ISSUE 22

CORO LAB

Your guide to investment ideas

THE INCOME AND GROWTH CHALLENGE

Featuring Balanced Defensive and Capital Plus

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THE INCOME AND GROWTH CHALLENGE

Investors who are near or already in retirement face the most challenging of investor needs: simultaneously investing for both immediate income and long-term growth. The key challenge is to ensure a sustainable standard of living by balancing the needs of today with those of the future.

Given the ongoing market preference for market-linked income withdrawal plans (most often called living annuities), this issue again focuses on the key risks investors face when selecting this option. We also propose strategies with which to manage the trade-offs that need to be considered in ensuring appropriately prudent retirement income planning.

Prudent retirement income planning starts with setting an appropriate strategic asset allocation and forming reasonable long-term return expectations. We continue to hold the view that living annuity investors need to moderate their expectations about the level of income that can be sustained over a full retirement, recommending an initial drawdown rate of below 5% as a starting point in the planning process. While weaker recent market returns resulted in our current return expectations for the next ten years being broadly in line with the actual experience over the last decade, we continue to advocate a hard limit on exposure to growth assets of around 60% for most retirees.

CURRENT MARKET PREFERENCES

LIVING ANNUITIES REMAIN THE PREFERRED COMPULSORY INCOME PRODUCT

Retirement savers currently have two options when it comes to purchasing a compulsory post-retirement income: traditional guaranteed annuities or living annuities (see Figure 1). While living annuities provide the benefits of flexibility and heritability, and are often the most appropriate retirement income solution, they expose investors to capital market and longevity risks.

Living annuities need to be managed on an ongoing basis in an appropriate manner. Sadly, they are often bought for the wrong reason. Investors with insufficient retirement capital may find the potential of drawing a higher initial income (relative to a guaranteed annuity) attractive in helping to maintain a certain lifestyle in the early years of retirement. But hardship will follow if the capital underpinning their pension is depleted over too short a period. This scenario will play out if the income drawdown rate significantly exceeds the after-fees investment returns earned.

>> FIGURE 1 CURRENT COMPULSORY POST-RETIREMENT INCOME OPTIONS

GUARANTEED ANNUITY	LIVING ANNUITY
A post-retirement income product, underwritten by a life office, that guarantees your pension for life.	A post-retirement income product, where the level of income is not guaranteed for life.
How it works The investor pays an upfront premium in exchange for a guaranteed fixed or growing annual income payable for life. The premium paid should be seen as an expense incurred to secure protection against the uncertainties of life. An income will be paid however long you may live, but once the annuity is bought, the capital spent on its purchase is no longer part of your estate.	**How it works** It is a sophisticated product, typically aimed at investors with significant retirement capital and/or access to good financial advice. Many investors decide to combine the security of a guaranteed annuity with the heritability and flexibility of a living annuity by using them in combination. A living annuity allows the investor to: ▪ construct a portfolio from a variety of underlying investment options such as unit trusts; ▪ draw any level of income between legally defined limits, currently set at a minimum of 2.5% and a maximum of 17.5%; and ▪ bequest any unused assets to chosen beneficiaries at death.
Features Guaranteed annuities can provide a level or growing income, pay an income for the duration of the longest life in the case of a couple and may guarantee a minimum income payment period, often ten years. The insurance cost of additional benefits will typically lead to a lower initial income rate. A key feature of guaranteed annuities is that the underlying investment portfolios are typically invested in income assets only. Prevailing long-term interest rates are therefore a key driver in the level of guaranteed income that can be bought at any given point in time.	**Features** The income level for a living annuity is selected annually. The sustainability of the income that can be drawn from a living annuity depends on the interplay between the after-fees return earned on the capital invested in the living annuity, and the rate of income withdrawn. When the income drawdown rate exceeds the investment return, a portion of current income is effectively paid from capital, reducing the capital base available to fund future income payments. Living annuities provide the advantages of flexibility, choice and the retention of ownership, but create the responsibility to make sound decisions and potentially expose the investor to longevity risk.

INCREASED RISK-TAKING BY RETIRED INVESTORS IS OF CONCERN

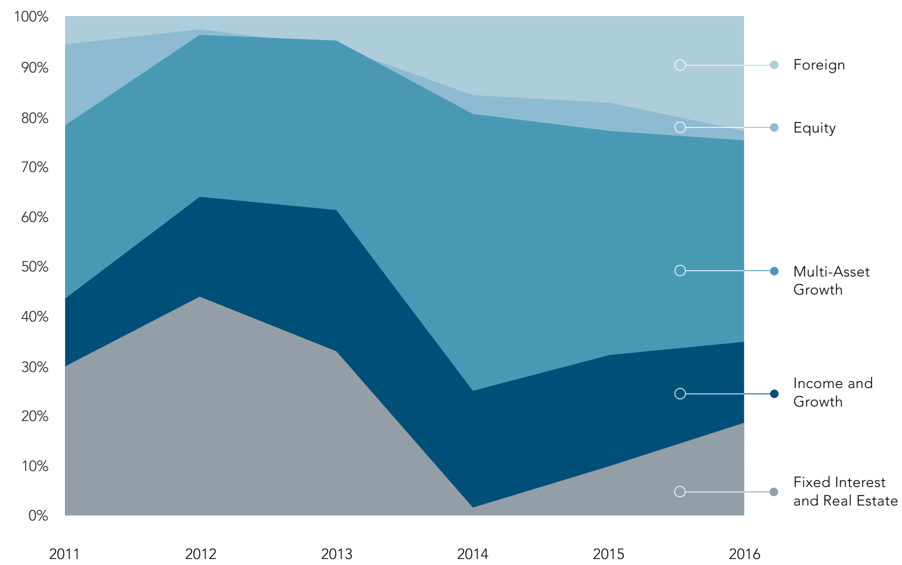
The extraordinary returns delivered by growth assets in the strong recovery since the 2008 global financial crisis have contributed to a welcome decline in the average living annuity drawdown rate – from 7.0% in 2011 to 6.6% in 2014. This relatively benign market environment also resulted in a significant number of retirement investors taking on additional risk in their retirement funding portfolios.

Living annuity portfolios that did not comply with Regulation 28 (i.e. those that have more exposure to risk assets than allowed for retirement funds) increased from 19% in 2012 to 24% by end-2014. This is consistent with the industry cash flow trends as illustrated in Figure 2, which shows that the multi-asset growth category (your typical balanced fund) has enjoyed a substantial share of inflows, while flows into fixed interest funds have dwindled. It therefore appears as though many investors, who preferred income funds when interest rates were higher, have skipped the income and growth risk bracket (with smaller risk budgets) and instead invested in long-term growth funds (with larger risk budgets).

This, we believe, is of some concern. Many of the top South African balanced funds performed particularly well during the 2008 financial crisis, which may have created a false sense of security among investors who expect these funds to repeat the same levels of performance during the next inevitable market slump. As there is no commitment from the managers of these balanced funds to preserve capital in bad years, it is crucial for investors to understand the potential consequences of a typical balanced fund's risk budget (i.e. the possibility of larger participation in market losses in future).

In contrast, income and growth funds (lower-equity multi-asset funds) offer reduced volatility relative to traditional balanced funds. We believe that this is the more appropriate consideration, particularly for those investors who are in the final stages of their retirement accumulation phase, or who have recently retired. It is our view that these investors should consider funds that explicitly aim to reduce downside risk in the short term.

>> FIGURE 2 SHARE OF NET INFLOWS BY MANDATE TYPE



Source: ASISA as at 31 March 2016, Coronation Research
Years ending September, except 2016 which is the six months to March

KEY RISKS FOR LIVING ANNUITY INVESTORS

SEQUENCE-OF-RETURNS RISK

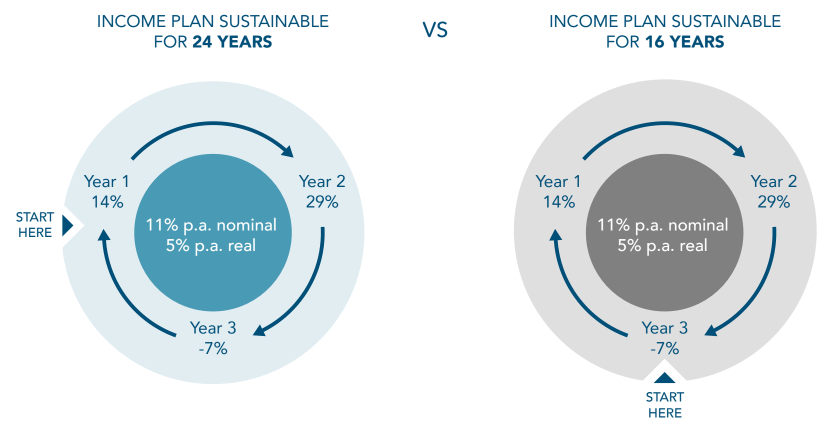
In previous issues, we have argued the need for a more conservative asset allocation for investors who are close to retirement. We continue to hold this view and believe that a prudent allocation to growth assets should not exceed 60% for most retirees.

The reason behind this argument is because the sequence in which retired investors earn their returns matters. If the value of your retirement capital declines just after you start your drawdown programme, the income withdrawn will represent a larger portion of your assets than if you had experienced growth over the same period. This means that in future years you will need to draw a larger portion of the remaining capital to achieve the same level of income.

The importance of the sequence of returns is best illustrated by means of an example (see Figure 3). Consider a portfolio that returns a nominal 11% p.a. and a starting drawdown rate of 7%, which adjusts annually by inflation of 6%. This annualised return of 11% is made up of calendar year returns of 14%, 29%, and -7% respectively, which repeats in the same sequence for the entire investment horizon. If you first experience the two years of positive growth before suffering the 7% loss in the third year, your retirement plan will be sustainable for eight years longer than if you were unlucky enough to experience the 7% loss in your first year of investment (before the two years of gains).

This simplified example illustrates that if a retirement date coincides with an adverse market environment, the impact on accumulated savings can be devastating. Investors are also much more vulnerable to a market loss late in the accumulation cycle (i.e. close to their retirement date), and hence our view that these investors should not be overexposed to risk in the current environment.

>> FIGURE 3 THE IMPORTANCE OF SEQUENCE OF RETURNS



Assumptions: Starting drawdown rate = 7% adjusting annually by inflation of 6%
Sustainability period measured to year when maximum annual drawdown rate = 17.5% (ILLA MAX)
Annual return series repeat in same order for full period of retirement

Source: Coronation Research (acknowledgement GAO; Milevsky & Macqueen)

INFLATION RISK

Inflation risk refers to the possibility that the future purchasing power of your accumulated capital may be less than you require to maintain your standard of living as a result of rising prices. Any long-term investor, specifically those already in retirement, should therefore primarily be interested in the real, or after-inflation, rate of return. If the rate of return achieved on an investment equals that of the inflation rate, the investor is merely protecting the purchasing power of what has been saved. If the inflation rate exceeds the rate of return achieved, the investor's purchasing power is reduced

While the impact of inflation is not that noticeable from year to year, the compounded effect can be devastating. Retirees with a lengthy retirement are especially vulnerable to this risk, as it becomes increasingly more difficult to earn additional income as time passes. At an inflation rate of 6% per year, the purchasing power of one rand today will fall by more than 75% over a period of 25 years.

Expected inflation (see Figure 6) therefore is an important input in the retirement planning process, particularly in a country such as South Africa which continues to struggle with slow growth and stubborn inflation. Inflation expectations have remained above the upper limit of the SARB's target range almost consistently since 2011, and the latest Bureau for Economic Research (BER) poll shows that South Africans are expecting long-term inflation to remain stuck very close to the 6% target limit.

Sequence-of-returns risk and inflation risk can, to a large extent, be managed by investing in an appropriately constructed portfolio. The right balance between income and growth assets to achieve the dual objectives of reasonable growth after inflation (over the longer term) and capital preservation (over the short term) is essential. On page 17 we discuss Capital Plus and Balanced Defensive, two funds that are managed to meet these objectives. We also include a detailed impact of inflation analysis, comparing Capital Plus to a cash investment, in an appendix on page 19.

LONGEVITY RISK

While it is rather unsettling to think of one's own mortality, most of us underestimate the investment horizon that needs to be planned for in retirement. Advances in healthcare technology and improvements in nutrition mean that people are living longer, and therefore life expectancy is increasing. For example, if you are a South African female retiring at 65, you can expect to live a further 20 years (see Figure 4). But your effective time horizon may be longer as you may live beyond the average retiree. The prudent approach would therefore be to plan your affairs to have a sustainable income for at least 25 – 30 years. At a 6% inflation rate, this means that you will require nearly six times (allowing for inflation) the level of income at the end of your planning horizon than at the start – just to be able to buy the same amount of goods and services.

If a 30-year planning horizon sounds unpalatable, investors can transfer this risk to a life office by purchasing a guaranteed annuity, where the excess contributions made by those living less than the 20-year average, fund the additional income required by those who live longer.

>> FIGURE 4 SOUTH AFRICAN LIFE EXPECTANCY AT RETIREMENT AGE

RETIREMENT AGE	MALE	FEMALE
60	81	84
65	82	85
70	84	86
75	85	87

Source: Actuarial Society of South Africa

RETURN EXPECTATIONS

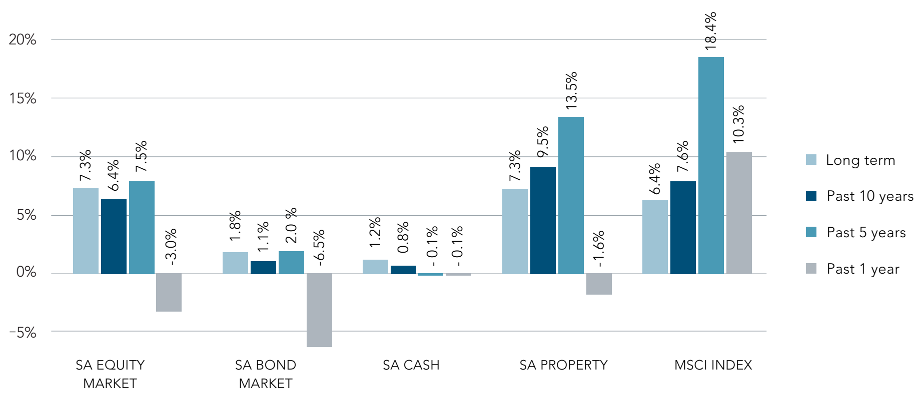
YOU CAN'T ALWAYS EXTRAPOLATE THE RECENT PAST

Over the very long term, South African equities have delivered better returns than any other market in the world (in local currency terms). As is clear from Figure 5, growth assets (local equities, foreign equities and local listed property) have delivered annualised real returns (i.e. in excess of inflation) of around 6% - 7.5%, while income assets (bonds and cash) produced around 1% – 2% real per annum. In the last 10 years, most asset classes (with the exception of local property) delivered real returns that were more in line with their long-term averages than is often the case. This will not be repeated in all planning periods.

The past five or ten years is therefore a poor basis for setting return expectations. It is better to use a combination of very long run returns (see Figure 5) and current valuation levels to set return expectations. We provide our current forecast in Figure 6.

While the headline index values still indicate an expensive local market, most of the more recent market performance resulted from a small number of very large international businesses that happen to be listed on the JSE. Many commodity and domestic counters have sold off significantly, providing current entry prices that have historically been consistent with double-digit returns. This change in share prices supports an increase in average annual expected returns of 1%-2%.

>> FIGURE 5 ASSET CLASS REAL RETURNS TO 31 MARCH 2016



Source: Triumph of the Optimists, Global Financial Data, I-Net Bridge, Coronation, MSCI
Note: 115-year average real returns. Shorter history for MSCI (44 years) and property (35 years)

If we look at global equities, valuations are much closer to fair value than they have been a few years ago. The above-average returns achieved over the past five years were partly based on a market rerating. This means that investors are paying more for future earnings, implying lower future returns. It should also be noted that while the slumping rand bolstered returns from these investments over the past five years, this cannot be relied upon year after year. While we continue to believe that global equity is the asset class with the highest return potential over the next several years, the gap between offshore and local assets narrowed significantly.

In turn, income assets are unlikely to deliver significant real returns, given that the sluggish state of the global economy probably means that central banks will have limited scope to tighten the unprecedented 'easy money' monetary policies followed in most of the developed world, leading to very low interest payments today and the potential for losses in the great unwinding of tomorrow. We expect local income assets to produce somewhat better returns given the post-'Nenegate' sell-off in government bonds and the fact that we are already late in the current interest rate hiking cycle.

Putting all of this together in a portfolio with a risk budget appropriate for income and growth investors, we find that investors should expect annual returns that are 1%-3% lower, on average, than experienced over the most recent decade.

>> FIGURE 6 10-YEAR FORECASTS FOR LOCAL AND OFFSHORE ASSET CLASSES

	LAST 10 YEARS* %	10-YEAR FORECAST** %
LOCAL EQUITY	13.1	8 – 12
GLOBAL EQUITY	14.4	9 – 13
LOCAL PROPERTY	16.4	8 – 12
LOCAL BONDS	7.5	8 – 9
GLOBAL BONDS	13.7	4 – 6
LOCAL CASH	7.1	7 – 9
INFLATION	6.3	6 – 7
50:50 PORTFOLIO***	11.2	7.7 - 10.4

*Source: *Deutsche Bank as at 31 March 2016 and **Coronation Fund Managers forecasts. While these forecasts are not guaranteed to occur, they are based on our best estimates of possible future returns and present a more prudent basis for information planning assumptions than historical results achieved over the past decade. *** The 50:50 portfolio is a proxy for a typical income and growth fund with 50% exposure to growth assets (30% local equity, 15% global equity and 5% local property) and 50% income assets (35% local bonds, 10% global bonds and 5% local cash).*

RETIREMENT PLANNING STRATEGIES

We have shown that a typical retiree who draws an income from a living annuity needs to plan for 25 – 30 years, can expect a relatively high inflation rate and, for at least the next 10 years, should expect more muted returns than those of the past decade. The prudent planner's response to this backdrop will include:

- moderating income drawdown rates;
- ensuring that post-retirement portfolios have the appropriate balance between income and growth assets; and
- considering the introduction of dynamic spending rules (see page 15–16) to aid the sustainability of a retirement income plan.

SELECTING THE INITIAL INCOME DRAWDOWN RATE

Drawing too high an income at the start of your retirement and/or expecting too high a rate of return is as dangerous as investing too conservatively or too aggressively.

Consider the 'income rate and return analysis' in Figure 7. This table shows a variety of possible initial income rates, from 2.5% to 17.5%. This range represents the current legal drawdown limits applicable to living annuities. It also shows a variety of potential annualised net investment returns that may be earned, from 2.5% to 15%, in each column.

>> FIGURE 7 INCOME RATE AND RETURN ANALYSIS

	NOMINAL NET INVESTMENT RETURN P.A.					
SELECTED INCOME RATE P.A.	2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
2.5%	21	30	50+	50+	50+	50+
5.0%	11	14	19	33	50+	50+
7.5%	6	8	10	13	22	50+
10.0%	4	5	6	7	9	20
12.5%	2	3	3	4	5	7
15.0%	1	1	2	2	2	3
17.5%	1	1	1	1	1	1

Average income drawdown levels for living annuities continued their downward trend. In 2014, the average income drawdown level for all living annuitants was 6.59% versus 6.63% in the prior year. (Source: Asisa)

Source: Asisa Standard of Living Annuities with additional calculations by Coronation

Each cell in the resulting table represents the number of years before income (adjusted for inflation of 6%) will start to decline. Another way to think about this is how many years you have before your standard of living will start to decline in the different scenarios. At a rate of return of 15% p.a. (historically Coronation Capital Plus achieved 13.5% per annum since inception), any initial income rate up to 7.5% represents a sustainable income, as income will continue to grow in line with inflation for at least 50 years. However, note what happens when the expected return drops by 2.5 and 5 percentage points to 12.5% or 10.0%: the period of sustainability drops dramatically to 22 and 13 years respectively at the same drawdown rate. Given our current outlook for financial market returns, it would be less than prudent for most retirees to consider initial income drawdown rates much above 5% (and then only from a portfolio with appropriate exposure to growth assets.)

An inflation-linked guaranteed annuity payable for life would yield an initial income of 4.5%-5.0% if you retire in your early 60s. The current market rate for this type of annuity is a good starting point when deciding on a sustainable drawdown rate at the time of retirement.

INTRODUCTION OF SPENDING RULES

Most academic work on drawdown rates assumes that retirees want to grow income annually by inflation to maintain constant purchasing power (sometimes referred to as the standard withdrawal rule). The inherent 'problem' with this approach is that each year increases are granted regardless of the investment return earned on the underlying portfolio. If retirees want to fully protect themselves against running out of capital in virtually any circumstance over an approximate 30-year period, they need to start with a very low initial drawdown rate (4% or less). Formal spending rules can help to make higher initial drawdown rates (5% – 6%) more sustainable, while still allowing higher current income.

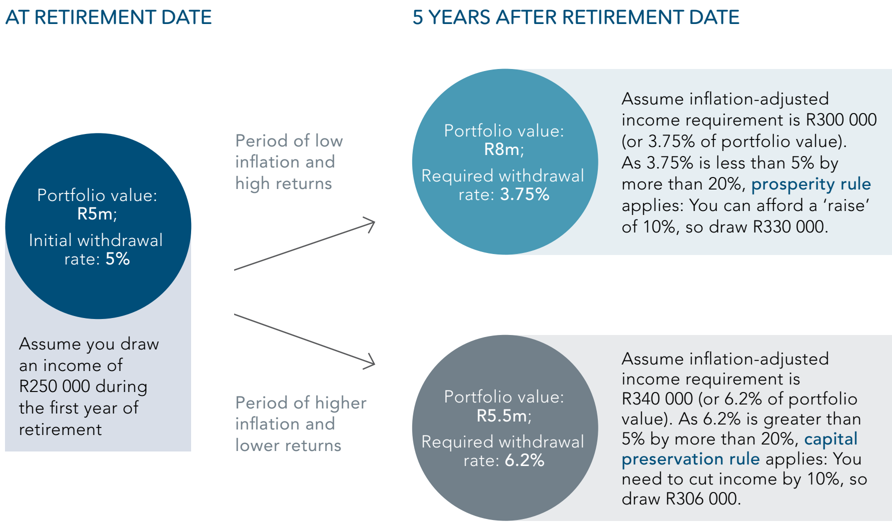
In practice, investors are likely to be advised to moderate their income requirements after tough return periods to enhance stability of their plans. Setting formal spending rules up front is an attempt to make the application of this form of self-regulation more consistent and easier to implement. Two rules can be used to protect the investor against running out of money:

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

The capital preservation rule: If the increased withdrawal rate in a given year exceeds the initial withdrawal rate by more than a certain percentage (e.g. 20%), the withdrawal rate is cut by a predefined percentage (e.g. 10%). This rule is only applied in the first half (10 to 15 years) of retirement.

This spending rule could be further refined (at the expense of giving up some safety) by adding a prosperity rule (see Figure 8): If the withdrawal rate falls by more than a pre-set percentage (e.g. 20%) below the initial withdrawal rate, the withdrawal is increased by a defined percentage (e.g. 10%).

>> FIGURE 8 APPLYING THE CAPITAL PRESERVATION AND PROSPERITY RULES



Source: Coronation Fund Managers

It is important to note that sustainable withdrawal rates are typically lower when assets are more expensive than normal (when 10-year PE 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. Studies show that 80% of the variation in safe withdrawal rates for different retirement years can be explained by:

- the remaining portfolio value on the tenth anniversary of the retirement date, and
- the rate of inflation experienced over the first 10 years of retirement.

It is therefore imperative that investors are advised to appropriately moderate income expectations during the initial phase of retirement to ensure long-term sustainability of their income plans. The rules may be further augmented by applying a 'valuation discount' to initial withdrawal rates in periods where asset class valuations are stretched.

CORONATION'S INCOME AND GROWTH SOLUTIONS

Coronation offers two funds that meet the needs of income and growth investors – Balanced Defensive and Capital Plus. The funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of real return over the long term with minimising the risk of capital loss over the short term.

Balanced Defensive can invest a maximum of 40% (currently 38.1%) in growth assets and is managed to deliver positive returns over any 12-month period with a high degree of probability. It is consistently one of the top performers in the Multi Asset – Low Equity category. Since inception in February 2007, Balanced Defensive has produced a nominal after-fees return of 10.8% p.a. (or 4.4% p.a. in real terms) at a standard deviation of 4.0%.

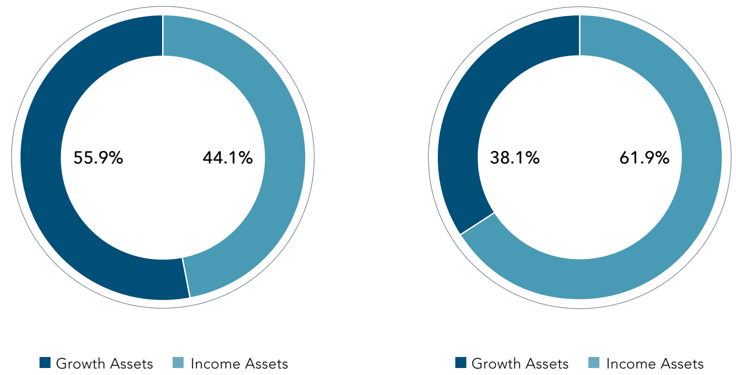
Capital Plus has a unique risk budget and is optimised for income and growth investors with longer time horizons.

Up to 60% (currently 55.9%) of the portfolio can be invested in growth assets and despite its larger risk budget, the portfolio also aims to preserve capital over any 12-month period. It has produced a nominal after-fees return of 13.5% p.a. (or 7.4% p.a. in real terms) since its inception in 2001 at a standard deviation of 7.0%.

With effect from 1 October 2015, Balanced Defensive's fee was reduced by 10 basis points to 1.4%. We will continue to discount the fee to 0.75% if the fund's performance over any 12-month period is negative. In the case of Capital Plus, the performance fee of up to 1% was removed. The base fee increased by 15 basis points to 1.4% and we will discount the fee to 0.75% if performance over any 24-month period is negative (previously 12 months).

>> FIGURE 9 ASSET ALLOCATION AS AT 31 MARCH 2016

CAPITAL PLUS | BALANCED DEFENSIVE



Both Capital Plus and Balanced Defensive have appropriate risk budgets for income and growth investors.

Up-to-date detailed information is available on www.coronation.com

APPENDIX: ACTUAL IMPACT OF INFLATION ANALYSIS

Part of the solution to make the required trade-off between an adequate current and future income is to optimise asset allocation as far as possible. An appropriate balance between investing for growth in the long term and capital protection in the short term must be achieved.

To illustrate why we argue for an appropriate balance between income and growth assets in a post-retirement income portfolio, consider the 'actual impact of inflation analysis' in Figure 10. This table compares the actual results that would have been achieved by investors drawing different levels of income from two portfolios with differing risk profiles. The first option is a very conservative income assets only portfolio; the second is a moderate risk income and growth portfolio, with a roughly even split between income and growth assets over time. We have used the average money market fund for the first option, and Coronation Capital Plus Fund as an example of the latter. The analysis is performed for the period July 2001 (when Capital Plus was launched) to 31 March 2016. Over this period, the average money market fund returned 7.9% p.a. (after fees), with a very low standard deviation of 0.7%, while Capital Plus returned 13.5% p.a. (after fees) at a standard deviation of 7.0%.

The first point to note is how quickly inflation erodes purchasing power. The table indicates that, if you drew an annual income of R70 000 in 2001, you need R167 013 to buy the same basket of goods and services today. The second point is that Capital Plus (the portfolio with roughly 50% invested in growth assets) was a lot more effective in generating income over the period, regardless of the initial income rate selected. For example, if your initial income rate was set at 5% in 2001, today you would still only draw 6.8% from Capital Plus, while your income requirement from an average money market fund would be 14.6%. Finally, it should be noted that a starting income rate of 9% selected 15 years ago (in an era when money market funds yielded 10%+) was too high even for a portfolio with adequate growth assets and below-average risk levels, as the required income to maintain the initial standard of living now exceeds the maximum allowed income drawdown rate.

>> FIGURE 10 ACTUAL IMPACT OF INFLATION ANALYSIS (JULY 2001 - MARCH 2016)

INCOME/DRAWDOWN RATE IN 2001	3%	5%	7%
Capital invested in 2001	R1 000 000	R1 000 000	R1 000 000
Annual income in 2001	R30 000	R50 000	R70 000
Annual income in 2016 (adjusted for inflation)	R71 577	R119 295	R167 013
Capital in 2016 if invested in average money market fund and after drawing an income	R1 323 995	R819 591	R506 648
Capital in 2016 if invested in Capital Plus and after drawing an income	R2 822 290	R1 747 080	R1 079 998
INCOME/DRAWDOWN RATE IN 2016			
Average money market fund	5.4%	14.6%	33.0% > MAX
Coronation Capital Plus	2.5%	6.8%	15.5%

Maximum drawdown limit is 17.5%
Note: Analysis includes 115 bps allowance for platform and advice costs

Source: Coronation Research

>> NOTES

THE CORONATION CLIENT CHARTER

- > We strive to always put our clients first
- > We have an unwavering commitment to the long term
- > We focus on producing top performance over all meaningful periods
- > We are uncompromising about ethics

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DATE OF ISSUE: MAY 2016