Why retirement income is about more than just the best quote…

By Rocco Carr, Business Development Manager at Glacier by Sanlam

Retirees, in general, battle with the concepts of longevity, safety and inheritance when they reach retirement, and it seems as if many tend to consider fees as one of the most important aspects when deciding which retirement income solution to choose. The notion is still for financial intermediaries to present the client with either a guarantee (from a life company, pension fund or the government), or a living annuity from any of the providers. The cheapest and most impressive solution (based on past performance) often tends to get the nod.

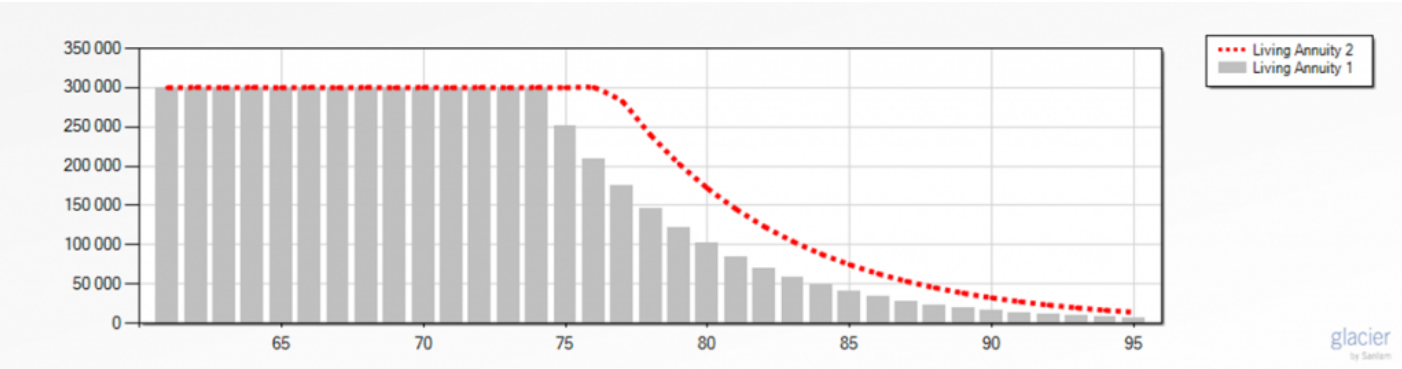
However, the correct answer does not lie in which solution to use, but rather which combination of solutions will protect the client against longevity, while still allowing options for future income stream management. The focus should therefore move away from the use of a single solution, to an optimised combination of solutions to manage an income stream. Retirement income stream management is perhaps the most important aspect of a retiree's post-retirement investment, to ensure that the income lasts as long as it is needed.

How does a guaranteed solution limit income stream management?

When a guaranteed solution is used, the income is known for the rest of your and your spouse's lives, but it does not allow flexibility should a crisis strike (e.g. unexpected medical expenses etc.). People tend to live according to their income, which could result in a crisis should such an event occur. Also, individuals often have a higher inflation rate than the official inflation rate. This could, for example, be as a result of increased spending on medical expenses, which typically have a higher inflation rate than most consumer goods. This in turn will raise the inflation rate of your overall spending. So even if your income escalation from a guarantee keeps pace with inflation, it more often than not doesn't keep pace with your own individual rate, as referred to above. You tend to get poorer, and with all your income fixed in a guaranteed solution, you will not have any flexibility to manage your income stream in future.

What are the limitations of a living annuity?

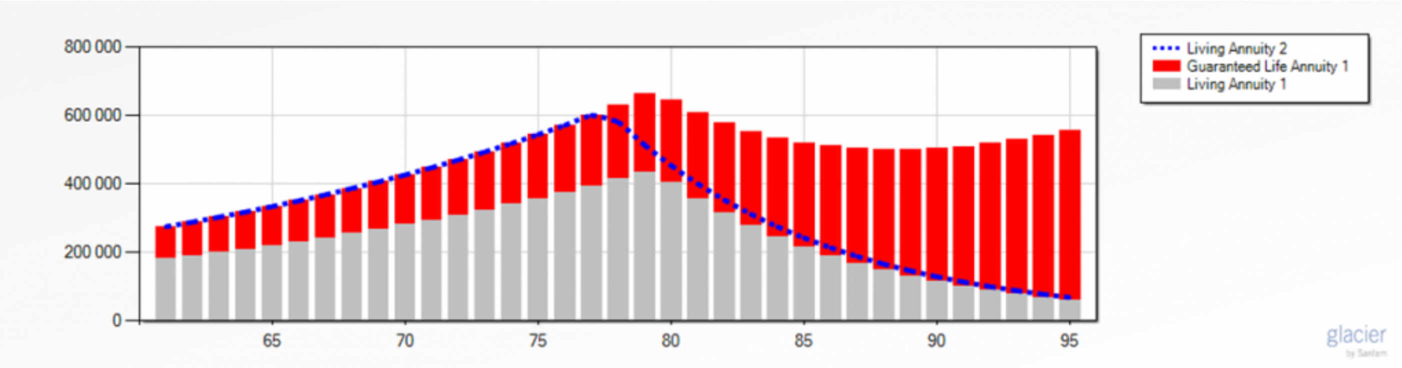
A living annuity allows for flexibility, but unless your portfolio consistently grows in excess of inflation (at a higher risk of volatility), the risk of outliving your capital is a real concern. Some people think that by focusing on cheaper fees this impact can be avoided, but the reality is that even if the portfolio is 1% cheaper, it only provides an inflation-related income for two more years, as is evident in the following graph. Fees alone will not make a big difference to manage a client's income stream.



How can one best manage a client's income stream in retirement while retaining some amount for an inheritance and reduce longevity risk?

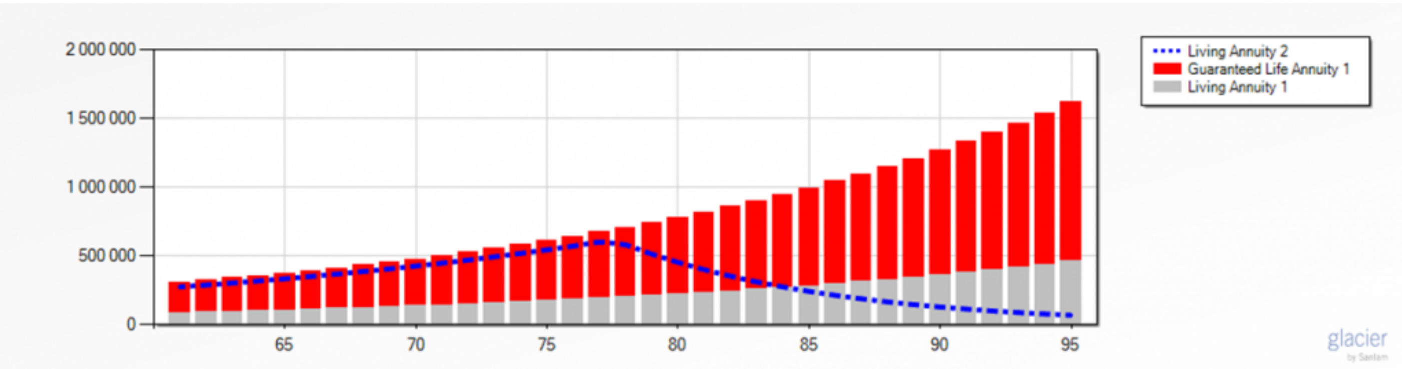
By combining a living annuity and a guaranteed life annuity, one builds in protection against longevity risk while maintaining flexibility to manage an income stream. In the following example, 70% was allocated to a living annuity, and 30% to a guaranteed life annuity (grey and red bars in combination). This is compared to 100% in a living annuity (blue line). The following becomes evident:

1. The income from the combination solution keeps pace with the living annuity up to a point, but then the living annuity reaches the 17,5% income threshold while the combination still protects the income.
2. The portion of the income that comes from the guarantee (red bars) becomes a larger portion of income as time passes (5% guaranteed escalation was used), thereby reducing the client's exposure to market volatility.
3. The portion in the living annuity still allows the client the flexibility to adjust their income once a year should inflation catch up, or should a crisis happen.
4. The reality in this example is that the income from the 70% living annuity, at age 85, is projected to be similar to the income from 100% in the living annuity. Therefore, as far as inheritance is concerned, the heirs will roughly inherit the same amount after age 85, but should the client live longer, they will be protected against longevity.



Some clients, who may not be concerned about leaving an inheritance, would prefer a guaranteed solution, but even with guaranteed rates as good as they are currently, it is wise to keep 30% in a living annuity to maintain a level of flexibility. The following graph uses the same data as the previous one, but in this case 70% was allocated to the guaranteed life annuity.

However, the 30% in the living annuity would still allow for income stream management during a crisis or when an increase in income is needed.



It therefore makes sense to focus on overall income stream management in retirement, rather than only considering a single quote.

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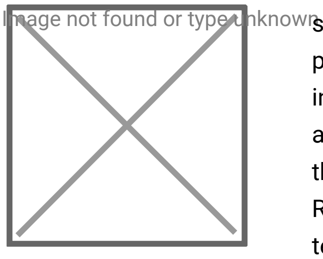
Rocco Carr



Rocco joined Sanlam Personal Portfolios (now Glacier) as a business development manager (BDM) in January 1999. His primary goals are developing and maintaining business in his somewhat sizeable region. He and his team service the Free State, North-West, Northern Cape, and parts of the Eastern Cape provinces. Rocco is also a champion on various wrap fund portfolios, including the Sanlam Multi-Manager/Glacier wraps. His team's annual Investment Summit as well as his roadshow throughout the region, are two events that are anticipated months in advance, and they help educate the intermediaries and brokers who attend them. Prior to working for Glacier, Rocco worked at Old Mutual as a broker consultant, which followed his seven years as an English teacher. Rocco holds a Bachelor of Arts (HED) degree from North-West University and an Honours degree from the University of the Free State (1990). He completed his MA at the latter institution in 1995. In 2005, he tackled an Advanced Diploma in Collective Investments at the Boston School of Finance and later, an Advanced Diploma in Financial Planning (Investments) at the University of the Free State in 2008.