09/20

THE INCOME & GROWTH CHALLENGE

CORO LAB

Your guide to investment ideas

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: not only do they need to invest their life savings to facilitate a regular income drawdown (for which they need capital preservation in the short term), but also for that income drawdown to be sustainable over a multi-decade time horizon (for which you require longer-term capital growth that can deliver inflation-beating returns).

As living (market-linked) annuities are often the most appropriate option from which to draw a retirement income, this issue discusses the key challenges that such investors will encounter during retirement (**page 5**), explain how being invested in the appropriate mandate can prevent the next retiree disappointment that we believe is in the making (**page 9**) and share practical tips that may guide appropriately prudent retirement income planning (**page 15**).

The choices you 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.

ALLOCATING YOUR RETIREMENT SAVINGS

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Any cash amount withdrawn reduces the amount with which to purchase a post-retirement annuity income.

The first R500 000 withdrawn is tax free.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, which will pay them a retirement income for life.

Once you've decided on the amount that you want to invest, you have two main options from which to draw your retirement income: a living 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:

	LIVING (MARKET-LINKED) ANNUITY	GUARANTEED (LIFE) ANNUITY
How does it work?	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.	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.
Who carries the risk?	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.	The insurer carries the risk that you will live longer than the average life (longevity risk), as well as the investment risk associated with making regular income payments over time.
Can I change my 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.**	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 that 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.
What about heritability?	Whatever capital remains at death is inherited by nominated beneficiaries.	Once transferred to the insurer, you cannot leave any capital to your estate or heirs.
Can I switch between the two?	Yes. A living annuity can be transferred between providers, and it can be converted to a life annuity at a later stage.	No. Once you have chosen a guaranteed annuity, there is no option to convert to a living annuity, nor to switch between providers of guaranteed annuities.

Understanding your living annuity investment

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. In the current environment, there may be an argument for allocating a portion of your capital to a guaranteed annuity to relieve some of the drawdown pressure on the remaining portion of your living annuity investment. Read more on **page 7.**

THE LIVING ANNUITY RISKS YOU NEED TO BE AWARE OF

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.

PURCHASING POWER

REDUCES

if the investment rate of return < the inflation rate

IS MERELY **PROTECTED**

investment rate of return = the inflation rate

Here's why:

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. You can read more about the rising risk of inflation **here**.

*a prudent financial planning assumption for inflation, informed by the very long-term average

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 allocating a portion of their retirement capital to 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. In essence, you transfer longevity risk to the life office by paying them a fee. Deciding when to do that, and with how much of your retirement capital, requires a detailed discussion with a qualified financial planner.

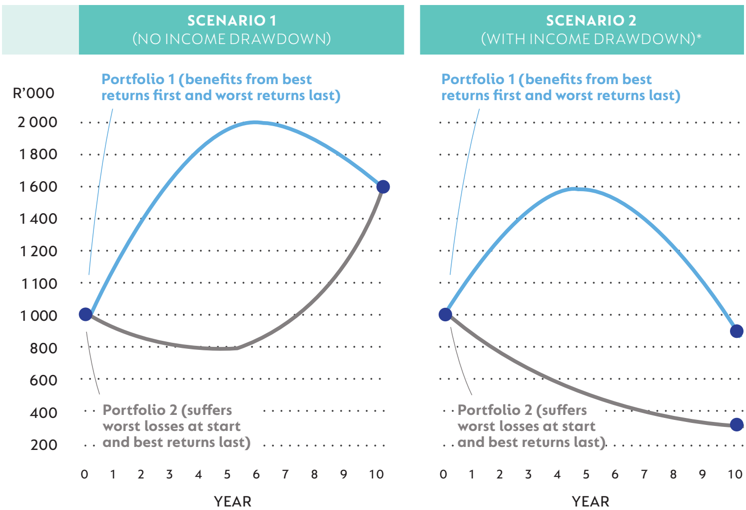
> **Women should take into consideration the fact that they generally live longer than men, and may often require an income beyond 25 – 30 years after retirement. They face the additional obstacle of lower pension payouts often as a result of working reduced hours (or taking breaks in their careers) as a result of family responsibilities.**

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 income withdrawal against the portfolio.



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

Source: Coronation research

Is it possible to manage these risks in retirement?

YOU NEED TO NORMALISE YOUR RISK EXPOSURE

For the past five years, returns delivered by the low to medium risk multi-asset fund category (the funds that are specifically managed to meet the needs of living annuity investors) have disappointed. This has resulted in many living annuity investors having de-risked, resulting in very significant overweight positions in cash or income funds.

While this strategy to de-risk may have worked over the past five years, cash yields today are 3% lower than they were a year ago at 3.5% (**see table below**). At the same time, longer bond yields have increased, meaning that we have seen a dramatic steepening of the bond yield curve. This was partially driven by the policy response to the Covid-19 crisis as well as the impact of the lockdowns on the local economy.

CASH YIELDS HAVE HALVED, WHILE LONG BOND YIELDS HAVE STEEPENED

	CASH YIELD	LONG BOND YIELDS*	DIFFERENCE IN YIELD
1 year ago	6.3%	9.6%	3.1%
Today	3.5%	10.8%	7.3%

A better way to participate in higher long bond yields?

Some investors may think that investing a portion of their capital in a dedicated bond fund is a sure way to increase the yield, and therefore total return, of their portfolios. However, in doing so you also introduce significant duration risk to your portfolio. Those already in retirement could consider an allocation to guaranteed annuities as a safer way to gain access to the higher yields offered by long bonds. See the section on guaranteed annuities on **page 11.**

*2035 South African Government Bond

Why is this problematic?

The potential problem for these investors over the medium to long term is that if you are not invested in real assets and inflation starts to tick up, the effect on your savings will be dramatic over time.

Most retirees are invested in funds where the base rate is the cash yield rather than the long bond yield. As a result, they are not necessarily well positioned for the market environment that we are facing today. In fact, we believe that many retirees are actually set up for yet another return disappointment over the next five years given the change in return expectations on both sides of the risk spectrum.

ARE YOU INVESTED IN THE CORRECT MANDATE?

The much steeper yield curve requires retired investors to take action

WHY?

- Lower short rates guaranteed to disappoint
- Higher long rates, but this comes with risk

Those invested in income and cash funds risk a disappointment in the making

WHY?

- Income and cash funds not suitable for long-term horizons
- Duration typically 1-2 years
- Cash yield now 3% less

The rational response would be to re-risk appropriately

HOW?

- Bonds offer high real yields, but not without risk (read more on **page 8**)
- Opportunities exist in risk assets despite cloudy outlook

Rather take advantage in a risk-conscious manner

HOW?

- **Coronation Capital Plus** and **Coronation Balanced Defensive** mandated to deliver on this (read more on **page 15**)
- Proven absolute return philosophy

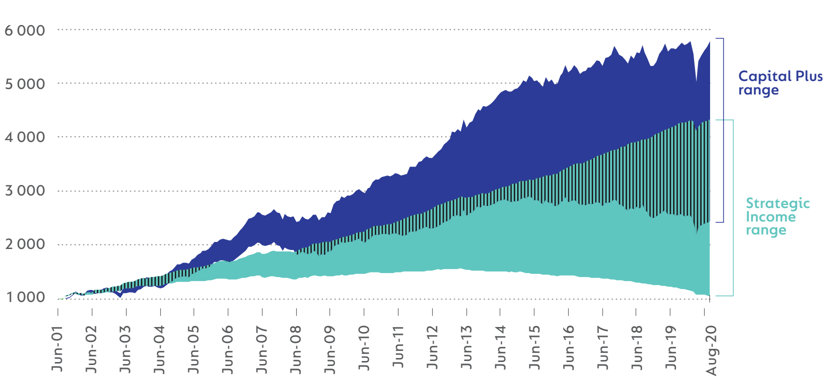
WHY YOU NEED GROWTH ASSETS IN THE FIGHT AGAINST INFLATION

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 managed income fund, Coronation Strategic Income, and our moderate risk income and growth portfolio, Coronation Capital Plus.

Each shaded section shows the range in which your living annuity balance would have moved for starting drawdown rates of 2.5% and 7% a year respectively. The analysis is for the period July 2001 (when both funds were launched) to 31 August 2020. Over this period, the average money market fund returned 7.9% p.a. (after fees), while Strategic Income delivered 9.9%* (after fees) p.a. Capital Plus returned 11.2%* (after fees) p.a. over the same period. (Source: Morningstar as at 31 August 2020).

Figure 1

FUND	GROWTH ASSET EXPOSURE	CURRENT BALANCE	
		INITIAL DRAWDOWN OF 2.5%	INITIAL DRAWDOWN OF 7%
Strategic Income	10%	4.2x starting capital	1.2x starting capital
Capital Plus	70%	5.6x starting capital	2.6x starting capital



Source: Coronation as at 31 August 2020

** Coronation Strategic Income Fund Benchmark: 110% of the STeFI 3-month Index*
Highest Annual Return: 18.7% (Nov 2002 - Oct 2003); Lowest Annual Return: 2.0% (April 2019 - March 2020)

Coronation Capital Plus Fund Benchmark: CPI + 4%p.a.
Highest Annual Return: 33.8% (Aug 2004 - Jul 2005); Lowest Annual Return: -9.3% (April 2019 - March 2020)

The most crucial insight from **Figure 1** 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 drawdown of 2.5% (increasing at 6% per year), an investment in Strategic Income would have resulted in 4.3 times your nominal capital 19 years later. In contrast, an investment in Capital Plus would have increased to just shy of 6 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 10% in nominal terms. In contrast, an investment in Capital Plus would have more than doubled the nominal value than in Strategic Income at the same starting income level.Tellingly, the investor in Strategic Income would be drawing 20% of capital (practically they would have to take a forced reduction in income as the drawdown rate exceeds the maximum 17.5% allowed within a living annuity), while investors in Capital Plus would only be drawing 8.7%. 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 10** 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.

Using attractive guaranteed annuity rates to enable appropriate growth asset exposure and sustainable income drawdown rates in your living annuity portfolio

With cash yields having reduced and long bond yields having increased, the rates available from guaranteed annuities* have also increased. By our calculations, traditional guaranteed annuities currently offer inflation-linked income rates ranging from 6.3% at the age of 60 to 10.7% at the age of 80**.

This means that there is an opportunity for investors who retired five or more years ago (and who have been most affected by the weaker market returns) to allocate a portion of their retirement capital to a guaranteed annuity in which they can take advantage of these higher rates available. This will allow the investor to re-risk the remainder of their living annuity portfolio (out of cash or income funds where we believe there is risk of a return disappointment going forward) so as to achieve a more sustainable drawdown rate. To find out more, speak to your financial adviser.

***Note:** We are considering plain vanilla 'no profit' guaranteed annuities with growing annual income, rather than fixed-rate, hybrid, embedded guarantee, smooth bonus/with profits guaranteed annuities.

Actual annuity quotes obtained in September 2020 from a reputable life insurer. Joint & survivor with principal life being a male and spouse three years younger, receiving 75% pension.

YOU NEED TO SELECT 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 2**. 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 2

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 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 10% p.a. (historically Coronation Capital Plus achieved 11.2% p.a. since inception), any initial income rate up to 5.0% represents a sustainable income, as it will take roughly 33 years before one reaches the maximum drawdown ceiling of 17.5% p.a. in your living annuity. However, note what happens when the expected return drops by 2.5 percentage points to 7.5%: the period of sustainability drops dramatically from 33 years to 19 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 (see **page 12**). 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.

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%).

Our solutions for living annuity portfolios

As is clear from this document, living annuity investors early in retirement should seek funds that allow a meaningful portion of the overall portfolio to be invested in growth assets. But the underlying investment fund also needs a strong focus on risk to reduce 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.

	CORONATION CAPITAL PLUS	CORONATION BALANCED DEFENSIVE
How does the fund address sequence-of-returns risk?	By aiming to deliver no negative returns over any rolling 18-month period. The fund has achieved this over 96% of its history.	By aiming to deliver 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 a reasonable proportion of the portfolio in growth assets – typically between 40% and 70%. Refer **Figure 2**. The fund aims to outperform inflation by 4% per year.	By investing in a reasonable proportion of the portfolio in growth assets – up to 50%. The fund aims to outperform inflation by 3% per year.
Can the fund address longevity risk?	This is best managed through selecting a prudent starting income drawdown rate. Refer **Figure 3** or spending rules on **pages 13-14.**	

Reasons to feel a little more optimistic

While Capital Plus and Balanced Defensive have not been able to reach their inflation-plus targets over the last five years (mainly due to anaemic market returns), we remain optimistic about the return outlook over the next three to five years. Both portfolios continue to hold a substantial weighting in South African bonds, both fixed rate and inflation linkers. The high real yield (currently around 9%) – 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 3

10-YEAR FORECASTS FOR LOCAL AND OFFSHORE ASSET CLASSES

	LAST 15 YEARS P.A. (ZAR)	LAST 10 YEARS P.A. (ZAR)	LAST 5 YEARS P.A. (ZAR)	10 YEAR FORECAST P.A. (ZAR)
Local equity	12.5%	10.6%	2.1%	7 – 10%
Global equity	14.1%	19.1%	14.9%	6 – 8%
Local property	9.6%	4.7%	-9.1%	7 - 10%
Local bonds	8.0%	8.3%	7.5%	9 - 11%
Global bonds	10.4%	11.6%	11.2%	3 - 4%
Cash	7.0%	6.2%	6.8%	5 - 6%
Inflation	5.6%	5.0%	4.5%	4 - 6%

As at 30 June 2020

Source: Coronation

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.

Disclaimer:

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Note that individual investor performance may differ as a result of the actual investment date, the date of reinvestment of distributions and dividend withholding tax, where applicable.Annualised performance figures represent the geometric average return earned by the fund over the given time period. Where foreign securities are included in a fund it may be exposed to macroeconomic, settlement, political, tax, reporting or illiquidity risk factors that may be different to similar investments in the South African markets. Fluctuations or movements in exchange rates may cause the value of underlying investments to go up or down. The Coronation Money Market fund is not a bank deposit account. The fund has a constant price, and the total return is made up of interest received and any gain or loss made on any particular instrument, in most cases the return will merely have the effect of increasing or decreasing the daily yield, but in the case of abnormal losses it can have the effect of reducing the capital value of the portfolio. Excessive withdrawals could place the fund under liquidity pressures, in such circumstances a process of ring-fencing of redemption instructions and managed pay-outs over time may be followed. A fund of funds invests in collective investment schemes that levy their own fees and charges, which could result in a higher fee structure for this fund. A feeder fund invests in a single fund of a collective investment scheme, which levies its own charges and could result in a higher fee structure for the feeder fund. Coronation Management Company (RF) (Pty) Ltd is a Collective Investment Schemes Manager approved by the Financial Sector Conduct Authority in terms of the Collective Investment Schemes Control Act. Unit trusts are traded at ruling prices set on every day trading. Forward pricing is used. For Domestic Unit Trust Funds and Tax Free Investments, including rand-denominated Offshore Unit Trust Funds, fund valuations take place at approximately 15h00 each business day, except at month end when the valuation is performed at approximately 17h00 (JSE market close). For these Funds, instructions must reach the Management Company before 14h00 (12h00 for the Money Market Fund) to ensure same day value. For Offshore Unit Trust Funds that are denominated in a foreign currency, fund valuations take place at approximately 17h00 each business day (Irish Time) and instructions must reach the Management Company before 12h00 (SA Time) to ensure the value of the next business day. For Retirement Products, fund valuations take place at approximately 15h00 each business day, except at month end when valuation is performed at approximately 17h00 (JSE market close). For these Products, instructions must reach the Management Company before 14h00 to ensure the value of the next business day. Additional information such as fund prices, brochures, application forms and a schedule of fund fees and charges is available on our website, www.coronation.com. Coronation Fund Managers Limited is a Full member of the Association for Savings & Investment SA (ASISA). Coronation Asset Management (Pty) Ltd (FSP 548), Coronation Investment Management International (Pty) Ltd (FSP 45646) and Coronation Alternative Investment Managers (Pty) Ltd (FSP 49893) are authorised financial services providers. Coronation Life Assurance Company Limited is a licenced insurer under the Insurance Act, No.18 of 2017.

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