A SUSTAINABLE INCOME IN RETIREMENT IS POSSIBLE

glacier
by Sanlam

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Investors today face many macro-environmental risks that could adversely affect their portfolios and pose very real threats to those drawing an income in retirement, including political, inflation, economic, regulatory and longevity risk.

Other risks that vary according to the specific investor include product risk (choosing the right product), investment risk (will the investor achieve the required growth rate), affordability (has the investor saved enough), employment (will the investor be forced to retire early) and preservation (have savings been preserved on changing employers throughout the years).

Longevity risk

Longevity risk is causing particular concern at present. A study by Allianz Life revealed that more retirees fear outliving their money (61%) than those that fear death (39%). This problem is compounded by increasing life expectancy rates across the world, together with a poor retirement savings rate and lack of preservation of savings when changing employment. A 65-year-old couple in South Africa today faces a 50% chance of at least one of them living to age 94.

Currently, most retirement savings are invested in investment-linked living annuities (ILLAs). This does provide flexibility in terms of income drawn, but retirees are taking on more investment risk in order to sidestep longevity risk.

Asset allocation and investment returns cannot completely manage longevity risk – even if the client takes on more risk. The expected returns may not materialise, leaving the retiree exposed to longevity risk.

Stability versus sustainability

Many people arrive at a retirement date without having saved up enough capital – and this means some tough decisions need to be made. In this case they need to take a reduction in income from day one of retirement.

By taking an ILLA income that increases with inflation every year (in real terms), the retiree will often reach the legislated 17.5% income cap within a few years, resulting in capital depletion.

By taking an income that is a fixed percentage of capital from the start, the income will still grow (in nominal terms) but at a sustainable rate. This will, however, leave the investor exposed to market shocks as the capital value could fluctuate during the course of the year.

Is there a better way?

Early last year, Glacier launched the investment-linked lifetime income plan (ILLI) which combines features of the guaranteed annuity with the flexibility of the ILLA.

For many retirees it doesn't have to be an either-or decision between the two products. Rather, many may benefit by using the ILLI in combination with the ILLA.

Example:

A 65 year old retiree has capital of R10m at retirement, with an initial income of R700 000 per annum. In this example we compare an investment in a moderate ILLA with that of a combination investment (60% aggressive ILLA and 40% conservative ILLI).

Fifteen years later, at age 80, the retiree would have a real income of R485 000 per annum in the combination investment, against a real income of R378 000 per annum in the moderate ILLA.

Assuming a 4% real return every year, the amount of capital (or legacy) remaining in the combination investment at age 80 would still be substantial, at R11 million. The moderate ILLA at this stage would have a capital amount of R15 million, but this needs to be weighed up against the fact that the retiree has achieved a higher real income in the combination investment and has peace of mind that the income received is sustainable.

The combination investment creates a portfolio which is similar in volatility and risk profile to that of the moderate ILLA, but with a higher real income.

New thinking and new solutions required

Clients are under increasing pressure to save more in an uncertain world with rising costs. As an industry we know innovative solutions are needed to address this problem.

We believe that by combining the ILLA and ILLI, clients receive:

- Sustainable income
- Maximum growth, but with a safety net
- Income that could keep pace with inflation
- A legacy to leave their beneficiaries.

The combination investment provides a way for retirees to receive a growing income for life, with moderate volatility, without carrying the longevity risk themselves.