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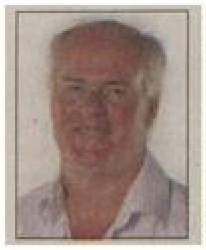
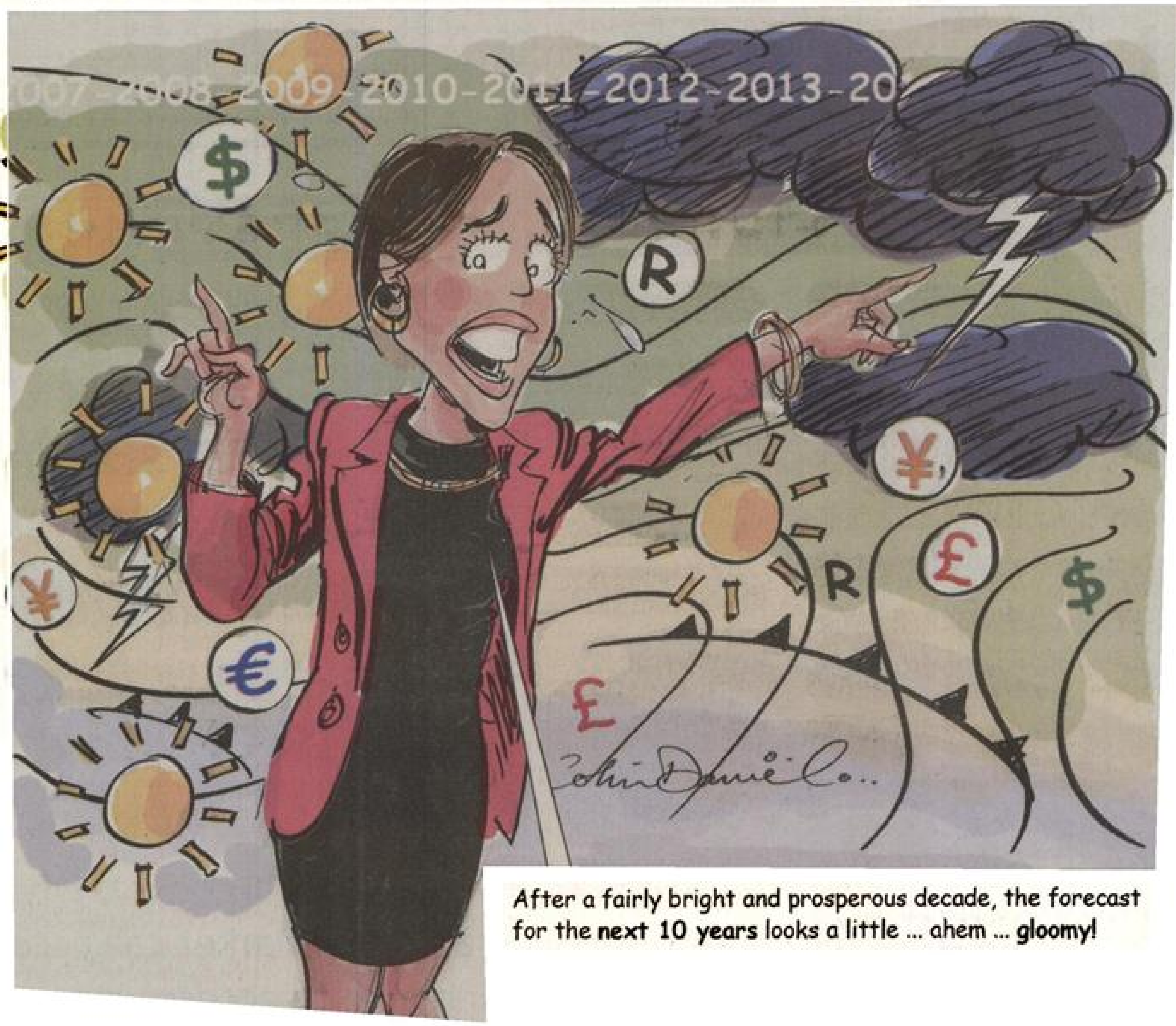
AFTER A DECADE OF OUTSTANDING RETURNS, INVESTORS ARE FACING A LEAN 10 YEARS

Gloomy market outlook means rethinking your pension funding



Despite the credit crisis three years ago, the past 10 years have provided excellent returns for local investors. The next decade looks decidedly less sunny, especially if you are relying on growth assets to fund your pension. **Bruce Cameron** reports



After a fairly bright and prosperous decade, the forecast for the **next 10 years** looks a little ... ahem ... **gloomy!**

Pensioners using investment-linked living annuities (illas) for a retirement income face the bleak prospect of poverty in the future because of a fundamental change in anticipated investment returns for the next 10 years.

After 10 fat years we are now into the lean years, which will require a total readjustment and reassessment of your calculations if they were based on the outstanding returns of the past 10 years.

But now "the dark clouds of unsustainable budget deficits and debt levels, coupled with a general loss of faith in the ability of politicians to deal decisively with these issues, will continue to sap market confidence for the foreseeable future," says Louis Stassen, a senior portfolio manager at Coronation Asset Management, who heads the absolute investments unit.

The consequences will affect almost everyone, from those saving for retirement to people who have already retired.

Particularly at risk, Stassen says, are pensioners on illas, who have no way to make up for investment shortfalls.

They either have to cut back on spending now or face the prospect of future years of destitution.

Stassen, who was speaking at a presentation to financial advisers, says many pensioners are basing their calculations on having sufficient money in retirement on investment returns of between 12.5 and 15 percent a year.

However, the reality is that returns of this size are not likely to be seen for the next 10 years as the local and world economies seek to recover from the shocks of the 2008 subprime meltdown and the more recent crisis of countries facing the prospect of defaulting on debt.

For example, South African equities provided an annual average return of 16.7 percent over the past 10 years, which is far ahead of long-term averages. Coronation predicts that for the next 10 years it is prudent to assume a return range for South African shares of between nine and 11 percent a year.

Local property is expected to drop from an annual average return of 22.7 percent to between eight and nine percent a year.

Stassen says if an illa pensioner is drawing an income equal to 7.5 percent of residual savings and is receiving a 15-percent nominal (before-inflation) return, he or she can expect a sustainable income for more than 50 years.

Drop the investment return to 12.5 percent and the pensioner will be in trouble within 22 years.

Drop the return to 10 percent and after 13 years the pensioner will not be able to make ends meet.

The problem is that, according to Alexander Forbes research reported in Personal Finance earlier this year, the average illa annuitant draws down an annual income of more than 10 percent of the residual capital financing his or her pension.

Stassen says that with a 10-percent drawdown rate and a 15-percent annual investment return, a pensioner will reach a parlous financial situation within 20 years of retiring; with a 10-percent drawdown and a 12.5-percent return, the danger point comes at nine years; and with a 10-percent drawdown and a 10-percent return, a pensioner will be in trouble after seven years.

He says illa pensioners should be very cautious about having an initial investment drawdown rate above six percent if they want to have a sustainable income for life.

The only bright spot for investors is that returns on global equities are expected to move from the disappointing 2.3-percent annual average for the past 10 years to between 13 and 15 percent a year.

Stassen says the investment return problems for pensioners are compounded by other challenges. These include:

◆ **Inflation.** The rate of inflation can be expected to go up because of things such as higher electricity costs. And the inflation rate for pensioners in the LSM8 and higher groups is greater than national average inflation. This is because of things such as medical inflation, which is higher than the national inflation rate and affects older people more than healthier younger people.

Stassen says that many illa investors may also be too conservatively invested, meaning that their pensions may not be able to increase in line with inflation.

◆ **Income tax rates.** Taxes are expected to increase in the future.

◆ **Life expectancy.** On average, your life expectancy is increasing, meaning you will need more money for more years in retirement. Pensioners retiring in their early sixties need to plan on having a sustainable income of at least 25 to 30 years.

PREDICTED AVERAGE ANNUAL PERFORMANCE OF THE DIFFERENT ASSET CLASSES

Asset class	Past 10 years	10-year forecast
Local equity	17.3%	9-11%
Global equity*	2.3%	13-15%
Local property	22.7%	8-10%
Local bonds	10.3%	8-9%
Global bonds*	5.7%	5-7%
Local cash	9.0%	7-8%
Inflation	5.9%	6%+

* Assume inflation differential of 3-4% a year

SOURCE: CORONATION

DEFINITIONS

◆ **Traditional guaranteed annuity:** These pensions are guaranteed for life by the life assurance company from which you purchase the pension with your retirement fund savings. They come with numerous variations, of which the most important is the ability to keep a pension in line with inflation.

A level annuity will cost you less, but the buying power of your pension will be rapidly eroded by inflation. With an inflation rate of just over seven percent, the buying power of your pension will halve in 10 years. An inflation-linked annuity will cost more, but your pension will maintain its buying power.

◆ **Investment-linked living annuity:** With this type of annuity you take the risk that your retirement savings will be sufficient to provide you with a sustainable income for life. You must draw a pension of between 2.5 and 17.5 percent of the value of your residual savings calculated annually.