09/22

PIVOTING TOWARDS INCOME AND GROWTH

COROLAB

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

Pivoting towards income and growth

- Investors near or in retirement face a significant inflexion point in their investment journeys
- Those looking to pay themselves a retirement income from a living annuity can expect to navigate a new set of risks that they may not have encountered before
- It is possible to manage these risks by ensuring that you invest in an appropriate fund and by applying some prudence when selecting your starting income rate (drawdown)
- Coronation offers two bespoke funds with excellent track records that are managed with the aim of supporting the specific needs of living annuity investors

MIND THE PIVOT

Saving towards your retirement could take up most of your working life (30 - 40 years). If you manage to stay the course, invest sufficiently (enough) and appropriately (with adequate exposure to risk assets) history tells us there are few risks that could derail this long-term goal. The only investment outcome you need to concern yourself with is maximising capital growth in a tax-efficient manner as you build your nest egg during this accumulation phase of your retirement journey.

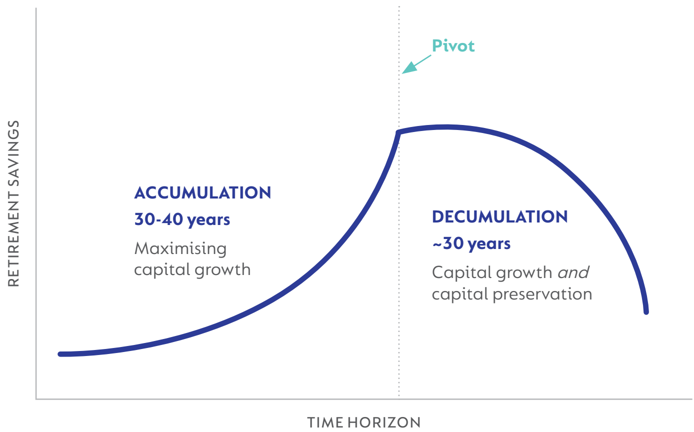
However, as you near your retirement date, your investment objectives will start to change as you enter the decumulation phase of this journey. Your investment objectives now need to deliver on two needs simultaneously:

- generating **capital growth (that is ahead of inflation)** over what could be yet another multi-decade period; *and*
- **capital preservation** in the short term as you need to draw a sustainable regular income from your accumulated savings.

The risks you are likely to face to achieve these outcomes are trickier to navigate, but not impossible. If you invest in an appropriate fund that is specifically managed for this phase of your retirement (→ ***page 12***), coupled with choosing a prudent starting income drawdown rate (→ ***page 7***), these risks are likely to become more manageable.

YOUR RETIREMENT JOURNEY COMPRISES TWO PHASES

Each phase will require a different mandate to accommodate your specific needs



Understanding the risks associated with a living annuity investment

Living annuities are often the most appropriate option from which to draw a regular income in retirement, providing the benefits of flexibility and inheritability. However, because they pay a regular income, investors in these products face a number of new risks that they may not have encountered (or considered) as part of the accumulation phase of their retirement journeys. These risks (detailed below) need to be managed on an ongoing basis and in an appropriate manner.

KEY RISKS FOR LIVING ANNUITY INVESTORS

INFLATION RISK The risk that one's future purchasing power gets eroded by the impact of inflation	**LONGEVITY RISK** The risk of outliving one's retirement capital	**SEQUENCE-OF-RETURNS RISK** The risk that an investor's retirement date coincides with an adverse market environment (retiring at the wrong time)

But investors often underestimate the following:

The invisible impact of inflation risk catching up over the long term	The length of their investment time horizon in retirement	The impact of an adverse market environment when they have too much exposure to growth assets

You can address these risks by:

Choosing the appropriate Coronation fund that is managed with the aim of delivering real (ahead of inflation) outcomes through reasonable exposure to growth assets (→ *see case study on page 12*)	Planning for an investment horizon of at least 30 years; choosing a sustainable income drawdown rate (with the assistance of your adviser); and investing in the appropriate Coronation fund that holds sufficient exposure to growth assets	Choosing the appropriate Coronation fund that is risk conscious and focuses on managing downside risk with the probability of ensuring a smoother return path

INFLATION RISK

As the prices of the products and services we use rise, an investors' future purchasing power may be less than what they require to maintain their standard of living throughout retirement. While the eroding effect of inflation on one's savings may not be that noticeable in the short term, the impact over time can be devastating, as is clear from the following example:

At an inflation rate of 6% per year (a prudent financial planning assumption for inflation, informed by the very long-term average), the purchasing power of one rand's worth of savings today will reduce in value to only 17 cents over a period of 30 years (a prudent planning horizon).

INFLATION HAS AN INVISIBLE IMPACT OVER TIME

For any given basket of goods and services that you can buy today...

...that same amount can only buy 17% of that basket in 30 years' time.

Retirees with a lengthy retirement horizon are particularly vulnerable to this risk. Especially if their investment rate of return is less than the inflation rate (in which case their purchasing power reduces) or equal to the inflation rate (in which case their purchasing power is merely protected). This makes it very difficult to sustainably fund regular withdrawals that also need to grow with inflation.

How we address this risk on investors' behalf

We have a track record of managing funds that are designed to achieve healthy outcomes ahead of inflation (so as to grow investors' purchasing power) while also managing the risk of adverse market outcomes (downside). Coronation Capital Plus and Coronation Balanced Defensive are benchmarked against CPI + 4% and CPI + 3% respectively, and therefore invest in the appropriate combination of assets designed to achieve these favourable outcomes (***refer to the case study on → page 12***).

LONGEVITY RISK

The prudent investor will dedicate multiple decades to accumulating their retirement savings. Yet, many investors underestimate the fact that the time they spend in retirement (and, as such, the period over which their retirement savings need to last) will likely also span multiple decades.

How investors can address this risk

Plan for a longer retirement time horizon

Most people in their early sixties can expect to live another 20 to 30 years. It is thus considered prudent to plan for a longer lifespan of at least 30 years.

30 years

prudent retirement planning horizon

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.

Invest in an appropriate fund

On page 12 (→ ***case study***), we demonstrate how investing in appropriate levels of growth assets has supported long-term growth over a multi-decade time horizon.

Select a prudent income drawdown rate

Selecting an income drawdown rate (at the start of your retirement) that is too high is as dangerous as being too optimistic about your expected investment rate of return. The following table explains why this is the case. It maps a retiree's initial income rate (between 2.5% and 12.5% per year) against a number of potential net investment returns (from 2.5% to 15% per year). The value in each cell represents the number of years over which you will be able to maintain your standard of living, assuming an inflation rate of 6%.

IT'S CRUCIAL TO SELECT A PRUDENT INITIAL INCOME RATE

		INVESTMENT RETURN P.A. (NET OF FEES)					
		2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
INCOME RATE P.A.	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

ASISA Standard on Living Annuities

5%

prudent initial income drawdown rate

For example, at a net investment rate of return of 10% p.a. (Coronation Capital Plus has achieved 11.0% p.a. since inception as at end-July 2022), any initial income drawdown rate up to 5.0% represents a sustainable level, as it will take roughly 33 years (a prudent investment horizon in terms of retirement planning) before you reach the maximum drawdown limit (of 17.5% p.a.) in your living annuity.

However, note what happens when the expected investment return drops to 7.5%: the period over which you can sustain an income drawdown of 5% p.a. drops dramatically from 33 years to 19 years. This illustrates how sensitive the sustainability of your chosen income drawdown rate is to investment returns, and supports our view that for most investors an initial retirement income drawdown rate of 5% p.a. is prudent. (→ ***read more about spending rules on page 14***).

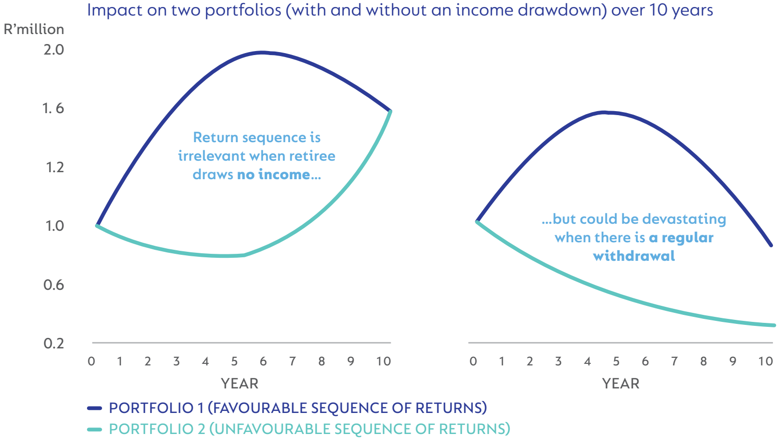
SEQUENCE-OF-RETURNS RISK

Even if investors do all the right things up to the point of their retirement, their retirement date may still coincide with an adverse market environment. 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 two 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: **Portfolio 1** (blue line) benefits from a more favourable sequence of returns (best returns first and worst losses at the end), while **Portfolio 2** (mint line) has a poor sequence of returns (suffers worst losses at the start and best returns at the end). The first scenario (left-hand side) shows the portfolios' return path when there is no retirement income drawn and the second scenario (right-hand side) shows the portfolios' return path when there is a regular retirement income* withdrawal.

AN UNFAVOURABLE RETURNS SEQUENCE MATTERS MORE IN YOUR DECUMULATION YEARS OF RETIREMENT

Impact on two portfolios (with and without an income drawdown) over 10 years



**6% income drawdown which increases by 6% per annum*
Source: Coronation research

This simplified example illustrates how devastating the impact on accumulated savings can be if a retirement date coincides with an adverse market environment and when there is a regular income withdrawal against the portfolio. In contrast, when an investor draws no income from the affected portfolios (as is the case during your accumulation phase of retirement saving), the sequence in which returns are delivered is irrelevant.

How we address this risk on investors' behalf

It is critical that investors identify an appropriate fund for this phase of their retirement journeys, and not simply remain invested in any balanced fund. The Coronation Capital Plus and Coronation Balanced Defensive funds are specifically designed for retired investors in the decumulation phase of their retirement investing journeys. This means that the portfolios are risk-conscious, with a low tolerance for volatility. By focusing on managing the downside risk, the fund managers aim to achieve a smoother return path that supports annual income withdrawals over an extended period of time (→ ***read more on page 12***).

Managing bespoke funds for living annuity portfolios

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 two funds are specifically designed and managed for the retired investor who needs to draw an income from their investment over multiple decades.

CHOOSING THE RIGHT FUND

The Coronation Capital Plus and Coronation Balanced Defensive are risk-conscious funds, constructed to manage all three risks faced by living annuity investors (→ ***see page 5***). However, there is a difference in emphasis to cater for retired investors whose objectives may differ as well. The following table should help investors align their individual risk prioritisation with the most appropriate fund.

	CAPITAL PLUS	BALANCED DEFENSIVE
Return scorecard	Returned 5.3% p.a. (real) since inception*, ahead of its CPI + 4% benchmark	Returned 3.0% p.a. (real) since inception*, in line with its CPI + 3% benchmark
Risk emphasis	Prioritises the management of **inflation risk** by investing a reasonable proportion of the portfolio in growth assets – typically between 40% and 70% The Fund has achieved positive returns over rolling 12-month periods 91% of the time	Prioritises **sequence-of-returns risk** by limiting growth asset exposure to a maximum of 50% of the portfolio As such, the Fund aims to deliver no negative returns over any rolling 12-month period. The fund has achieved this over 99% of its history
Who should consider investing in it?	Its greater emphasis on managing inflation risk makes the fund more suited to investors in the **first half** of retirement who want their accumulated savings to support an annual income drawdown over a 30-year planning horizon	Its greater emphasis on managing sequence-of-returns risk makes it more suited to investors with a **low tolerance for volatility**, or those in the **second half** of their 30-year retirement planning horizon

**As at end-July 2022*

PUTTING THE MANAGEMENT OF THESE RISKS TO THE TEST

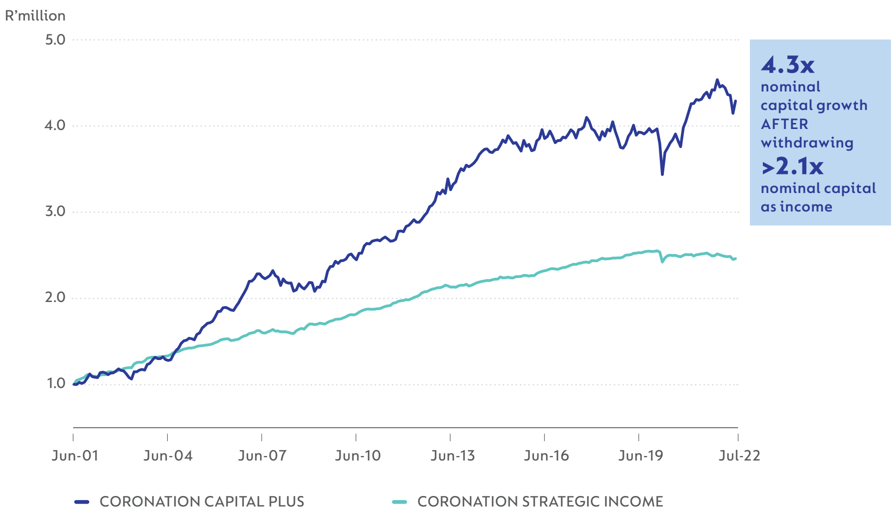
The following case study demonstrates how well the appropriate fund mandate (with adequate exposure to growth assets) can support a prudent initial income drawdown rate over a multi-decade horizon.

The chart tracks living annuity investments in two Coronation funds with different risk profiles. Our flagship living annuity portfolio, Coronation Capital Plus, has a moderate risk profile, with an expected average growth asset exposure of 60% through the cycle, while the managed income fund, Coronation Strategic Income, is a conservative portfolio, with an expected average exposure to growth assets of 5%.

The lines show the growth in nominal investment outcomes (unadjusted for inflation) over a 21-year period for a starting drawdown rate of 5% a year from both funds, which increases by 6% annually. During this time, the Coronation Capital Plus Fund has delivered a return of 11.0% per annum, while Coronation Strategic Income has returned 9.5% per annum (as at end July 2022).

FUNDS WITH MODERATE RISK EXPOSURE SUPPORT PRUDENT INCOME DRAWDOWN RATES BETTER

Growth in nominal capital of R1m invested at inception and after accounting for a regular income withdrawal of 5% p.a. which increases by 6% p.a.



Source: Coronation and Morningstar as at 31 July 2022

Key take-outs from this exercise

- It is clear that Coronation Capital Plus, the fund with appropriate levels of growth asset exposure, is much better at supporting long-term investment growth than Coronation Strategic Income, delivering 4.3 times the initial capital amount invested, compared to Coronation Strategic Income's 2.4 times initial capital. And that is even after the retiree has withdrawn more than double the initial capital amount invested (>R2m) by way of income.
- This further illustrates the crucial role that growth assets fulfil in providing protection against the eroding effects of inflation.

Conclusion

Investors looking to pay themselves a retirement income from a living annuity should seek to invest in funds that are managed to help combat the three key risks that are unique to this phase of their retirement journeys, namely inflation risk, longevity risk, and sequence-of-returns risk (→ *see page 5*). And then apply some prudence when selecting their initial income drawdown rate (→ *see page 7*).

Coronation offers two bespoke funds – Coronation Capital Plus and Coronation Balanced Defensive – that are designed to combat these risks through a combination of appropriate levels of growth asset exposure and a focus on downside risk (→ *see page 11*).

Planning strategies

WHAT TO CONSIDER IN RETIREMENT

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:

Consider delaying your retirement date, if possible

By continuing to earn an income and not drawing from your retirement savings for another five years, an investor can retire with 60% more capital assuming a return of 10% p.a., which is aligned with a reasonable expected rate of return on assets.

Consider pursuing a post-retirement career

Finding ways to supplement your retirement income has the added benefit of helping investors stay engaged and achieving greater personal fulfilment.

Consider the introduction of dynamic spending rules

By managing your income drawdown rates more actively in response to your investment portfolio's performance, retirees can avoid reaching unsustainable drawdown levels that make running out of money inevitable. In other words, first earn the returns before withdrawing them.

RULE	WHAT HAPPENS TO YOUR ANNUAL INCOME?		
Modified withdrawal rule	Your annual income **increases** annually with inflation	**Except** when the retirement portfolio produces 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
Capital preservation rule	Your annual income **reduces** by a pre-defined percentage (e.g. 10%) **if** the increased withdrawal rate in a given year exceeds the initial withdrawal rate by more than a certain percentage (e.g. 20%)	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%)

Disclaimer:

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For **enquiries** you can call us on **0800 22 11 77**
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For **more information or to invest online**, visit us on **www.coronation.com**.