THE INCOME AND GROWTH CHALLENGE

CORO LAB

Your guide to investment ideas

09/18

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We have an unwavering commitment to the long term

We focus on producing top performance over all meaningful periods

We are uncompromising about ethics

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 discuss the key issues that you will encounter in managing your post-retirement capital, propose our solutions aimed at addressing these needs and share 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 to make sure that they are not withdrawing more from their living annuities than can be sustained. While we continue to hold the view that an initial drawdown rate of below 5% p.a. is a good starting point, we are more optimistic of future returns from these levels and believe the disappointing equity returns of the last three years are not the new normal. In fact, we believe investors need to consider keeping a healthy exposure to equities, which should remain the largest driver of investment growth over time.

THE CHOICES *investors face in, or near, retirement*

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 on the next page)**. A guaranteed annuity guarantees a pension for life, while a living annuity provides no income guarantee, but offers the potential for capital growth. A third, relatively new option is the hybrid annuity which combines features of guaranteed and living annuities. Hybrids typically guarantee an income over the lifetime of the investor, with some potential for income growth, and 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 capital that can be drawn down is restricted.

Figure 1

CURRENT COMPULSORY POST-RETIREMENT INCOME OPTIONS

	GUARANTEED ANNUITY	LIVING ANNUITY
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.	• 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 10 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).	• 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.

KEY RISKS *for living annuity investors*

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 and 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.

IMPACT OF PAST AND FUTURE RETURNS ON LIVING AND GUARANTEED ANNUITIES FEASABILITY

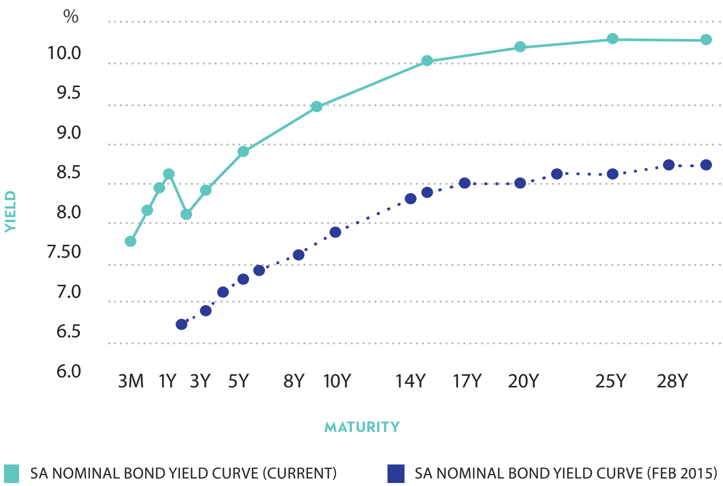
It is important to understand what informs the quoted income rates on guaranteed living annuities and how it differs from your experience in living annuity portfolios. Many investors assess the feasibility of living annuities based on performance from underlying funds over the recent past. In contrast, guaranteed annuities are assessed on the income offered by the life office going forward using future expected returns from markets such as the yield offered on long-dated bonds in the bond market. It is important to note that, while the income levels quoted on guaranteed annuities have become more attractive, one could assume that the same underlying drivers would benefit living annuity investors in their own portfolios going forward.

There is currently a large difference between the returns experienced in a typical living annuity over the last three years compared to the income levels currently offered in guaranteed annuities. This can partially be explained by the significant increase in fixed interest rates. The chart below shows the yields of SA nominal government bonds at different maturity levels. It clearly illustrates the significant increase in yield on offer over the last three and a half years – as much as 1.75%. It is important to understand that the tailwinds provided by higher yields on fixed-interest assets are already baked into income levels offered by guaranteed life annuities. In contrast, it is still to be earned by living annuity investors in future years.

Figure 2

THE HEADWINDS OF LOW YIELDS HAVE NOW TURNED INTO HIGH-YIELDING TAILWINDS

SA NOMINAL GOVERNMENT BOND YIELDS AT DIFFERENT MATURITY LEVELS



Source: Bloomberg

SEQUENCE OF RETURNS RISK

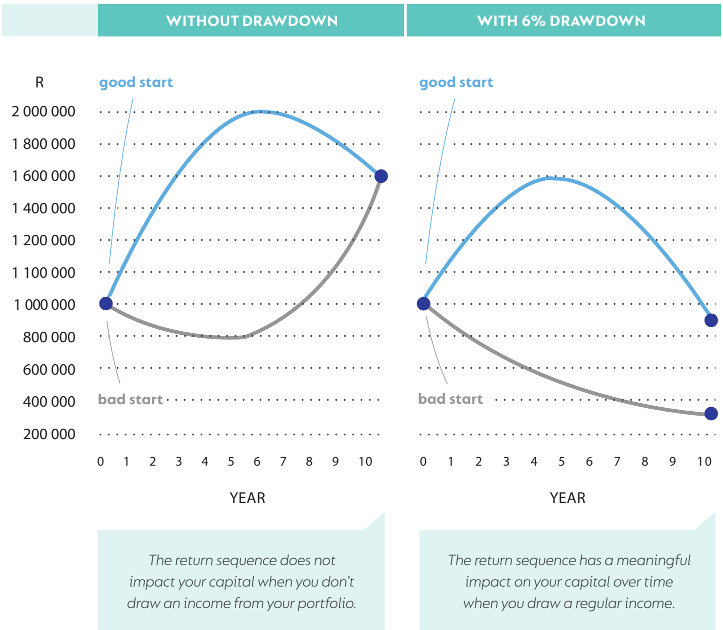
While we do believe equities will help retirees beat inflation, we have long argued the need for a more conservative asset allocation among those close to retirement.

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 3)**.

Figure 3

THE PATH IN WHICH RETURNS ARE DELIVERED MATTERS



Source: Coronation Research

Consider two investment portfolios that deliver the same nominal return of 5% p.a. after inflation over a period of 10 years, but in different annual sequences. One portfolio benefits from the best returns first (25% in year 1; 20% in year 2; 15% in year 3, etc.) and suffers the worst losses at the end (-4% in year 8; -6% in year 9; -8% in year 10). The other portfolio has the opposite experience whereby it suffers the worst losses at the start and only benefits from the best returns at the end. The example shows how the sequence in which returns are delivered is irrelevant when an investor does not draw an income from it as both portfolios end up with the same capital value at the end. In contrast, the sequence has a meaningful impact on the end value when there is a regular withdrawal against the portfolio – in this instance a starting annual income level of 6% that increases at 6% p.a.

This simplified example illustrates that if a retirement date coincides with an adverse market environment, the impact on accumulated savings can be devastating.

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.

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 8 we discuss Coronation Capital Plus and Coronation Balanced Defensive, two funds that are managed to meet these objectives.

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 may want to consider a hybrid annuity option wherein longevity protection can be added to a living annuity to provide income certainty beyond your planned horizon by transferring the risk to life office. Alternatively, you can also purchase 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 end up living longer.

Women should take into consideration the fact that they generally live longer than men, and may often require an income beyond 25 – 30 years after retirement. They face the additional obstacle of lower pension payouts often as a result of gaps in their careers for time taken to have children, as well as a larger percentage of their income spent on the household and broader family.

MANAGING THESE RISKS *in retirement*

Coronation offers two funds that meet the needs of income and growth investors – Coronation Balanced Defensive and Coronation 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 ASISA Multi Asset – Low Equity category. Since inception in February 2007 (to end-July 2018), Balanced Defensive has produced a nominal after-fees return of 9.8%[1] p.a. (or 3.6% p.a. in real terms) at a standard deviation of 4.1%. The fund currently maintains a 40.1% exposure to growth assets.

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

Up to 70% (currently 60.4%) of the portfolio can be invested in growth assets and despite its larger risk budget, the portfolio also aims to preserve capital over any 18-month period. It has produced a nominal after-fees return of 12.2%[2] p.a. (or 6.2% p.a. in real terms) since its inception in July 2001 at a standard deviation of 6.8%.

1. Highest annual return: 21.2% (Jun 2012 - May 2013); Lowest annual return: 2.0% (Mar 2008 - Feb 2009).

2. Highest annual return: 33.8% (Aug 2004 - Jul 2005); Lowest annual return: -6.2% (Nov 2007 - Oct 2008).

REASONS TO FEEL *a little more optimistic about the future*

THE OUTLOOK HAS IMPROVED

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% p.a. 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 10 years. The reality of how markets work means that one's expected return increases as past returns remain lower for longer. 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 10 years. In our view, local growth assets (equities and property) will deliver real returns in line with their 10-year averages **(see Figure 4)**. Equities also provide the opportunity for competent active fund managers to enhance outcomes by generating outperformance over the market.

Figure 4

10-YEAR FORECASTS FOR LOCAL AND OFFSHORE ASSET CLASSES

	LAST 10 YEARS*	10-YEAR FORECAST** (ZAR)
Local equity	11.2%	8 - 12%
Global equity	12.5%	8 - 12%
Local property	16.0%	9 - 12%
Local bonds	9.8%	8 - 9%
Global bonds	8.5%	4 - 5%
Cash	7.0%	6 - 7%
Inflation	5.4%	4 - 6%

*Source: *Deutsche Bank as at 30 June 2018 and **Coronation 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.*

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 **Figure 5**. The chart tracks 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.

Each shaded section of the graph shows the range in which your living annuity balance would have moved for starting drawdown rates of between 2.5% and 7% p.a. increasing by 6% p.a. The analysis is for the period July 2001 (when both funds were launched) to 30 June 2018. Over this period, the average money market fund returned 7.9% p.a. (after fees), while Strategic Income delivered 10.4% (after fees) p.a. Capital Plus returned 12.3% (after fees) p.a. over the same period. (Source: Morningstar as at 31 July 2018)

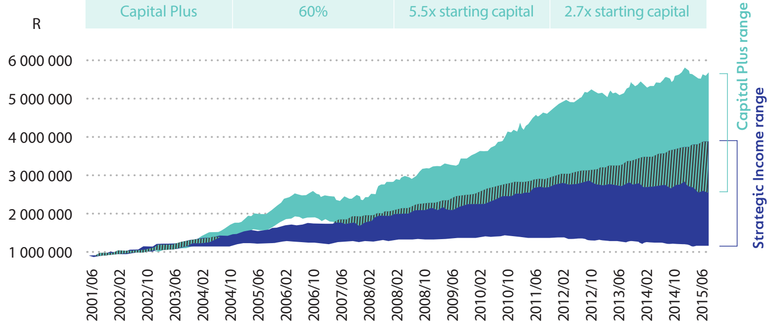
The most crucial insight from **Figure 5** is how exposure to equities can support long-term investment growth. Strategic Income can invest only a maximum of 25% in growth assets, while Capital Plus can have up to 70% in these investments. At a starting annual income level of 2.5% (increasing at 6% per year), an investment in Strategic Income would have resulted in nearly four times your nominal capital 17 years later. In contrast, an investment in Capital Plus would have increased to more than five and a half times your nominal capital.

At a more aggressive starting annual income level of 7% (increasing at 6% per year), an investment in Strategic Income would have increased by roughly 30% in nominal terms. In contrast, an investment in Capital Plus would have double the nominal value than in Strategic Income at the same starting income level. Tellingly, the investor in Strategic Income would be drawing 13.5% of capital compared to only 7% in Capital Plus. This is despite having already drawn income that cumulatively added up to double the amount initially invested. This further illustrates the crucial role that growth assets fulfil in providing protection against the eroding effects of inflation. The chart also shows 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 12 of this guide.

Figure 5

LIVING ANNUITY EXPERIENCE IN A CONSERVATIVE AND MODERATE RISK PORTFOLIO

FUND	EXPECTED AVERAGE GROWTH ASSETS	CURRENT BALANCE: INITIAL DRAWDOWN OF 2.5%	CURRENT BALANCE: INITIAL DRAWDOWN OF 7%
Strategic Income	10%	3.9x starting capital	1.3x starting capital
Capital Plus	60%	5.5x starting capital	2.7x starting capital



Source: Coronation as at 30 June 2018

PLANNING STRATEGIES *to consider in retirement*

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 6**. 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 6

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

Source: ASISA standard of Living Annuities

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 12.5% p.a. (historically Coronation Capital Plus achieved 12.2% 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 percentage points to 10.0%: the period of sustainability drops dramatically from 22 to 13 years at the same drawdown rate of 7.5%. But by reducing your income drawdown rate from 7.5% to 5.0%, the period of sustainability increases to 33 years.

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.)

SPENDING RULES
for capital preservation

DESIRED OUTCOME	Retirees want to grow income annually by inflation to maintain constant purchasing power (standard withdrawal rule).
PROBLEM	Each year, increases are granted regardless of the income return on the underlying portfolio. Capital could run out over a ±30-year period.
SOLUTION	Need to start with a low initial drawdown rate (4% or less). Formal spending rules can help to make higher initial drawdown rates (5%-6%) more sustainable. Moderate income requirements after tough return periods.

By applying a few spending rules, retirees can ensure capital preservation. The idea being that one dynamically adjusts your income drawdown in response to returns. In other words, first earn the returns before spending them.

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**. 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%).

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