ISSUE 27

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. In this issue, we propose strategies to manage the trade-offs that need to be considered in ensuring appropriately prudent retirement income planning.

In recent years, we have warned investors to moderate their expectations for long-term returns, and make sure that they are not withdrawing more from their living annuities than can be sustained. We continue to hold this view, recommending an initial drawdown rate of below 5% as a starting point in the planning process.

Still, we believe the disappointing equity returns of the last three years are not the new normal. In fact, we would urge investors to keep a healthy exposure to equities, which should remain the largest driver of investment growth over time.

INVESTING IN RETIREMENT

RETIREMENT INCOME OPTIONS

Most retirement savers consider two options when it comes to purchasing a compulsory post-retirement income: a traditional guaranteed annuity or a living annuity (see Figure 1).

According to the 2016 Living Annuities Survey released by the Association for Savings and Investment South Africa (ASISA), South Africans have some R333 billion invested in living annuities. 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. This scenario will play out if the income drawdown rate significantly exceeds the investment growth, especially during the first decade after retirement.

>> 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% per year; 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. You get better value from guaranteed annuities if they are bought later in life (when the insurance premium to insure longevity risk is lower) or when bonds are attractively valued (which is not currently the case in our view).	**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.

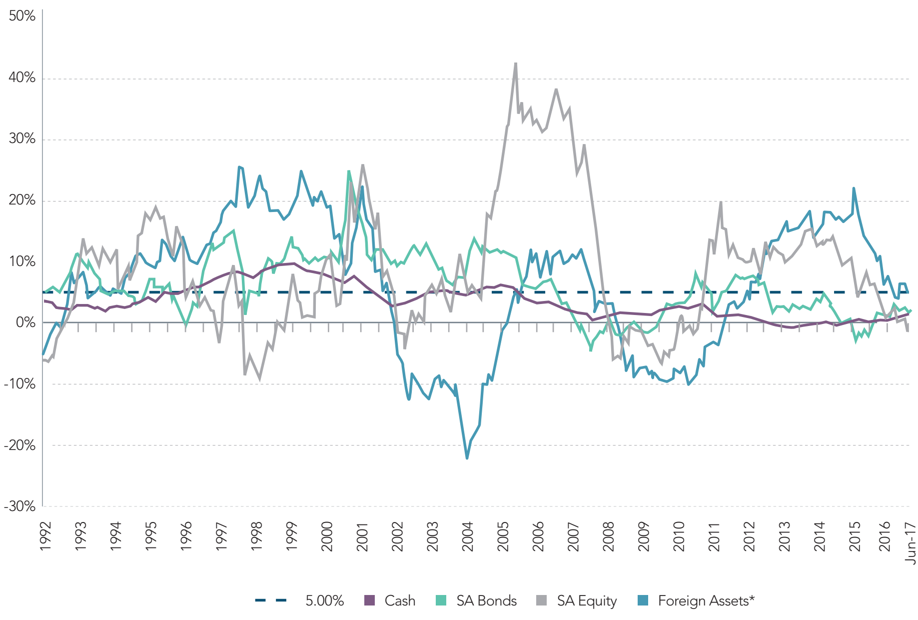
HYBRID ANNUITY:
These relatively new products combine features of guaranteed annuities and living annuities. Hybrids typically guarantee an income over the lifetime of the investor, with some potential for income growth, and has a degree of flexibility in terms of drawdown rates. However, the choice of underlying investments is often more limited than with a living annuity and the percentage of the capital that can be drawn down is also restricted.

TOUGH INVESTMENT CLIMATE FOR RETIREES

After a relatively benign period, investment returns have been disappointing in recent times. Equities (shares) in particular have not delivered any real growth.

>> FIGURE 2: FALTERING MARKET RETURNS

Real returns over three-year periods



* 60% MSCI World Index, 40% 3-month US Treasuries

Source: Coronation

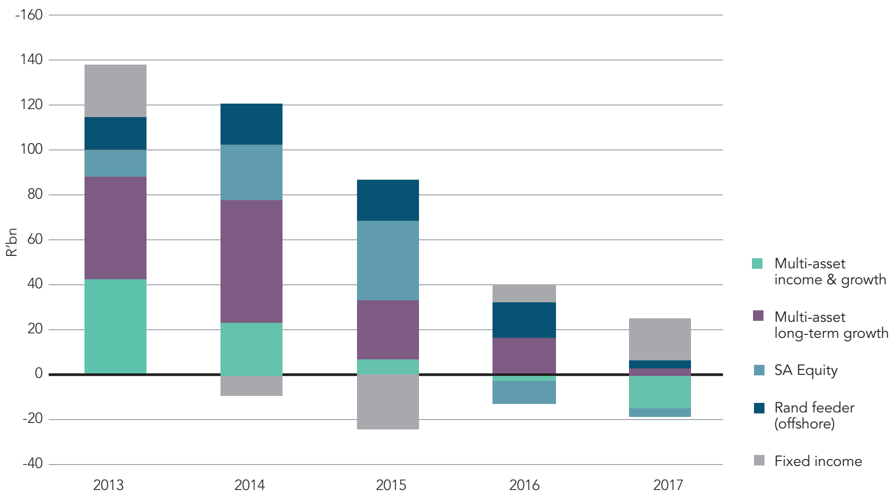
While equities are more volatile and risky, traditionally they deliver the best growth over time. Over the past three years, however, investors in living annuities with a strong equity exposure have seen disappointing returns. Even over the past ten years, their outcomes have been relatively weak, with very little reward for the investment risk taken.

In fact, these investors would have achieved very similar returns regardless of whether they were invested in managed income funds, income-and-growth or even balanced funds – which all have very different levels of equity exposures – over the past decade.

This has been very frustrating for investors. Many have started to shift away from underlying unit trusts with larger exposures to equities and towards those with more fixed income investments like bonds, which have delivered similar returns at lower historical risk. This is evident from Figure 3, which shows that fixed income funds have enjoyed a substantial share of inflows, while large amounts flowed out of income and growth funds (lower-equity multi-asset funds).

>> FIGURE 3: EQUITY EXODUS

SA Industry net flows by category



As at end-July 2017

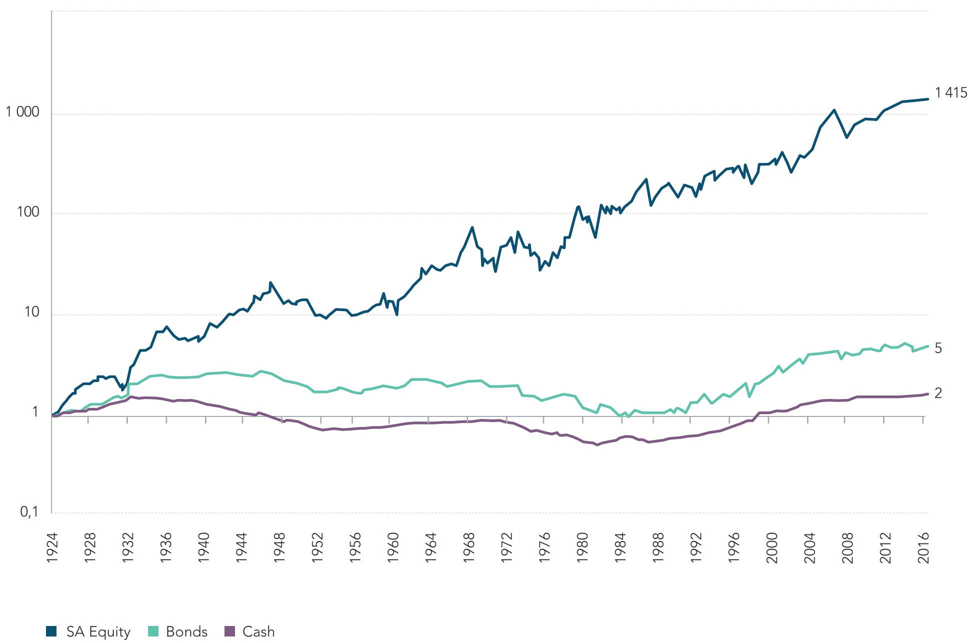
Source: ASISA, Coronation

This is concerning. We believe that equities will deliver the strongest investment growth over time, and provide the most reliable hedge against inflation. Retirees who do not have enough exposure to these growth assets may risk an erosion of their savings.

It is important to point out the context of the disappointing returns over the past ten years (to end-July 2017). At the start of the period in 2007, domestic and global equity markets were still elevated before the global financial crisis would wipe out 44% of the value of SA equities. The end point coincides with an extended period of stock market malaise in SA amid domestic uncertainty. This has had a distorting impact on the returns. The peculiarities of this window of time will not necessarily repeat and do not violate the fundamental principles supporting the expectation that equities will outperform over the long term. Given the anomaly of the measurement period, as well as the more attractive valuations we are seeing in local equities (explored on page 11), it is not unreasonable to expect future returns that are in line with long-term averages.

Equities have been the long-term driver of growth in retirement capital for almost a century, as is evident from Figure 4. For retirees, judicious exposure to growth assets is crucial.

>> FIGURE 4: EQUITIES ARE KEY TO INVESTMENT GROWTH



Source: Coronation

KEY RISKS FOR LIVING ANNUITY INVESTORS

SEQUENCE-OF-RETURNS RISK

While we do believe equities will help retirees beat inflation, we have long argued the need for a more conservative asset allocation among those close to retirement.

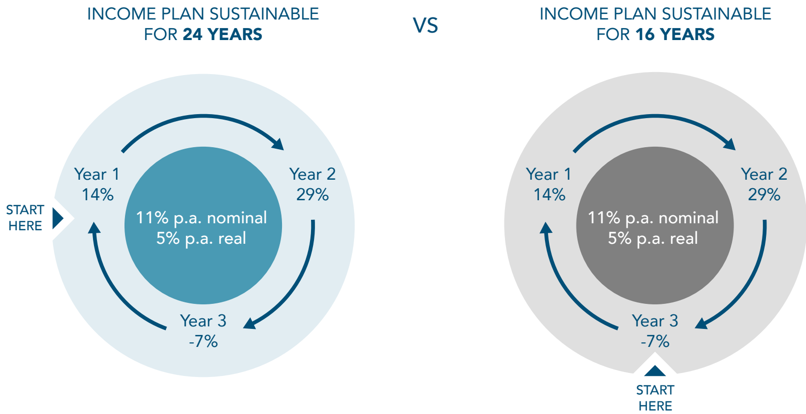
The sequence in which retired investors earn their returns matter. If the value of your retirement capital declines just after you start your drawdown programme, the income withdrawn will represent a larger portion of your assets than if you had experienced growth over the same period. This means that 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 5 on the following page.)

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 repeat 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.

>> FIGURE 5: 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

As a result of rising prices, the future purchasing power of your savings may be less than you require to maintain your standard of living. 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 over time, 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 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.

Sequence-of-returns risk and inflation risk can, to a large extent, be managed by investing in an appropriately constructed portfolio, while selecting a conservative income drawdown rate early in retirement. 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. In the appendix on page 19, you will also find an analysis of the importance of growth assets in combating inflation.

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.

Studies indicate that the prudent approach would 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 retirees living less than the roughly 20-year average, fund the additional income required by those who live longer.

RETURN EXPECTATIONS

Over the very long term, South African equities have delivered better returns than any other market in the world. However, the past decade has seen domestic equities deliver annualised real returns (i.e. in excess of inflation) of less than 5% per annum. Returns over the past three years in particular have been diminished.

We believe the most recent underperformance by equities does not reflect what investors can expect over the next ten years. As local equities have sold off, valuations have grown more attractive and many local stocks now offer more value than at any point over the past five years, in our view. Fundamentals should prevail and investors should be rewarded for taking risk over the next ten years. In our view, local growth assets (equities and property) will deliver real returns in line with their 10-year averages (see Figure 6). Equities also provide the opportunity for competent active fund managers to enhance outcomes by generating outperformance over the market.

Global equities continue to offer strong opportunities for investment growth, and our portfolios have exposure to what we believe are some of the most exciting companies in the world. Some caution is, however, required. The current bull market on Wall Street has now run for more than eight years, the second-longest in modern history. Accordingly, we have reduced our global equity allocations and have added downside protection to our funds.

In terms of income assets, we have a negative view on global government bonds. These assets are hugely distorted as a result of quantitative easing and we believe the recent correction in the 35-year bond bull market is only the tip of the iceberg. We expect local income assets to produce returns in line with the past decade.

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

	LAST 10 YEARS (ZAR)* %	10-YEAR FORECAST (ZAR)** %
LOCAL EQUITY	10.2	8 – 12
GLOBAL EQUITY	10.9	8 – 12
LOCAL PROPERTY	14.6	9 – 12
LOCAL BONDS	8.6	8 – 9
GLOBAL BONDS	10.0	4 – 5
CASH	7.3	7 – 8
INFLATION	6.1	6 – 7

*Sources: *Deutsche Bank as at 31 August 2017 and **Coronation Fund Managers forecasts. While these forecasts are not guaranteed, they are based on our best estimates of possible future returns and present a more prudent basis for planning assumptions than historical results achieved over the past decade.*

RETIREMENT PLANNING STRATEGIES

The 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 relatively muted returns. 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 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: YEARS BEFORE YOUR INCOME WILL START TO REDUCE IF INFLATION IS 6%

	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

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

After a long downward trend, the average income drawdown level for living annuities has increased slightly to 6.7% in 2016. (Source: ASISA)]

Each cell in the 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 12.8% 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% and 10.0% respectively: 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 an estimated 4.6% per year 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.

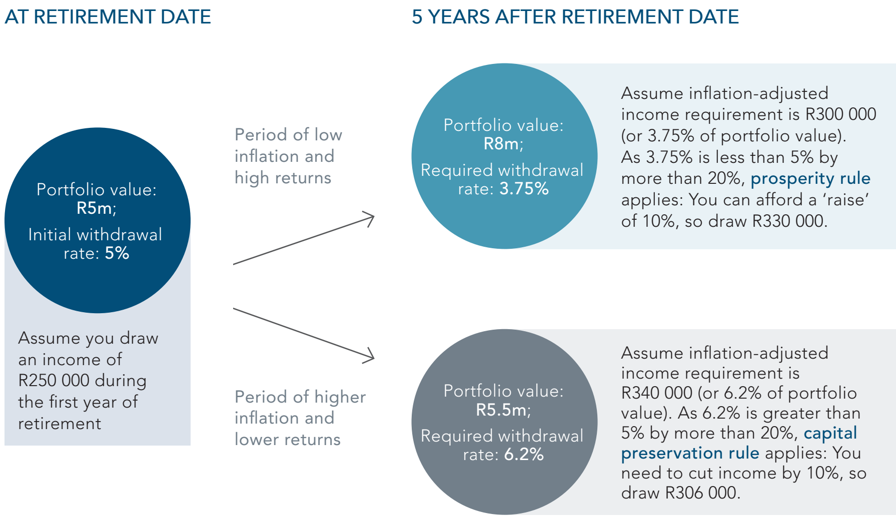
In practice, investors are likely to be advised to moderate their income requirements after tough return periods to enhance stability of their plans. Setting formal spending rules up front is an attempt to make the application of this form of self-regulation more consistent and easier to implement. Two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

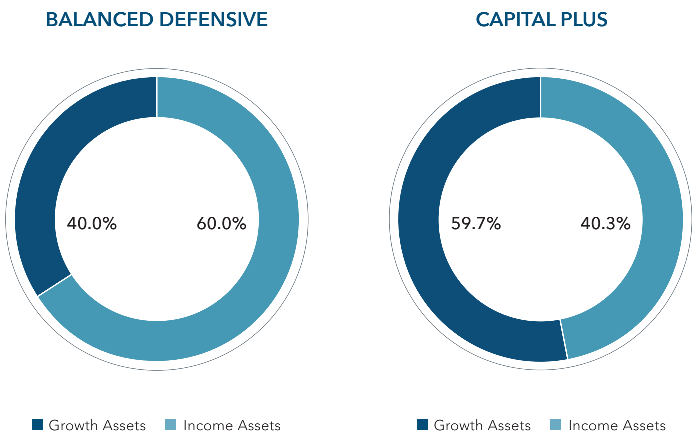
Coronation offers two funds that meet the needs of income and growth investors – Balanced Defensive and Capital Plus. The funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of real return over the long term with minimising the risk of capital loss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

Balanced Defensive can invest a maximum of 50% 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 (to end-July 2017), Balanced Defensive has produced a nominal after-fees return of 10.2% p.a. (or 4.1% p.a. in real terms) at a standard deviation of 4.1%. The fund currently maintains a 40% exposure to growth assets.

Capital Plus has a risk budget suitable to income and growth investors with longer time horizons.

Up to 70% (currently 59.7%) 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 12.8% p.a. (or 6.7% p.a. in real terms) since its inception in 2001 at a standard deviation of 6.9%.

>> FIGURE 9: ASSET ALLOCATION AS AT 31 JULY 2017



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

Maximum growth asset exposure in the Balanced Defensive fund was increased from 40% to 50% in October 2017, while for Capital Plus it was raised from 60% to 70%.

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

APPENDIX: USING GROWTH ASSETS IN THE FIGHT AGAINST INFLATION

To illustrate the importance of an appropriate balance between income and growth assets in a post-retirement income portfolio, consider the following graphs. The charts track living annuity investments in two Coronation funds: the very conservative Coronation Strategic Income and Coronation Capital Plus, which is a moderate risk income and growth portfolio.

The 'real capital' section of the graph shows the real purchasing power of the investor's money – i.e. the impact of inflation on their savings. The 'nominal capital' displays the investment amount before inflation is subtracted. The dark blue line shows monthly income over time, assuming a 6% starting drawdown rate increasing at 6% per year. The analysis is for the period July 2001 (when both funds were launched) to 31 July 2017. Over this period, the average money market fund returned 7.95% p.a. (after fees), while Strategic Income delivered 10.5% (after fees) per year and Capital Plus returned 12.8% (after fees) per year.

The first point to note is how quickly inflation erodes purchasing power. While your nominal investment may seem relatively buoyant, the actual buying power of your money starts to decline alarmingly fast.

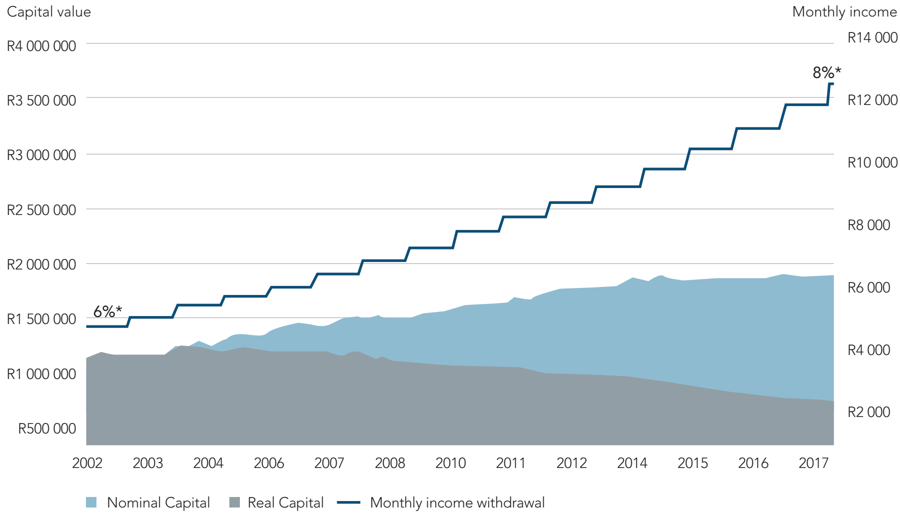
Secondly, and crucially, the two charts clearly show how exposure to equities can support long-term investment growth. Strategic Income can invest only a maximum of 25% in growth assets, while Capital Plus can have up to 70% in these investments.

At a starting annual income level of 6% (increasing at 6% per year), investors would currently draw 8% of their capital in Strategic Income. The increase in the percentage drawdown rate over time would be due to the decrease in real capital over that period. In contrast, investors in Capital Plus would currently only be drawing 4.6% of their capital every year. This is because they have seen an increase in real capital over time.

Finally, the charts show how sensitive the capital value is to the starting income drawdown rate. Withdrawing a high rate of income at the start of retirement can have a large impact on the life of an investment. For more on selecting the initial income drawdown rate, refer to page 13 of this guide.

>> FIGURE 10: LIVING ANNUITY EXPERIENCE IN STRATEGIC INCOME

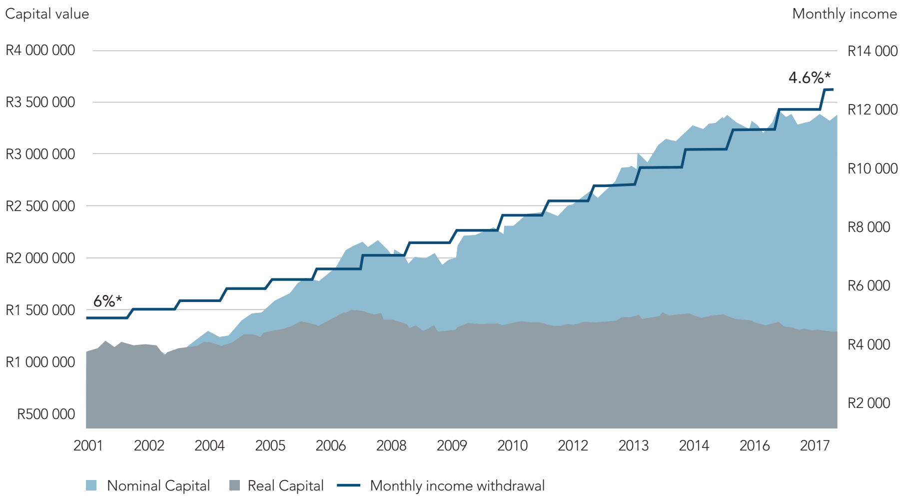
6% starting drawdown rate from R1m initial capital, with income increasing at 6% per year.



Source: Morningstar, with calculations by Coronation * Annual income as percentage of capital

>> FIGURE 11: LIVING ANNUITY EXPERIENCE IN CAPITAL PLUS

6% starting drawdown rate from R1m initial capital, with income increasing at 6% per year.



Source: Morningstar, with calculations by Coronation * Annual income as percentage of capital

>> 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

CORONATION
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