THE INCOME AND GROWTH CHALLENGE

COROLAB

Your guide to investment ideas

08/19

CORONATION

TRUST IS EARNED™

THE CORONATION CLIENT CHARTER

We strive to always put 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

Investors who are near or already in retirement face the most challenging of needs: investing their life savings to simultaneously generate an immediate income and to ensure long-term capital growth.

In this issue, we discuss the key challenges that such investors will encounter during retirement when invested in a market-linked living annuity, explain how two of our funds are specifically managed to address those challenges and share practical tips that may guide appropriately prudent retirement income planning.

THE CHOICES *investors face at retirement*

Investors who are close to retirement need to make two choices with respect to the retirement savings they have accumulated over their working lives. Both decisions require careful thought and input from a qualified financial adviser.

TAKING A CASH LUMPSUM? IF SO, HOW MUCH? →

- The amount an investor can withdraw is determined by the pension fund of which he/she is a member.
- Any cash amount withdrawn reduces the amount with which to purchase a post-retirement annuity income.
- The first R500 000 withdrawn is tax free.

INVESTING THE REST →

- Whether or not investors withdraw a cash lumpsum, they need to select between two annuity options or a combination thereof, that will pay them a retirement income for life.

THE TWO MAIN ANNUITY OPTIONS AT RETIREMENT

Retirement savers currently have two main options from which to draw their post-retirement income: a living (market-linked) annuity or a guaranteed (life) annuity underwritten by a life insurance company. Both products have their own set of advantages and limitations, as outlined in the following table:

	GUARANTEED (LIFE) ANNUITY	LIVING (MARKET-LINKED) ANNUITY
How does it work?	A guaranteed pension for life. Your accumulated retirement savings are paid as a premium to a life insurer, who agrees to pay you an income for the rest of your life at a set or predetermined escalating rate.	No income guarantee but offers the potential for capital growth. Your accumulated savings are invested in a portfolio of underlying investment options such as unit trusts.
Who carries the risk?	The insurer carries the risk that you will live a no longer than average life (longevity risk), as well as the investment risk associated with making regular income payments over time.	You carry the investment and longevity risk as the selected income payment is not guaranteed. The value of your retirement pot can go up and down, depending on the performance of the investment option(s) you have chosen.
Can I change my level of income?	You typically only have a choice at inception of the annuity, between a level or an escalating life annuity. A **level** life annuity provides an income which stays the same in rand terms for the rest of your life. This means that your spending power is less in future years, as the cost of your expenses increase due to inflation, while your income remains the some. An **escalating** life annuity adjusts your income at a predetermined rate (or inflation), resulting in a lower starting level of income.	You can set your level of income (ranging between 2.5% p.a. and 17.5% p.a. of your total capital investment) once a year (on the anniversary of your investment). **Note: when your income rate exceeds that of your investment return, you start to pay out a portion of your income from your capital, reducing the capital base available to fund future income payments. The lower the level of income you take, the longer your capital will last. This is important should you have a long life expectancy.**
What about heritability?	Once transferred to the insurer, you cannot leave any capital to your estate or heirs.	Whatever capital remains at death is inherited by nominated beneficiaries.
Can I switch between the two annuity options?	No. Once you hove chosen a guaranteed annuity, there is no option to convert to a living annuity, nor to switch between providers of guaranteed annuities.	Yes. A living annuity can be transferred between providers, and it can be converted to a life annuity at a later stage.

THE KEY RISKS
faced by living annuity investors

Living annuities are often the most appropriate option from which to draw a post-retirement income, providing the benefits of flexibility and heritability. However, they expose investors to a number of risks (detailed below) that need to be managed on an ongoing basis in an appropriate manner.

1. Inflation risk

The risk that one's future purchasing power gets eroded by the impact of inflation

Due to rising prices, the future purchasing power of an investor's savings may be less than they require to maintain their 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.

Here's why:

PURCHASING POWER

REDUCES
IF
the investment rate of return < the inflation rate

IS MERELY **PROTECTED**
IF
the investment rate of return = the inflation rate

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 difficult to earn additional income as time passes. At an inflation rate of 6% per year, the purchasing power of one rand today will reduce in value to only 25 cents over a period of 25 years.

2. *Longevity risk*

The risk of outliving one's retirement savings

Most people in their early sixties can expect to live another 20 to 30 years. But of course, no-one can predict when they will die. It is therefore considered prudent to plan for a longer lifespan of at least 30 years. At a 6% inflation rate, you will require nearly six times 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 a 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.

3. Sequence of returns risk

The risk that an investor's retirement date coincides with an adverse market environment

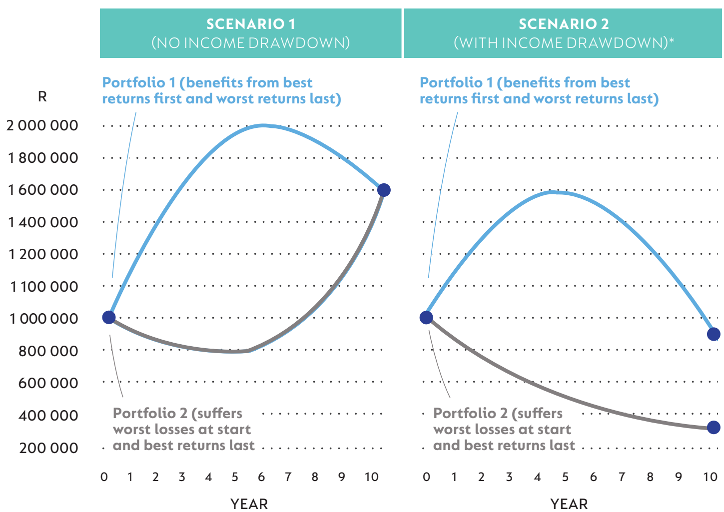
Even if investors do all the right things up until the point of retirement, they may still fall victim to retiring at the wrong time.

The order in which they receive returns on their investment plays a role. If a higher proportion of negative returns takes place at the beginning of retirement, it will have a lasting negative effect and reduce the amount of income an investor can withdraw over their lifetime.

Consider the following scenarios for two investment portfolios, delivering the same real (after inflation) return of 5% p.a. over a period of 10 years, but in different annual sequences.

This simplified example illustrates that the sequence in which returns are delivered is irrelevant when there is no income drawdown. In contrast, the impact on accumulated savings can be devastating if a retirement date coincides with an adverse market environment and there is a regular withdrawal against the portfolio.

Figure 1



**6% income drawdown which increases by 6% per annum*

Source: Coronation research

MANAGING THESE RISKS *in retirement*

Investors early in retirement should seek funds that allow a meaningful portion of the overall portfolio to be invested in growth assets. But the living annuity's underlying investment fund also needs a strong focus on risk and reducing the likelihood of potential negative returns over shorter time periods – this is important because the investor will be drawing a regular income from the fund.

Coronation offers two funds that are constructed to meet the needs of living annuity investors – our flagship living annuity portfolio Coronation Capital Plus and its lower-risk sibling Coronation Balanced Defensive. The funds are designed and managed specifically for the retired investor who needs to draw an income from their investment over multiple decades.

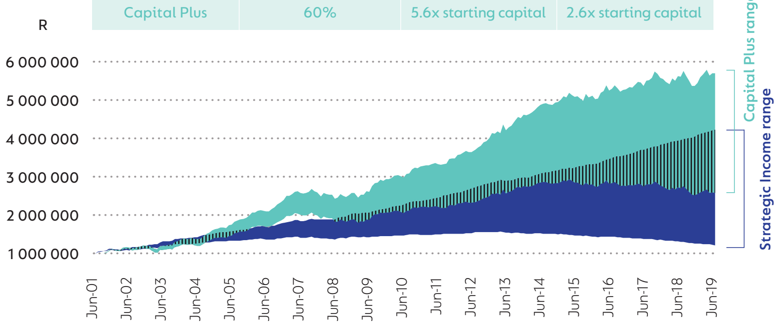
	CAPITAL PLUS	BALANCED DEFENSIVE
How does the fund address sequence-of-returns risk?	Aims to achieve no negative returns over any rolling 18-month period. The fund has achieved this over 96% of its history.	Aims to achieve no negative returns over any rolling 12-month period. The fund has achieved this over 100% of its history.
How does the fund address inflation risk?	By investing in a reasonable proportion of growth assets – typically ranging between 40% and 70% of the portfolio. **Refer Figure 2.**	By investing in a reasonable proportion of growth assets – up to a maximum of 50% of the portfolio.
Can the fund address longevity risk?	This can only be managed through selecting a prudent starting income drawdown rate. **Refer Figure 3 or spending rules on page 13.**	This can only be managed through selecting a prudent starting income drawdown rate. **Refer Figure 3 or spending rules on page 13.**

USING GROWTH ASSETS IN THE FIGHT AGAINST INFLATION

The following graph demonstrates how, in the fullness of time, the benefit of having reasonable exposure to growth assets becomes clear for income-drawing investors. The chart tracks living annuity investments in two Coronation funds: the conservative Coronation Strategic Income Fund and Coronation Capital Plus, which is a moderate risk income and growth portfolio. Each shaded section of the graph below 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 31 July 2019. Over this period, the average money market fund returned 7.9% p.a. (after fees), while Strategic Income delivered 10.3%* (after fees) p.a. Capital Plus returned 11.7%* (after fees) p.a. over the same period. (Source: Morningstar as at 31 July 2019).

Figure 2

FUND	ASSET EXPOSURE	CURRENT BALANCE: INITIAL DRAWDOWN OF 2.5%	CURRENT BALANCE: INITIAL DRAWDOWN OF 7%
Strategic Income	10%	4.2x starting capital	1.2x starting capital
Capital Plus	60%	5.6x starting capital	2.6x starting capital



Source: Coronation as at 31 July 2019

** Refer to the fund information table at the end of this document.*

The most crucial insight from **Figure 2** 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 4.2 times your nominal capital 18 years later. In contrast, an investment in Capital Plus would have increased to more than 5 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 20% 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 16.3% of capital compared to only 7.8% 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 on page 7 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 significant impact on the life of an investment. In the following section we provide more detail on selecting a prudent initial income drawdown rate.

SELECTING A PRUDENT 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 3**. This table shows a variety of possible initial income rates, from 2.5% to 17.5% (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 3

YEARS BEFORE YOUR INCOME WILL START TO REDUCE IF INFLATION IS 6%

	EXPECTED 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 just shy of 12% per annum since inception), any initial income rate up to 5.0% 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 50+ years to 33 years at the same drawdown rate of 5.0%. This illustrates how sensitive income sustainability is to an investors' expected return. 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.)

PLANNING STRATEGIES *to consider in retirement*

The typical retiree who draws an income from a living annuity needs to plan for 25 – 30 years and can expect moderate inflation and an improved return outlook (which we discuss in more detail below). The prudent planner's response to this backdrop however remains one of:

- 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.

The reality is that most South Africans do not plan sufficiently for retirement and leave saving for it too late. There are however ways to make what they have managed to save last a little longer.

- One option is to delay their retirement date by five years if at all possible. By continuing to earn an income and not drawing from your retirement savings, an investor can retire with 60% more capital assuming a 10% return p.a. which is aligned with a reasonable expected rate of return on assets.
- Another option is to supplement their post-retirement income by way of part-time work or starting a microbusiness. A post-retirement career of their choice has the added benefit of helping investors stay engaged and achieving greater personal fulfilment.

REASONS TO FEEL A LITTLE MORE OPTIMISTIC

While Capital Plus and Balanced Defensive currently have below-maximum exposure to risk assets and offshore assets, we are optimistic about the return outlook for our fixed-interest exposure. Both portfolios continue to hold a substantial weighting in South African bonds, both fixed rate and inflation linkers. The high real yield (currently around 8.8%) – thanks to well-contained inflation – is very attractive and provides a solid risk-adjusted building block towards achieving the portfolios' targeted return of inflation plus 4% (Capital Plus) and inflation plus 3% (Balanced Defensive).

Figure 4

10-YEAR FORECASTS FOR LOCAL AND OFFSHORE ASSET CLASSES

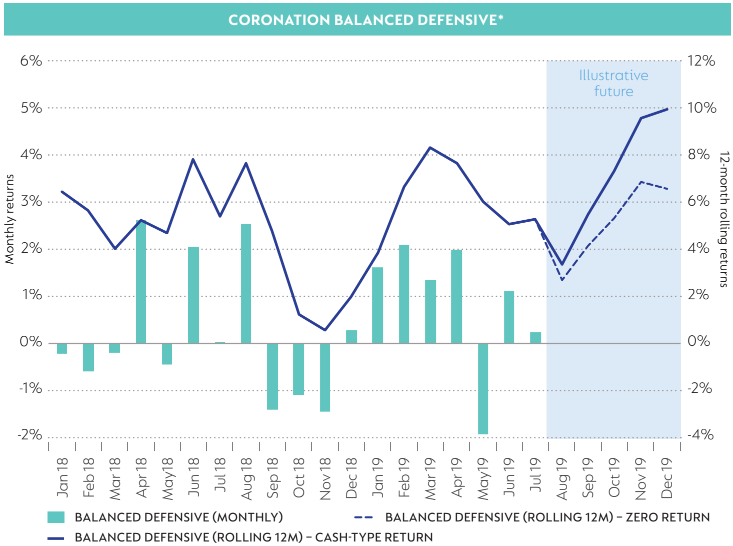
	LAST 10 YEARS*	10-YEAR FORECAST** (ZAR)
Local equity	13.5%	9 - 12%
Global equity	17.6%	7 - 9%
Local property	11.7%	9 - 12%
Local bonds	9.0%	9 - 10%
Global bonds	9.3%	4 - 6%
Cash	6.2%	6 - 7%
Inflation	5.2%	4.5 - 6%

*Source: *Deutsche Bank as at 31 July 2019 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.*

Further, we don't believe that the funds' current rolling 12-month returns are reflective of calendar year 2019 so far. In the event that both funds only deliver cash-type returns (of 7.5% p.a.) for the remainder of the year, we expect rolling 12-month returns to be in the low single digits **(refer to Figure 5 and 6)**. In the event that the funds deliver no return for the remainder of the year, we still expect much-improved rolling 12-month returns by the end of this year.

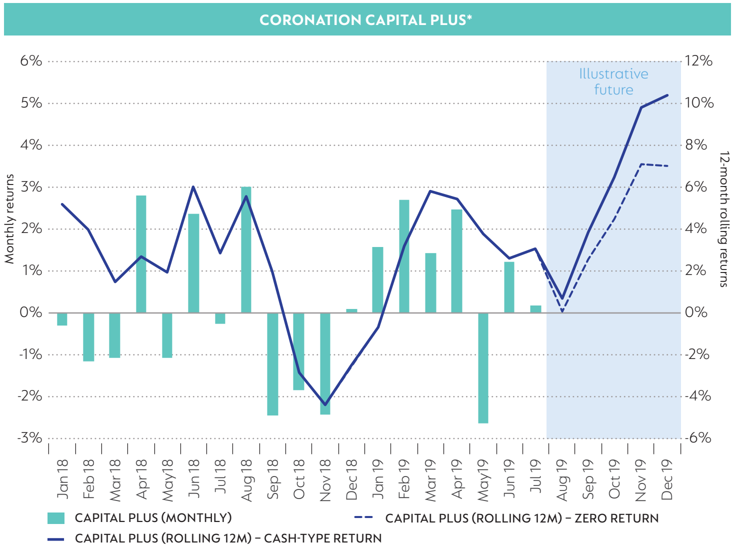
CURRENT 12-MONTH FIGURES NOT YET REFLECTIVE OF 2019 SO FAR

Figure 5



Actual figures as at 31 July 2019. Source: Morningstar.
Forecast period uses both zero return and cash-type return of 7.5% p.a.

Figure 6



Actual figures as at 31 July 2019. Source: Morningstar.
Forecast period uses a cash-type return of 7.5% p.a.

**Refer to the fund information table at the end of this document.*

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%).

NOTES

NOTES

NOTES

*Fund information table

FUND	LAUNCH DATE	BENCHMARK	PERFORMANCE SINCE LAUNCH (AFTER FEES)	LOWEST ANNUAL FIGURES SINCE LAUNCH	HIGHEST ANNUAL FIGURES SINCE LAUNCH
Coronation Strategic Income	2 July 2001	110% of the STeFI 3-month Index	**10.3%**	**2.6%** (Jun 2007 – May 2008)	**18.7%** (Nov 2002 – Oct 2003)
Coronation Balanced Defensive	1 February 2007	CPI + 3%	**9.4%**	**0.5%** (Dec 2017 – Nov 2018)	**21.2%** (Jun 2012 – May 2013)
Coronation Capital Plus	2 July 2001	CPI + 4%	**11.7%**	**-6.2%** (Nov 2007 – Oct 2008)	**33.8%** (Aug 2004 – Jul 2005)

Disclaimer

For **enquiries** you can call us on **0800 22 11 77**
or email us at **clientservice@coronation.com**.

For **new applications or transactions** you can email your forms directly to **transact@coronation.com** or fax us on **+27 21 680 2100**.

For **more information or to invest online**, visit us on **www.coronation.com**.