

# Poor market conditions at retirement can shrink your capital

Your financial security in retirement may be determined by when in an investment cycle you retire. Retire at the beginning of a market decline and you will be far worse off than if you retire at the beginning of, or during, a bull market.

Louis Stassen, a senior portfolio manager who heads Coronation Asset Management's absolute investments unit, says the sequence of investment returns can be critical for a pensioner with an investment-linked living annuity (illa).

The best time to retire with an illa pension is in years of good investment returns because you will be withdrawing a pension from a growing capital base. In other words, to maintain a fixed rand income requires a lower percentage of your accumulated capital base when investment returns are rising.

The reverse is true in years of market decline – the same fixed rand amount will absorb a greater percentage of your capital base.

Stassen says anyone entering retirement on an illa in times of a market downturn will need to draw a larger portion of capital to achieve the same level of income.

For example, take someone with R5 million in retirement capital who initially draws down R300 000 (including all costs) a year, and increases the amount at an average of five percent a year to counter the

## HOW INITIAL POST-RETIREMENT RETURNS CAN AFFECT YOUR PENSION

**Table 1: Good returns occur in first year of a repeating cycle**

End year	Rand pension	DD	Investment return	Residual capital
1	R300 000	6.0%	21.0%	R5 687 000
2	R315 000	5.5%	12.5%	R6 043 500
3	R330 750	5.5%	-5.0%	R5 427 113
4	R347 288	6.4%	21.0%	R6 146 588
5	R364 652	5.9%	12.5%	R6 504 678
6	R382 884	5.9%	-5.0%	R5 815 704
7	R402 029	6.9%	21.0%	R6 550 547
8	R422 130	6.4%	12.5%	R6 894 469
9	R443 237	6.4%	-5.0%	R6 128 671

**Table 2: Losses occur in first year of a repeating cycle**

End year	Rand pension	DD	Investment return	Residual capital
1	R300 000	6.0%	-5.0%	R4 465 000
2	R315 000	7.1%	12.5%	R4 668 750
3	R330 750	7.1%	21.0%	R5 248 980
4	R347 288	6.6%	-5.0%	R4 656 608
5	R364 652	7.8%	12.5%	R4 828 451
6	R382 884	7.9%	21.0%	R5 379 135
7	R402 029	7.5%	-5.0%	R4 728 251
8	R422 130	8.9%	12.5%	R4 844 386
9	R443 237	9.1%	21.0%	R5 325 391

Assumptions: Initial capital amount of R5 million; inflation average 5% a year; nominal average annual growth rate of 8.95% (that is, almost 4% real return); income paid annually in advance; rand pension grows by 5% a year; drawdown (DD) rate expressed as percentage of opening residual capital balance. SOURCE: CORONATION

effects of inflation. The initial drawdown is six percent of capital and the annual average return is 8.95 percent (see tables, above).

Table 1 reflects what happens when good returns occur in the first year of drawing a pension. Table 2 reflects what happens when retirement starts with a bad year.

After nine years, the person who retired into a good investment year has substantially more capital and therefore a lower drawdown rate in percentage terms than someone who retired into a negative investment market, who after nine years is starting to see a drawdown rate

hitting unacceptable levels.

Stassen says that for any retirement investment portfolio to be sustainable, you need capital growth assets such as equities and property because of the debilitating effects of inflation. If you invest in low-volatility money market funds, your returns will be far lower and unlikely to out-perform inflation. In other words, the purchasing power of your rand will decline rapidly.

"For example, if you drew an annual income of R70 000 in 2001, you would need R130 103 to buy the same basket of goods and services today," Stassen says.

The problem, however, is that by investing in assets that counter the effects of inflation you can create a problem for yourself if you are drawing an income from your investments, namely that your returns in the equity and property capital growth asset classes can vary substantially.

Stassen says, for example, the local equity market achieved an average return of 16.7 percent a year over the past decade at a standard deviation (the propensity to move in either direction) of 20 percent.

"The standard deviation reflects the wide range of calendar returns

achieved by the market over the 10-year period, from a high of 46 percent in 2005 to a low of minus 28 percent in 2008."

He says the sustainability of a retirement income plan is most often at its optimum when the standard deviation is 10 percent or less. It is important therefore for illa pensioners to invest in growth assets, but where the effects of market downturns can be limited.

The best options for most illa pensioners are portfolios that are managed to limit the downside risk, preserving your capital for future years, Stassen says.