Living Annuities: Shifting the paradigm

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Drawing on the analogy of baking a cake, I know all too well that the reality of the end-result doesn't always match my (or in this case my child's) expectations. The same holds true for retirement. We all have expectations, dreams and goals, and yet research shows us that in reality, 51% of South African retirees aren't able to make ends meet.

The past five years have been an incredibly tough time for retirees with living annuities. This is due to the fact that asset classes that generally provide growth, i.e. equity and property, haven't done so. Added to this, figures from ASISA show that income withdrawal rates in SA – averaging between 6.5% and 7% - are still significantly too high. And then still add on to that ever-increasing longevity rates, and the picture starts to look dire.

The tale of two risks

Coupled with longevity risk, retirees also face sequence-of-returns risk. This refers to the possibility of a market downturn in the lead up to retirement, or just shortly after retirement. Drawing income from a lower capital base can seriously hurt an investor's retirement savings. Reducing the withdrawal rate after a downturn can help the portfolio recover, but not all retirees are in a position to do so.

Let's consider an average client drawing 7% p.a. and who needs to increase this by inflation each year to meet their needs. Assume that the inflation rate is 5% and total fees are 2%. This translates into a total required return of 14% (or CPI +9%). There isn't a single traditional asset class today that will deliver that return for the client over the long term. Historically, equities, which have been the best performing traditional asset class, have delivered 6-7% above inflation. We therefore need to broaden our thinking and include other non-traditional asset classes into our portfolios which are capable of generating better returns and can assist in controlling risk – particularly for retirees needing their income to last for the rest of their life.

As an example, private equity, a form of alternative investment, is able to return 9% - 10% above inflation because of the illiquidity premium. This means that investors are compensated – in the form of the extra return – because of the time their capital is locked-in.

A new way of looking at portfolio construction: Asymmetric Living Annuity philosophy

The above two risks can be translated into investment risks which need to be managed. The corresponding investment risks which need to be managed for are capital loss and volatility. The investment philosophy which we feel maximises the probability of managing these risks is asymmetric returns. Essentially this means managing the downside so that we don't need as much of the upside (or capturing more of the upside than you do of the downside) – giving a smoother return profile. If for example we capture two-thirds of the upside of the equity market and only one-third of the downside, our returns over the long term equal that of the equity market, but at half the volatility. This is step one in managing for volatility. By including non-traditional assets in the portfolio as well we can further reduce volatility while still keeping growth assets in the portfolio. As a result, we're able to address both longevity (risk of running out of money) and sequence (risk of a drawdown at the wrong time) risks. New thinking is required to solve the living annuity problem faced by many retirees. We believe that solving the sequence-of-risk conundrum can improve the odds of a retiree's money lasting the course. It's time to change the paradigm and use all the tools at our disposal. This method has resulted in the launch of the Glacier Invest Living Annuity Income Solutions, which we've been working on for the past two years and which is one of the highlights of my career to date. Read more about the solutions.

View the presentation

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