FINWEEK (English)
10 Nov 2011, p.50

DRAWDOWN SHOWDOWN

Retirees will have to tighten their belts by a fair number of notches.

A new report from Coronation urges pensioners to curb the percentage paid out of their living annuity (drawdown) every year.

"With expected annualised long-term real returns from local equities in the 3% to 5% range (compared to 11% achieved over the past decade) and around 2% for bonds (versus 4% historically), the margin for error in the making of investment and financial planning decisions is likely to become much smaller than most of us are used to," say Pieter Koekemoer and Adrian van Pallander of Coronation.

Currently, the drawdown rate, as determined by investors and their advisers, may be between 2.5% and 17.5% of capital. "Initial drawdown rates of above 7% can be justified using historic return patterns, (but) it would be less than prudent to consider much above 5% given our current outlook for financial market returns."

In fact, say Koekemoer and Van Pallander, if you want to fully protect yourself against running out of capital in virtually any circumstance over an approximate 30-year period, you need to start with a very low initial withdrawal rate (4% or less).

One way of making sure your money will last is by setting up dynamic drawdown rules – a form of self-regulation to govern your withdrawals. This can be set up by your financial adviser.

Basically, it boils down to creating two rules, says Coronation.

The **modified withdrawal rule** will increase your withdrawals annually with inflation, except when the retirement portfolio has produced a negative return in the prior year and when the current year's increased rate is higher than the initial withdrawal rate. There's no catch-up for missed increases in later years.

The **capital preservation rule** states that if the increased withdrawal rate in a given year exceeds the initial withdrawal rate by more than a certain percentage (say 20%), the withdrawal rate is cut by a predefined percentage (say 10%). This rule is only applied in the first half (around 15 years) of retirement.

As an example, assume you retire with R5m in capital and choose an initial withdrawal of R250 000, or 5%. Assume that five years later your portfolio is worth R5.5m and your inflation-adjusted withdrawal is calculated to be R340 000. This withdrawal rate represents 6.2% of your capital, which is 24% higher than your initial withdrawal rate. Because it exceeds the pre-defined percentage of 20%, the required withdrawal is cut by 10% to R306 000. "This spending rule could be further refined (at the expense of giving up some safety) by adding a prosperity rule: If the withdrawal rate would fall by more than a pre-set percentage (say 20%) below the initial withdrawal rate, the withdrawal is increased by a defined percentage (say 10%)."

According to Coronation, a 2007 American study found that these two rules together could double the sustainable withdrawal rates without significantly increasing the risk of running out of money late in retirement.

"It's (also) important to note that sustainable withdrawal rates are typically lower when assets are more expensive than normal (when 10-year p:e multiples for equities are high and bond yields are low), and higher when assets are priced at below average values. For a retiree, valuation levels at the point of retirement and during the immediate decade thereafter are likely to play a significant role in outcomes.

"It's therefore imperative that investors and their advisers appropriately moderate income expectations during the initial phase of retirement to ensure long-term sustainability of their income plan," say Koekemoer and Van Pallander.

IF YOU assume that the retirement planning period is 30 years, the maximum drawdown rate that would have provided a sustained, inflation-adjusted retirement income over the length of retirement (also known as the SAFEMAX rate), considering 110 years of asset return data, is 3.84% for South Africa. The worst historical year to have retired was 1937. SA's SAFEMAX rate is similar to that of many other economies, with countries such as Switzerland, the UK, US, Canada, Australia, Denmark and Sweden all ranging between 3.6% and 4.4%.

Source: Coronation