Retiring comfortably: How living annuities can withstand risks

Many South Africans choose to invest their retirement savings in a living annuity to provide them with an income during retirement. While there are advantages to this kind of investment, such as making provision for a financial legacy for beneficiaries, there are also disadvantages, such as the risk that returns from an underlying investment portfolio may be worse than expected, and negatively affect income and capital.

Another risk is that of longevity. "People are generally living to an older age," says Darren Burns, Head of Investment Solutions at Glacier Invest. "The issue is that people, when planning for their retirement, are saving for ten or 15 or 20 years, when they may be living 30 or 40 years after they retire, given the rapid pace of medical advancements and overall healthier lifestyles." To mitigate this risk, the focus is placed on preserving and growing capital within the living annuity portfolio at a rate that can at least keep up with inflation.

Sequence risk is another possible pitfall. "If you retire when the markets are experiencing excessive volatility, or they're not doing too well, you're going to be far worse off in the long term than someone that retired at the exact same age, with the exact same capital, with the exact same liquidity requirements – but with the markets going through a much better period," Burns says. "Over the long term, both these investors could achieve the same average return, but when they retired – whether it was when markets were at highs or at lows – will have an effect on their capital, because they are starting to draw down either off a high base or off a low base."

A new approach to portfolio construction

Burns believes that the traditional approach to portfolio construction doesn't offer income-drawing retirees enough protection from these risks. This has led to the development of the Glacier Invest Real Income Solutions – a new approach to living annuity portfolio construction, using tools that pursue an asymmetrical distribution of returns. These tools are hedge funds, smoothing techniques and alternative assets.

While traditionally hedge funds have been available only to big institutional investors, retail hedge funds are on the rise. "Our investment philosophy doesn't involve picking the actual assets themselves, it's rather about choosing the best managers. So, we decided to choose the best hedge fund managers to include in our portfolio." He adds that, initially, allocations were made to only fixed income hedge funds, but recently an allocation to an equity hedge fund was made in the higher risk Real Income Solutions.

To diversify even further, smoothing techniques are being used to create more income stability by holding back excess returns in good years and releasing them back to investors in years when markets perform poorly, providing a more stable return experience on a year-by-year basis.

Including alternative assets in Glacier Invest's Real Income Solutions was tricky from an administrative, legal and compliance perspective. "I don't think this has been offered by any other discretionary fund manager in this country. We're already investing in hedge funds as an asset class on their own, but here we are looking at private markets including private equity, private real estate and mezzanine debt, amongst others – the asset classes that are traditionally only available to institutional investors with sufficient capital who can tolerate illiquidity, which of course doesn't really benefit a living annuity client who needs to take drawdowns."

The structure of these solutions, however, allows for the provision of daily liquidity and pricing, despite the fact that some of the underlying private market instruments may not provide it. In addition, clients invested in these solutions immediately receive an illiquidity premium. "By investing in something that is illiquid, you should be paid a 2 to 3% premium, which means a 2 to 3% higher return guaranteed – because you're taking on that illiquidity risk. Including these assets into a retail portfolio was a challenge, but we have finally achieved the objective we set over two years ago. And as of the end of September, alternative assets were finally incorporated into our retail solutions."

Glacier Invest has created a similar product, the Glacier Invest Real Growth Solutions – available within an endowment – for those drawing an income from their discretionary portfolios. "Ultimately, they face the exact same risks as living annuity clients: volatility in the markets, living too long and outliving their capital," Burns says. These solutions, therefore, have the same aim as the Real Income Solutions: to reduce volatility and manage a more consistent sequence of returns, and to mitigate the risk of one's capital running out over one's lifetime.

Darren Burns, Head: Investment Solutions, Glacier Invest