GRAY ISSUE

Make sustainability a priority when planning your retirement income

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Over the last 20 years pension funds have increasingly passed the responsibility for generating income after retirement on to retirees and insurers, rather than paying pensions themselves. This trend, combined with healthy market returns, has meant that the value of the local annuities market has grown from about R8 billion bought in 2003 to over R30 billion bought in the last 12 months. At the same time, a lower proportion of individuals shopping around for pension-providing products are buying conventional life annuities compared to 10 years ago.

This is interesting considering that these are the only products that offer retirees guaranteed income for the rest of their lives. Today's new pensioners' problem is that income yields are currently low and therefore guaranteed products are an expensive way to buy a pension, especially one that adjusts for inflation. For those that have prepared well for retirement and can afford to pay up for certainty, this may not be a problem, but the data shows that most have not properly prepared for their retirement by saving enough. These retirees are choosing the relative flexibility of living annuities, hoping that potential market returns will make up for their lack of capital.

Low yields are outside of our control and the real issue is the lack of savings. Even if yields recover and annuities are more attractively priced, no product can magic a tiny nest egg into a bonanza. However, careful planning and sound investor behaviour can go some way to managing the problem.

Planning is paramount

Investors, if necessary with the help of their financial advisers, need to examine their circumstances and talk frankly about their options *before* they retire. Putting all the facts on the table at the outset may be a painful exercise, but the sooner this is done, the more options there will be to work with. Be realistic about how much you have saved and your potential lifespan. This will help with developing a plan that accounts for the key risks retirees face: the risk of outliving their money, and the risk of inflation eroding their buying power over time. Too many retirees do not assess these risks adequately, making decisions based on incorrect assumptions of how long they expect to live. With the possibility of living a lot longer than you might expect being a key risk to your financial health, it is advisable to consider limiting consumption in the early years of retirement.

Face the facts

Table 1 illustrates how much income you can afford to draw based on different levels of capital at retirement. For example, a person retiring at 60, earning R400 000 per year, with retirement capital equal to 12 years of final salary, can expect to draw around R250 000 per year (62% of final salary) and have this increase with inflation, and hopefully last for the rest of his/her life. These numbers are projections into the future and are based on a number of assumptions. Changing the assumptions changes the numbers but not the key message.

What the table shows is just how much capital is really needed to be able to enjoy an income in retirement close to what you had when you were still working. If you retire with far less than you need you can temporarily solve the problem by drawing more than is sustainable. This may work for a few years, but is really just 'kicking the can down the road' and deferring the pain. Not saving enough, and spending too much, will never result in a happy ending.

Prior to retirement, it is useful to consider the possibility of delaying this milestone. Bear in mind that going back to work after retiring is extremely challenging, but extending your career while you are still in it may be possible. While deferring retirement is not the most attractive option, it has a double positive impact: you have more years to save for retirement, and fewer years to live off your savings. If you put off your retirement date by five years, even before you take into account the extra money you will be able to save, your existing capital will have more time to grow.

Going back to our earlier example, a person looking to retire at age 60 with retirement savings equivalent to 12 years of final salary would be contemplating a 38% drop in income at retirement. By continuing to work and save for another five years, he/she could instead retire with 85% of his/her final salary, rather than the 62% replacement ratio available at age 60.

At the end of the day it is important not to underestimate the impact of saving for longer. Although working for longer is not appealing, it is certainly preferable to having to survive on too low an income, or having your money run out too soon. While you may not have much control over your own longevity, you can certainly influence the longevity of your retirement savings.

Table 01 | Illustrative replacement ratio for various retirement ages and capital savings

		Multiple of final salary in savings				
		4	**8**	**12**	**16**	**20**
Retirement age	55	20%	40%	59%	79%	99%
	60	21%	42%	62%	83%	104%
	65	22%	45%	67%	90%	112%
	70	24%	49%	73%	98%	122%

Assumptions:
Capital invested in a living annuity, income increasing in line with inflation at 6% until age 90 where the cap of 17.5% is reached. Investment return, after all fees, of CPI +4%

Source: Allan Gray research.

By Richard Carter, Director, Allan Gray Life