEFORE YOU DO

By Bruce Whitfield

My father – a Free State farmer for more than 60 years – recently retired, having worked to beyond his 80th year. In so doing he has pretty much guaranteed himself a comfortable and financially secure retirement. Why did he work for as long as he did? He wanted to. And, more importantly, he could. As his own boss he was able to dictate the scope, scale and magnitude of the tasks he set himself. And, fortunately, he loved his job. Sure, his view of the world was also shaped by early childhood memories of drought and the hardships of the Great Depression. Added to that, he'd also witnessed numerous friends and relatives come up short and vowed it wouldn't happen to him.

While my father's case may be unusual circa 2011, Mike Jackson, the CEO of PPS, says it's the way of the future. "I think the whole concept of retirement is a load of nonsense. At 65, the average middle class person has 20 years to live and the amount of money you need to ensure you maintain your lifestyle during that time is huge. It's a completely unrealistic expectation. At PPS we find self-employed professionals have no concept of retirement and keep

working well into their 70s and even their 80s, which is one of the reasons for their high life expectancy. Retirement was created by organisations to get rid of dead wood."

A combination of factors – including inadequate savings, high product costs, combined with the likelihood of muted future returns – means the vast majority of people currently working will be obliged to continue doing so for longer than they might have liked or risk outliving their savings. In an ever-tightening global labour market that's a daunting prospect.

The statistics are sobering. Less than one in 10 of us will retire at 65 – commonly accepted as a "normal" retirement age – and be in a position to sustainably replace 60% of our final salary cheque on a monthly basis. For 20 years the retirement industry, which peddled a plethora of costly and often inefficient savings vehicles, has put the number at 6%.

"A more scientific estimate concluded that more than half the people who have worked and contributed to a retirement fund achieved a pension that replaces less than 30% of their final salary. We believe the minimum target is 60%," says Stephen Nathan, CEO of 10X Investments. "Savers are at the mercy of an industry that makes



COVERSTORY

unrealistic promises, misleading projections, charges high fees and offers conflicted advice."

The South African Government has seen the writing on the wall and is working on proposals that the country's financial sector hopes will make retirement saving mandatory. However, the issues are complex. The bottom line is that unless you fall into the category the private banks refer to as "high net worth" the chances of retiring comfortably much before your 70th birthday are increasingly remote.

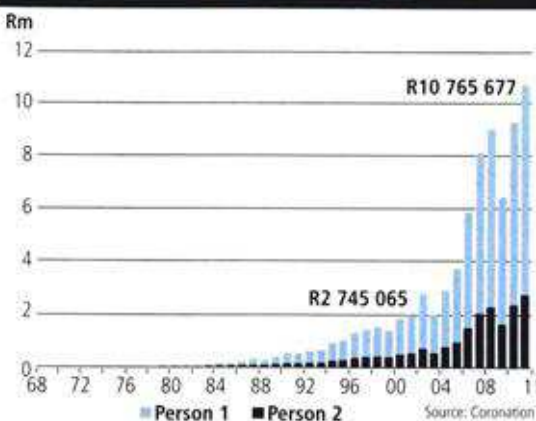
Magnus Heystek, director at Brenthurst Wealth Management, cautions: "Forget retiring at 55 – or even at 60 – as you're likely to be destitute by the time you're 75." You need to be finding ways to keep yourself gainfully employed and saving until you're at least 70 on the assumption you're likely to live for about 15 years beyond that. Even then, you might be cutting things a bit fine.

Nathan says: "For most people the concept of retiring comfortably ended with defined benefit plans. Defined contribution plans have transferred the retirement risk on to the individual – but relatively few individuals deal with that risk in an informed manner."

One way of addressing the retirement malaise is to make not only some form of retirement saving mandatory, but also to make it compulsory to preserve those funds when changing jobs. Both proposals are understood to be part of a much broader National Treasury discussion about SA's retirement funding crisis. (See box.)

One of the biggest constraints to starting to save early is a lack of faith in the investment process. A series of investment scandals and high fee structures have often put investors off even starting the process in the first place. The greatest difficulty facing investors is identifying the most appropriate savings vehicle. For example, there are about twice as many unit trusts in SA – almost 950 – than there are companies listed on the JSE. The local investment landscape is complex and fraught with a myriad conflicting options for private investors, who face a confusing plethora

THE POWER OF COMPOUNDING



of investment options. Making the wrong choice early can be devastating to long-term savings. Investors are encouraged to use brokers to select and switch products, all of which undermines the final return they receive on their investments.

In an ideal world we'd all save 15% of our gross salary for the 40 years of our working lives towards retirement. Using available tax advantages and the power of compound interest we'd have a sizeable nest egg by the time we're put out to pasture. Even if you've managed some form of forced saving over an extended period, have you preserved your retirement savings each time you changed jobs? The vast majority of us fail to do even the basics and the temptation to cash in your pension when changing jobs is enormous.

Coronation Fund Managers executive director Kirshni Totaram says all the data shows the impact of starting early and relying on the power of compounding. The graph above illustrates how "Person 1" who contributes R100/month between the ages of 21 and 31 and then elects to leave the money in a fund equivalent to the All Share Index benefits over a late starter. The end value is calculated when they reach 65.

Person 2 starts with a R100 saving at age 31 and saves for a full 34 years. Despite saving for less than a third of the time, the end value for Person 1 is three times higher than that of Person 2 – illustrating the impact of compounding. It means

our latecomer would need to invest at least R3 100/month to achieve the same outcome as Person 1 by the time he's 65. Totaram warns that amount becomes even more onerous if markets return less than they did previously.

Says Totaram: "It's normal human behaviour to forecast future returns based on (historical) long-term numbers, believing if they save large amounts closer to retirement the great returns from the market will bail them out. That's very dangerous. It makes the key assumption the trends and drivers that supported returns historically remain in place and will continue contributing to growth in the same way. We don't believe that to be true."

The exuberance of much of the first decade of the 21st Century has probably done many investors a disservice, in that it has created an artificial set of expectations for future returns. The returns registered globally in the first decade of this century came about as a result of a series of factors unlikely to be repeated any time soon: the structural change in inflation that characterised much of the past decade led to lower than average interest rates and a more generous tax regime, which in turn gave impetus to equity and bond markets.

INVESTING OPTIONS

Not everyone is a fan of traditional savings vehicles despite their apparent benefits. Paul Theron, MD of Vestact, says: "Retirement annuities are absolutely useless. They're a fee-gathering device for brokers and asset managers, and investors get screwed in the process. Goodness knows why Government persists with their tax cuts on contributions made to those investment dinosaurs. What's more: the cash they pay out after you retire is mostly taxable. Savers with small amounts to put away would be better off putting them in long-term cash savings accounts or buying Government retail bonds; while savers with a bit more should be putting money into a low-cost equity account and reinvesting the dividends."

The theory of living off dividends

RETIREMENT INDUSTRY REFORM

'A massively complex issue'

REFORM OF THE retirement industry is multi-faceted. It had its genesis in 2004, when the first proposals for the overhaul of retirement funding came to the fore. The great difficulty Government faces will be how to introduce reforms likely to include some form of forced savings, with the compulsory preservation of retirement monies by individuals as they switch jobs. That needs to be achieved without putting undue pressure on household budgets and adding to the burden borne by already stretched businesses whose primary cost already is the price of labour.

Government's long overdue pension system wish list is likely to be unveiled in second half 2011. Only then will advisers and the rest of SA's retirement industry be able to make its contribution to the debate.

Treasury says the hard work has been done on the Approved Funds Framework (AFF) Paper. It aims to release that by end-July. It will be the first Government proposal and open to public discussion – a process Olano Makhubela, chief director of financial investments and savings at the Treasury's financial sector policy unit, ambitiously hopes will last about two months, enabling a final version to be completed in time for the 2012 National Budget.

"It's a massively complex issue," says Makhubela. "We don't want to rush it through, because it has major implications for individuals and the savings industry. But that's no excuse to delay the process any further either."

The retirement reforms aim to incentivise lower income earners to save more and reduce the incentives for wealthier savers by putting a ceiling on tax breaks. Current proposals sit at a relatively modest savings level of around R200 000/year – it's a number the industry will argue strongly needs to be upped. However, Government thinking suggests otherwise.

Other controversial proposals under discussion include the possibility of again expanding the official retirement age after Government reduced the age at which men in State employment would be entitled to receive a pension to 60, in line with

women. But the SA Government (like many in the northern hemisphere) is looking at ways of reducing the State's financial burden. Rather than incur the wrath of trades union alliance Cosatu it may choose a compromise option by allowing State employees to continue in their jobs to ensure they make a greater contribution to the overall pension pot and delay the date of accessing the savings pool.

Though it's all well and good to introduce forced savings and mandatory preservation funds, the success of any scheme will depend on how it's structured, the options provided to investors and at what cost. The financial crisis and the unpredictable nature of the global economy mean returns for investors over the next 10 years are unlikely to be anywhere near those of the past decade. Plus the cost of most existing retirement savings vehicles is simply too high to provide certainty of even a 5%/year real return. Treasury's reforms are likely to address the issues of cost and transparency, including the marketing of false promises and unrealistic projected returns as a means to entice unsuspecting savers into pricey product lines. ■



is solid under the current tax regime. However, in order to achieve income of R500 000/year you'd need a portfolio worth R10m in current money and achieve an average yield of 5% – a big ask. And as Anglo American and Old Mutual investors learned to their cost in 2008, dividend flows are by no means guaranteed – which can force investors into eroding their

capital base.

Our grandparents might have been grateful to retire at 65 and spend their quaintly termed twilight years fondly eyeing the gold watch strapped firmly to their wrists while drawing on their defined benefit retirement funds for about five years – if they were lucky. Increasingly, the burden of responsibility for retirement

falls squarely on our own shoulders. You alone are responsible to ensure you don't become a burden on your children, and the State hopes you won't become dependent on its limited resources.

By the time you reach the age when Shady Pines Retirement Village seems an attractive proposition, your kids will have problems of their own to deal with and

COVERSTORY

will invariably blame this generation for denuding the planet of its natural resources – from fossil fuels, to forests and even safe water supplies. It's a grim reality. But current generations are living longer, with consequential higher expenses of that privilege that are going to be provided by nobody but themselves.

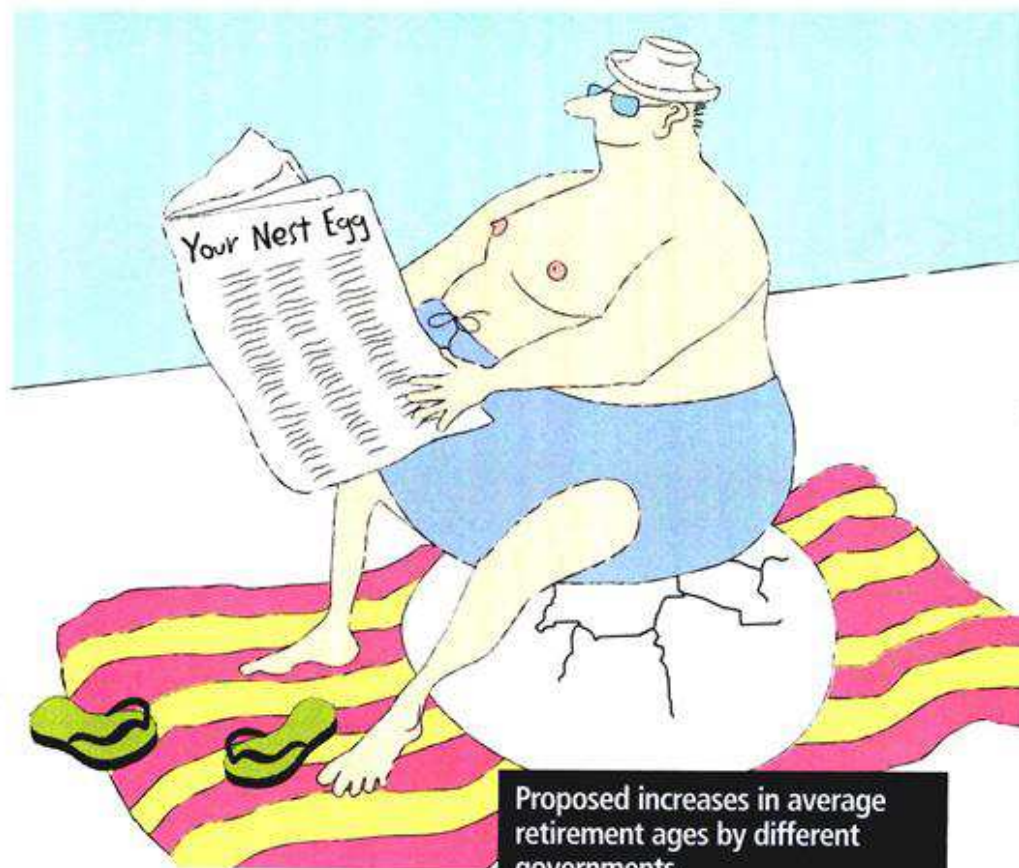
So what do you do? Park that Mauritius holiday, drive the old car till the traffic department refuses to renew its licence, on the basis that it's a risk not only to yourself but also to other road users? Even if you think you've put aside enough, the new global reality is declining investment returns mean your nose is going to be stuck to the grindstone for considerably longer than you might have intended. The longer you work, the more you can earn and – theoretically – save for your own benefit, placing less of a burden on the State, which will gain from your continued tax payments and the fact that it has no obligation to look after you.

Working till the age of 70 is considerably unappealing for most. However, in an environment where many workers in the professional world are considered to be past their prime at 50 and find themselves ousted in corporate retrenchment drives as their salaries become more expensive than hiring five bright graduates with fresh ideas, the reality of being able to work – certainly for a single employer up to the age of 70 – is fading. The only thing worse than having to work till you're 70 is being unable to work till that age, either because of a drop in physical ability or simply through workplace prejudice.

EXTENDED LIFE EXPECTANCY

While many governments worldwide have announced increases to average retirement ages – which will continue to expand over coming decades in an effort to delay the impact of the cost of state pensions on the fiscus – it means governments will require their citizens to be tied to their desks for ever extended periods. The United States is seeking to push its official retirement age UP to 67 and Britain to 68, while the Europeans have 70 as a 2040 target.

Life expectancies among the wealthy



Proposed increases in average retirement ages by different governments

	2040 target
United States	67
Britain	68
Europe	70

Current average retirement age

Greece	61
Germany	62
France	59,4
South Africa	60

are continuing to rise, courtesy of better lifestyles, diet and advances in primary healthcare. Organs whose failure five decades ago would have resulted in the relatively speedy demise of their human carrier can now be replaced with relative ease, albeit at considerable expense, thereby extending the period many of us will inhabit the planet. Since 1971 the life expectancy of the average 65-year-old in the rich world has improved by four to five years. By 2050 the average life expectancy in the developed world will have grown to around 70 – up from 65 currently and 61 in 1970.

In one academic study, university-age students shown digitised pictures of themselves as they might look in old age allocated more than twice as much of their income to retirement savings as students who were shown contemporary photos. If you're able to deny the reality of rapidly advancing age it would seem you're more likely to delay the implementation of a sensible savings strategy.

Governments are increasingly being forced to take the politically unpalatable step of altering their respective retirement ages. In mid-2010, French unions and students staged countrywide protests at their government's plans to raise the retirement

age to 62 – forcing its citizens to work longer to qualify for state pensions. Britain's current coalition government has proposed raising the official retirement age to 66 by 2016, with plans to increase it to 70 by 2046. Britain needs to shore up government finances: the longer citizens are productive, the more tax they'll pay and will ultimately be dependent on the state for a shorter period of time. Current European Union figures show the average current retirement age is 61 in Greece, 62 in Germany and 59,4 in France. SA's Government recently lowered the official retirement age of men to match that of women: 60. But Treasury is looking to a potential compromise situation.

However, as time moved on and medical advances accelerated, life expectancies expanded and pension pots became

rapidly depleted, putting a bigger onus on individuals to take care of themselves in their old age. Nowadays it's about the contribution you make, when you start making that contribution and whether or not by the time you stop working your savings can outlast you.

"As people approach retirement, we strongly advise they review their actual budget and look at two figures: the number to provide 'comfort' and the number for 'basic needs'. As you enter the final straight to retirement, you can then see how your savings compare to these two measures and how to meet those needs," says John Anderson, head of institutional strategy at Alexander Forbes. "We expect the cost of retiring to increase mainly because of longevity and the impact of reduced real returns from investments. It means people have to save for longer, retire later or reduce their standard of living in retirement."

Alexander Forbes statistics show that around 75% of individuals take out living annuities: half of those draw down more than 7,5%/year of their capital and an alarming 20% access the maximum 17,5%. It means there are a growing number of retirees who will run out of money.

How do you ensure you have enough? Well, a 45-year-old earning R50 000/month who hasn't yet started saving has a lot of catching up to do if he wants to achieve any kind of comfortable retirement. In order to achieve an NRR at the minimum recommended level of 60% an individual needs to save R13 500/month and achieve the ideal level of 75% if the calculation spikes to an even harder to afford R16 500 – at best around 40% of after-tax income.

Anderson stresses it's crucial to manage the factors within your control. Preserve retirement funds when changing jobs: don't under any circumstances cash in. "Our research indicates that of all the factors under our control that's the single biggest detractor of decent replacement ratios. Based on a standard set of assumptions you could expect a net replacement ratio of 75%. But using the observed preservation rates of members exiting funds, it drops to 28%."

SELECTING YOUR MANAGER

So who do you entrust your money to? Active managers' fees are notoriously high relative to their average performance record. Sure, if you pick a good manager you're likely to get a solid performance. But according to statistics released by 10X Investments 19/20, fund managers in South Africa have underperformed the All Share Index over the past two decades. "That ratio improves as the period decreases. Still, more than 85% of funds underperform the index over five years and 61,5% underperform it over one year," says 10X Investments CEO Steven Nathan. "Investors are led to believe professional managers reliably beat the market index but after costs the index beats professionally managed funds most of the time."

Active management is premised on the notion that the best fund managers can identify shares that will outperform the market and thus deliver their investors an

above-average return. However, the return of the market is finite so active management is a zero-sum game – before costs.

Retired Vanguard Group founder John Bogle, and author of *The Little Book on Common Sense Investing*, points out that trying to beat the market is ultimately a loser's game due to the costs associated with active management.

Veteran money manager Liston Meintjies says the conundrum of interest rates that are high when inflation is high and raises prices is murderous to those more than 10 years into retirement if they've been dependent on income. Five years ago – with R1m in capital – income was, say, R100 000, with expenses around R60 000. Now those numbers are probably reversed – and a large part of that is due to much higher medical bills.

Meintjies says retirees stepping aside now need to ensure they have a home that's paid for, at least R3m in discretionary assets that can be accessed if income from other investments falls too low and at least R350 000/year coming in from pensions and investments. Assuming you're getting a 5% yield it means you have R7m invested, implying a total nest egg of R10m – although to achieve that kind of income you probably need around R15m, with the lion's share in blue chip, high dividend-yielding assets.

The biggest threat to retirement savings, says Cannon Asset Managers' chief investment officer Adrian Saville, is



The biggest threat to retirement savings, is inflation. "Inflation running at 7%/year halves the purchasing power of a pension in 10 years and halves it again in 20 years"

CANNON ASSET MANAGERS' CHIEF INVESTMENT OFFICER ADRIAN SAVILLE

COVERSTORY

Most of us earn an income for less than half our lives: many are dependent on their parents for at least the first two decades, work for four more and then face two or even three more either as financially independent retirees or as additional burdens on their children



inflation. "Inflation running at 7%/year halves the purchasing power of a pension in 10 years and halves it again in 20 years."

Marriott Asset Management also stressed its concerns about the impact of rising prices on investments. "We consider inflation to be the most important economic variable for retirees, as it has a profound impact on the lifestyle of income-dependent investors. Inflation also affects the pricing and yields of assets," says a report, which adds investors need to ensure they own shares that produce reliable and growing income streams and, more importantly, need to acquire those at appropriate prices. A minimum return an investor should accept from an investment is inflation+3%, as you can buy Government-backed inflation-linked bonds guaranteeing the investor a real return of 3%.

The results you achieve from your retirement fund are determined by three factors: your savings, the return earned on your savings and the fees you pay. To get the best result you must also do three things: it isn't good enough simply to be a diligent saver – putting 15% of your gross income into a badly managed and costly savings vehicle early on will see your returns eroded. By investing sensibly

you must also consider age-appropriate portfolios and be aware of the percentages invested in different levels of risk and ensuring the correct asset mix is achieved.

Investec Asset Management product development actuary Johan Schreuder points to the fact that most of us earn an income for less than half our lives: many are dependent on their parents for at least the first two decades, work for four more and then face two or even three more either as financially independent retirees or as additional burdens on their children. The only way of guaranteeing you fall into the former category is if you have up to 20 times your final annual salary saved before you retire. If, like most people, you've left it late and only start saving at age 45 then to achieve that level of retirement funding would require you to save more than 50% of your monthly salary – that's simply unaffordable for most of us who tend to be short of money allocated for savings.

The fact that investment returns are likely to be more muted in the current decade than in the last also raises the risk of individuals falling for scams by people who promise and often deliver – for a period at least – way above-average returns. Warren Ingram, a director at Galileo

Capital, highlights the recent collapse of property syndication schemes as a case in point. While sensible advisers may have warned the promised returns of up to 12% were unrealistic, it opened the way for less prudent advice – driven by meaty commissions to be earned. "The promise of guaranteed returns is based on the apparent security of underlying property. And while honest advisers questioned the hefty upfront commissions and avoided punting the schemes to their clients, others weren't so fortunate."

Ingram adds: "The basic principles of investing are very simple and have remained unchanged for decades. The problem is that none of us like sacrificing now in order to benefit later. This trend is worsening as new generations of workers enter the market as our society rewards short-term thinking and places greater emphasis on immediate gratification – a terrible combination for long-term investors."

"The uncertainty about regulation and increased State intervention in the economy as a whole worries most retirees we deal with. They fear a changing political climate and the impact implicit taxes – such as power, fuel and toll roads – are having on their disposable income and destroying capital retirees have worked long and hard to save up."

In his massively controversial *Die Broke* – penned 15 years ago – US financial adviser Stephen Pollan told Americans their goal was to ensure they didn't outlive their savings. He also cautioned against being overly conservative. "You're a jerk if you leave a single penny," he said, overturning the long-held belief we owe our children an inheritance through working our fingers to the bone and saving every cent. Rather, he argued, use your money to build a great life while you're still around.

The new economic reality, said Pollan. Looking back at that book means his ideas formulated at the time of the tech boom were regarded as counter cultural but are increasingly mainstream amid financial turmoil and growing levels of uncertainty. Says Pollan: "*Die Broke* turned out to be a pretty good reading of the tea leaves." ■