05/21

THE INCOME & GROWTH CHALLENGE

CORO LAB

Your guide to investment ideas

CORONATION

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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 investor needs. Not only do they need to invest their life savings in order to draw a regular income from that retirement pot, but they also need for that regular income to be paid out over a multi-decade time horizon. To achieve this, they require both capital preservation in the short term and inflation-beating capital growth in the long term from their investment portfolio.

As living (market-linked) annuities are often the most appropriate option from which to draw a retirement income, this edition aims to help investors better understand their living annuity investment (**page 5**), and how being invested in the appropriate mandate can prevent the next retiree disappointment we believe is in the making (**page 9**). We also share some practical tips that may guide appropriately prudent retirement planning (**page 13**).

The choices you face at retirement

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

ALLOCATING YOUR RETIREMENT SAVINGS

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Any cash amount withdrawn reduces the amount with which to purchase a post-retirement annuity income.

The first R500 000 withdrawn is tax free.

HOW DO I INVEST 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 (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:

	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 inheritability?	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 inheritability. However, they expose investors to a number of risks (detailed below) that need to be managed on an ongoing basis in an appropriate manner.

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.

YOUR PURCHASING POWER

REDUCES

if the investment rate of return < the inflation rate

IS MERELY **PROTECTED**

if the 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.

*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

6x

the level of income you will need at the end of your planning horizon to sustain your current lifestyle expenses

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 may need to plan for a longer retirement

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

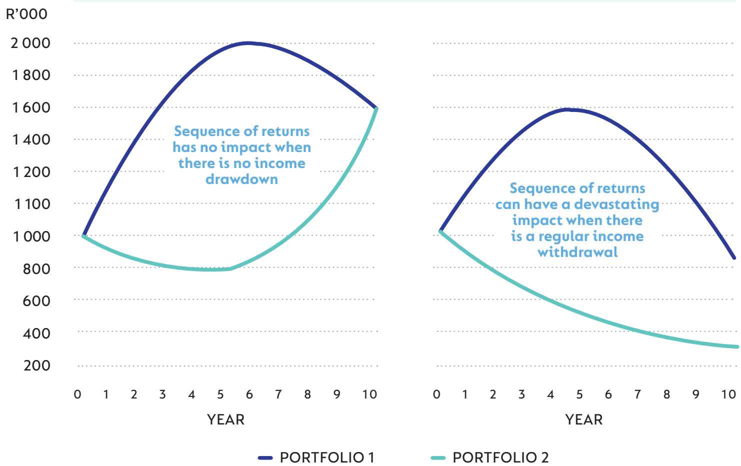
The risk that an investor's retirement date coincides with an adverse market environment

Even if investors do all the right things up to the point of their retirement, they may still fall victim to entering this next phase of their lives at the wrong time. This is likely to happen when a higher proportion of negative returns are earned in the early years of retirement. This 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, when there is no income drawdown, the sequence in which returns are delivered is irrelevant. 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.

SCENARIO 1 (NO INCOME DRAWDOWN)	**SCENARIO 2** (WITH INCOME DRAWDOWN)*

- **Portfolio 1 benefits from best returns first and worst losses at the end**
- **Portfolio 2 suffers the worst losses at the start and only benefits from best returns at the end**



**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 category (those funds being managed to specifically meet the needs of living annuity investors) have not met their inflation-plus return targets. While those returns were ahead of inflation, the funds underperformed more conservative portfolios (those without any exposure to growth assets) over the same period.

While this strategy to de-risk may have worked over the past five years, cash yields today (at 3.5%) are roughly 3% lower than they were in 2019 (**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 ALMOST HALVED, WHILE LONG BOND YIELDS HAVE STEEPENED

	CASH YIELD	LONG BOND YIELDS*	DIFFERENCE IN YIELD
2019	6.3%	9.6%	3.1%
Today	3.5%	11.1%	7.6%

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.

*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 yields roughly 3% less than in 2019

The rational response would be to re-risk appropriately

HOW?

- Bonds offer high real yields, but not without risk (read more on **page 8**)
- Significant opportunities in growth assets – especially equities

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

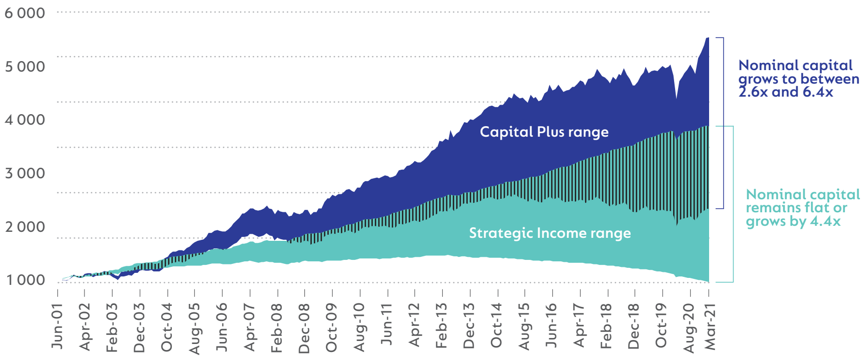
The following graph demonstrates how, in the fullness of time, the benefit of having reasonable exposure to growth assets becomes clear for income-drawing investors. The chart tracks living annuity investments in two Coronation funds: the conservative managed income fund, **Coronation Strategic Income**, 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 March 2021. Over this period, the average money market fund returned 7.7% p.a. (after fees), while Strategic Income delivered 9.8%* p.a. (after fees) Capital Plus returned 11.4%* p.a. (after fees) over the same period. (Source: Morningstar as at 31 March 2021).

Figure 1

WHAT HAPPENS TO YOUR RETIREMENT POT GIVEN DIFFERENT INITIAL DRAWDOWN RATES

FUND	MAXIMUM GROWTH ASSET EXPOSURE	GROWTH IN NOMINAL CAPITAL	
		INITIAL DRAWDOWN OF 2.5%	INITIAL DRAWDOWN OF 7%
Capital Plus	70%	6.4x	2.6x
Strategic Income	25%	4.4x	1.0x



Source: Coronation as at 31 March 2021

** 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)

Exposure to equities can support long-term investment growth

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 4.4 times your nominal capital 20 years later. In contrast, an investment in Capital Plus would have increased to just shy of 6.4 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 remained flat 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 22% 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 8.2% of capital. (And this is despite having already drawn an annual income from the portfolio that cumulatively added up to double the amount that was 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.

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 11.5% 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 by dynamically adjusting their 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 focusing on downside risk, the fund aims to achieve less volatility than the average balanced fund.	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 1**. 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

We remain optimistic about the return outlook for **Coronation Capital Plus** and **Coronation Balanced Defensive** over the next three to five years as both portfolios continue to hold healthy levels of growth asset exposure. With inflation expected to remain well within the South African Reserve Bank's target band, and the bulk of the underlying asset classes within each portfolio expected to contribute positively (with the exception of cash and global bonds), we believe the funds are positioned to deliver on their respective real return targets (inflation plus 4% in the case of Capital Plus and inflation plus 3% in the case of Balanced Defensive).

Figure 3

FUNDS POISED TO ACHIEVE TARGETED RETURNS IN THE NEXT 3-5 YEARS

ASSET CLASS	LIKELY TO DELIVER ON CPI + TARGET?	RISK
SA equities	✓	Medium
Global equities	✓	Medium
SA bonds	✓	Medium
SA property	✓	High
Commodities	✓	Medium
SA cash	✗	Low
Global bonds	✗	High

90%

of the assets held by Capital Plus and Balanced Defensive have a strong probability of achieving the targeted returns

Source: Coronation

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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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