2023

INVESTING FOR 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

Overview

Investors near or in retirement face a significant inflection 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, and for which the mandates of their pre-retirement investment funds didn't need to cater.

The risks that you are likely to face when you start drawing an income in retirement are trickier to navigate, but not impossible.

This edition unpacks these risks in more detail and explains how investing in an appropriate fund that is specifically managed for this phase of your retirement, coupled with choosing a prudent starting income drawdown rate, can help make these risks more manageable. It also showcases two bespoke Coronation funds that have supported the specific needs of living annuity investors over multiple decades.

What happens to your investment needs at retirement?

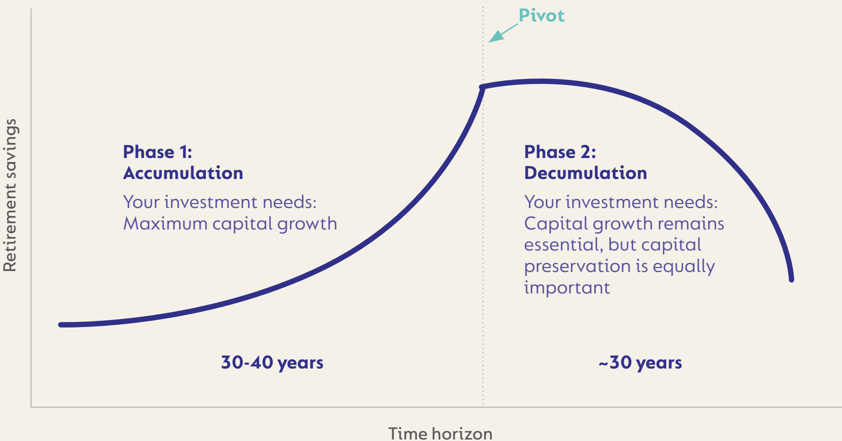
Saving towards your retirement could take up most of your working life (30-40 years). If you manage to stay the course, invest sufficiently (enough) and appropriately (with adequate exposure to risk assets), history tells us there are few risks that could derail this long-term goal. The only investment 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. **Read more in our *Investing tax-efficiently for long-term goals* edition of Corolab.**

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
- Equally important is capital preservation in the short term as you need to draw a sustainable regular income from your accumulated savings.

Your investment needs change as you near retirement

The two phases of your retirement journey



The risks you need to navigate

Living annuities are often the most appropriate product from which to draw a regular income in retirement, providing the benefits of flexibility and the fact that unused capital is heritable. 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.

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

Inflation risk

As the prices of the products and services we use rise, an investor's 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 R1'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

Who is most vulnerable to this risk?

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.

What about a material inflation shock?

While hyperinflation in response to a crippling currency devaluation remains a tail risk, studying examples of historical hyperinflation events (such as that of Germany's Weimar Republic post WW1) can provide some useful guidance on the range of outcomes that prevailed and the asset classes that are likely to provide protection against a material inflation shock. The key lesson for South Africans is that the traditional perception of riskiness between different asset classes is turned on its head. Foreign and locally listed equities provide much better protection against hyperinflation than cash or bonds.

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. Investors can address this risk by:

- Planning for a longer retirement time horizon

Most people in their early 60s 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. 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 end up funding the additional income required by those who live 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.

- Investing in an appropriate fund

On page 9, we demonstrate how investing in appropriate levels of growth assets has supported long-term growth over a multi-decade time horizon. Needless to say, we continue to see investors invest too conservatively in retirement.

- Selecting 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%.

For example, at a net investment return of 10% p.a. (**Coronation Capital Plus** has achieved 11.1% p.a. since inception as at end-April 2023), any initial income drawdown rate up to 5% 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.

It's crucial to select a prudent initial income rate

At a 10% p.a. investment rate of return, initial income drawdown rates up to 5% are sustainable

		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

It is important to note that the table above assumes that you will adjust your percentage income selected over time to maintain the same amount of real income (i.e. allowing for inflation of 6% per annum).
Source: ASISA Standard on Living Annuities; 2009

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 table 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 10.)

Sequence-of-returns risk

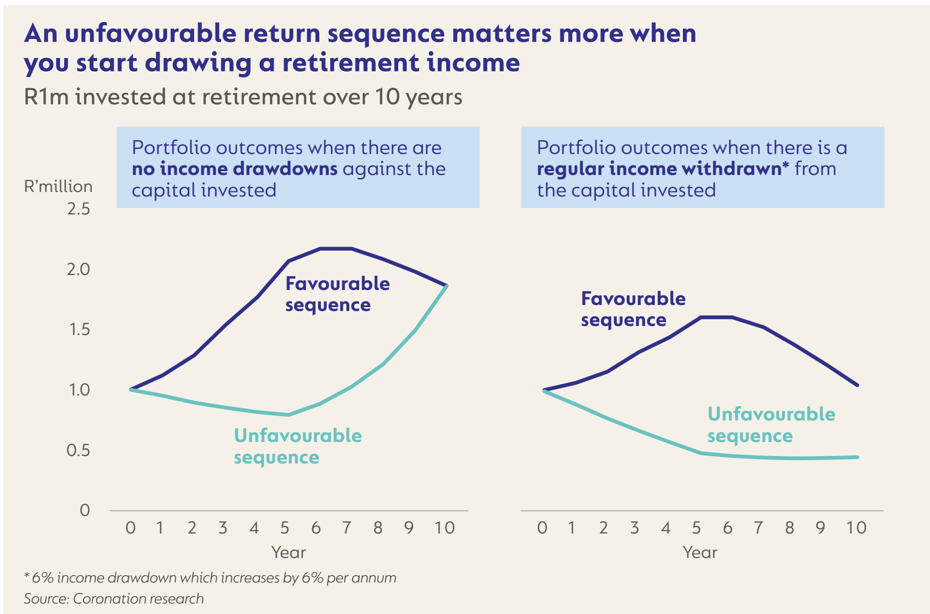
Even if investors do all the right things up to the point of their retirement, their retirement date may still coincide with an adverse market environment. This is likely to happen when a higher proportion of negative returns are earned in the early years of retirement. This will have a lasting negative effect and reduce the amount of income an investor can withdraw over their lifetime.

Consider the following exercise: the two graphs below depict two portfolios that achieve the same annualised return over 10 years but in different annual sequences. In the graph on the left, the blue line represents the portfolio that experiences more favourable returns early on, whereas the mint line represents a portfolio that suffers its worst returns first, followed by better returns towards the end of the 10-year period. Ultimately, the two portfolios end up with the same amount of capital, so the sequence in which returns are delivered is irrelevant.

The graph on the right, shows the outcomes when we add a withdrawal of 6% p.a. that escalates by 6% each year to allow for the impact of inflation on your living

An unfavourable return sequence matters more when you start drawing a retirement income

R1m invested at retirement over 10 years



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

Source: Coronation research

standard. It is immediately apparent how devastating the impact on accumulated savings can be if a retirement date coincides with an adverse market environment. The portfolio that suffers an unfavourable sequence of returns (mint line) ends the period with a capital value roughly half that of the portfolio with the better return sequence (blue line).

Although this risk of suffering an unfavourable sequence of returns at the start of your retirement cannot be eliminated, ensuring that the capital is protected during adverse market return periods can materially reduce it.

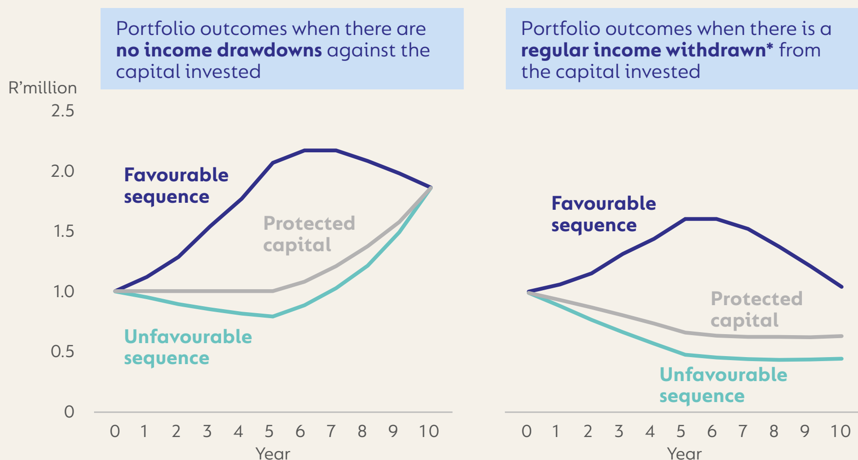
Consider the same scenario as before, but now with the inclusion of a third portfolio as represented by the grey line. In the graph on the left, this portfolio experiences the same market environment as the blue and mint lines but manages to protect capital during the early years when returns were negative, allowing the investor to end up with the same return at the end of the period.

When we add the income drawdown to this portfolio (see graph on the right), it becomes clear how vital capital preservation is during retirement in combatting sequence-of-returns risk.

The portfolio that protected capital during the first few years ends up with a final capital value around 40% higher than that of the mint portfolio, which experienced a poor initial sequence of returns.

Capital preservation is vital to combat sequence-of-returns risk

R1m invested at retirement over 10 years



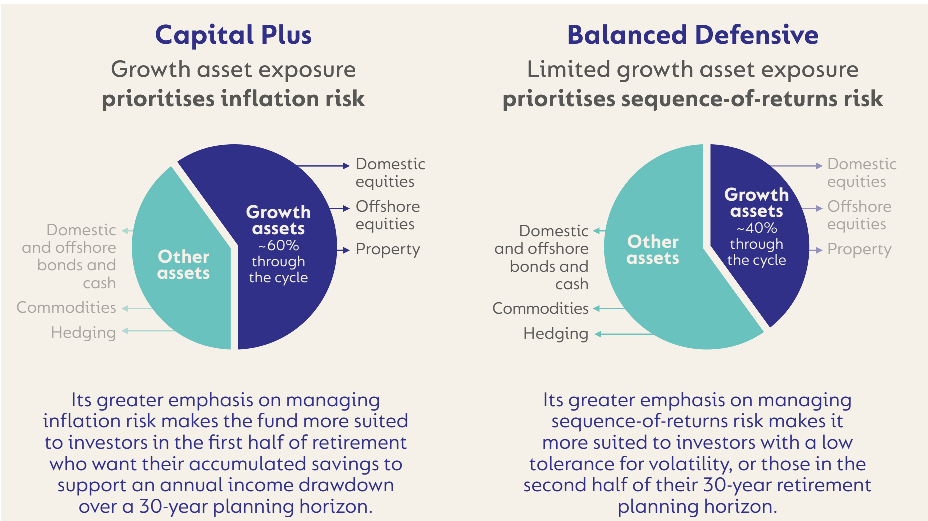
** 6% income drawdown which increases by 6% per annum*

Source: Coronation research

Choosing the right fund

It is critical that investors identify an appropriate multi-asset class fund for this phase of their retirement journeys that allows them to stay the course. Coronation offers two funds that are specifically designed and managed for retired investors in the decumulation phase of their retirement investing journeys – **Coronation Capital Plus** and **Coronation Balanced Defensive**.

The two funds are risk conscious, meaning that they are designed to manage all three risks faced by living annuity investors (as discussed on page 3). However, there is a difference in emphasis in these funds to cater for retired investors whose objectives may differ. The following visual will help investors align their individual risk prioritisation with the most appropriate fund.



Return scorecard and capital preservation outcome*

	Capital Plus	**Balanced Defensive**
Return scorecard	5.4% p.a. (real) since inception, ahead of its CPI + 4% benchmark	3.2% p.a. (real) since inception, in line with its CPI + 3% benchmark
Capital preservation outcome	Achieved positive returns over rolling 12-month periods 91% of the time	Achieved positive returns over rolling 12-month periods 99% of the time

** Performance data as at end-April 2023*

Putting the management of these risks to the test

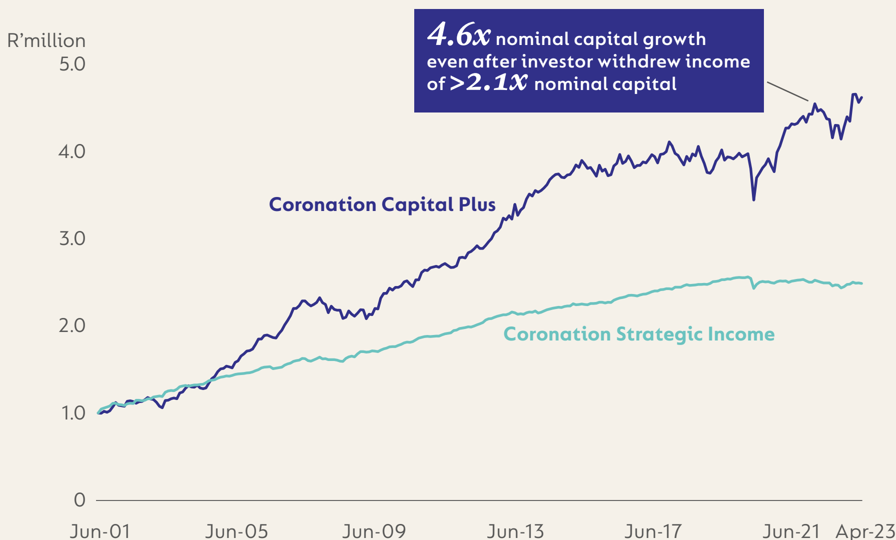
Below we demonstrate how well the appropriate multi-asset fund (with adequate exposure to growth assets that is managed in a way to enable its investors to stay the course) can support a sustainable prudent drawdown income rate over a multi-decade horizon.

Case study: Sustaining a prudent income drawdown over the long term

The following 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%.

Funds with moderate risk exposure sustain 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 30 April 2023

The lines show the growth in nominal investment outcomes (unadjusted for inflation) over a 22-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 11.1% per annum, while Coronation Strategic Income has returned 9.5% per annum (as at end-April 2023).

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 4.6 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 (>R2.1m) by way of income. This further illustrates the crucial role that growth assets fulfil in providing protection against the eroding effects of inflation, and if managed through a risk-conscious lens can allow for a smoother return path that enables its investors to stay the course.

Managing your income level on an ongoing basis

Further to selecting a prudent income level (as discussed on page 5), it may be worth considering 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.

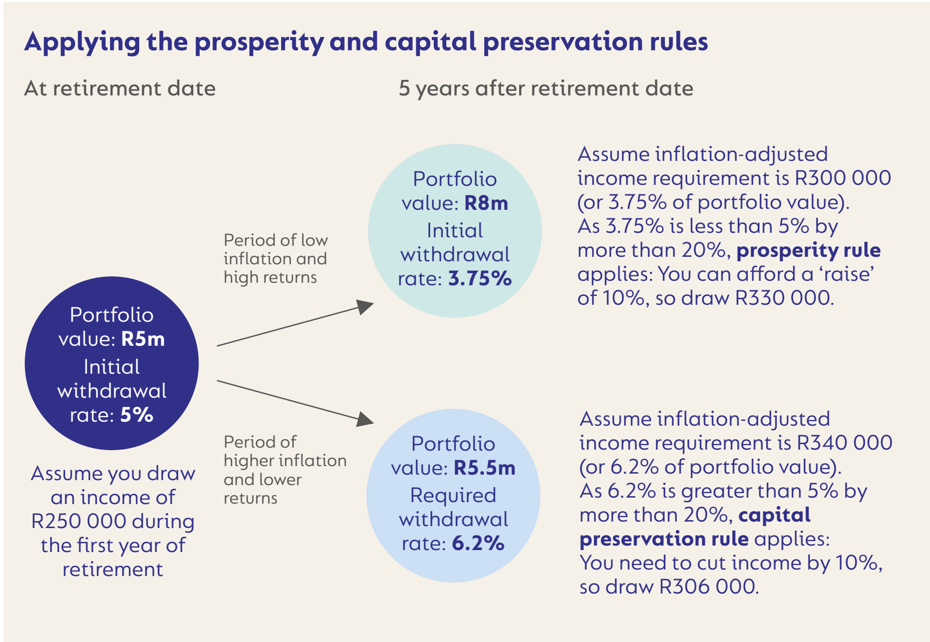
The modified withdrawal rule

Increase your withdrawal amount by inflation each year; except when the portfolio had a negative return in the previous year, and the new withdrawal rate exceeds the initial withdrawal rate.

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 (see visual below). 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

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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. 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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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