

Negative markets and living annuitants

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Retired people are often most impacted by a fall in the equity market. The primary reason is that they have reached the stage where they are dependent on their savings to meet their daily needs. Retirees are no longer adding to their nest eggs, but rather taking away. Living annuitants, in particular, are highly dependent on the return that they generate on their capital base. When markets fall, living annuitants are required to withdraw from their capital at depressed prices, effectively locking in some of their losses at lower values. This can increase the likelihood that they run out of money.

The information in the table below highlight - using realistic assumptions for market returns and costs¹ - the likelihood that a male (retiring at age 65) will not run out of money prior to death. Different asset allocation scenarios and withdrawal rate assumptions provide different outcomes. Note that withdrawals are increased by the rate of inflation every year in order to maintain the retiree's lifestyle.

Table 1

Probability of <u>not</u> running out of money (%), Males (after costs)			
Asset Allocation	25% Equity	50% Equity	75% Equity
Withdrawal Rate			
2.5%	99	99	99
4%	93	96	95
6%	68	76	80
8%	47	54	61
10%	35	39	45

Source: Nedgroup Investments

For example, a male with 50% of his savings invested in equity, who withdraws 8% income pa (increasing by inflation), will have a 54% chance of not running out of money. It is crucial that retirees take note of the implications of drawing more than they can afford. The results indicate that most strategies can comfortably accommodate a withdrawal rate of 2.5-4% pa, and that at a 6% withdrawal rate pa, a higher equity allocation improves one's odds to an acceptable level. Retirees who need to withdraw 8% or more have far less certainty, especially females (who tend to live longer in retirement), regardless of their asset allocations.

¹ Equity returns = Inflation + 7.5% pa with a volatility of 17%, Remainder of portfolio returns (bonds + cash) = Inflation + 2.5% pa with a volatility of 7% pa, Costs = 2.5% pa PA (90) Mortality tables. All calculations pre-tax.

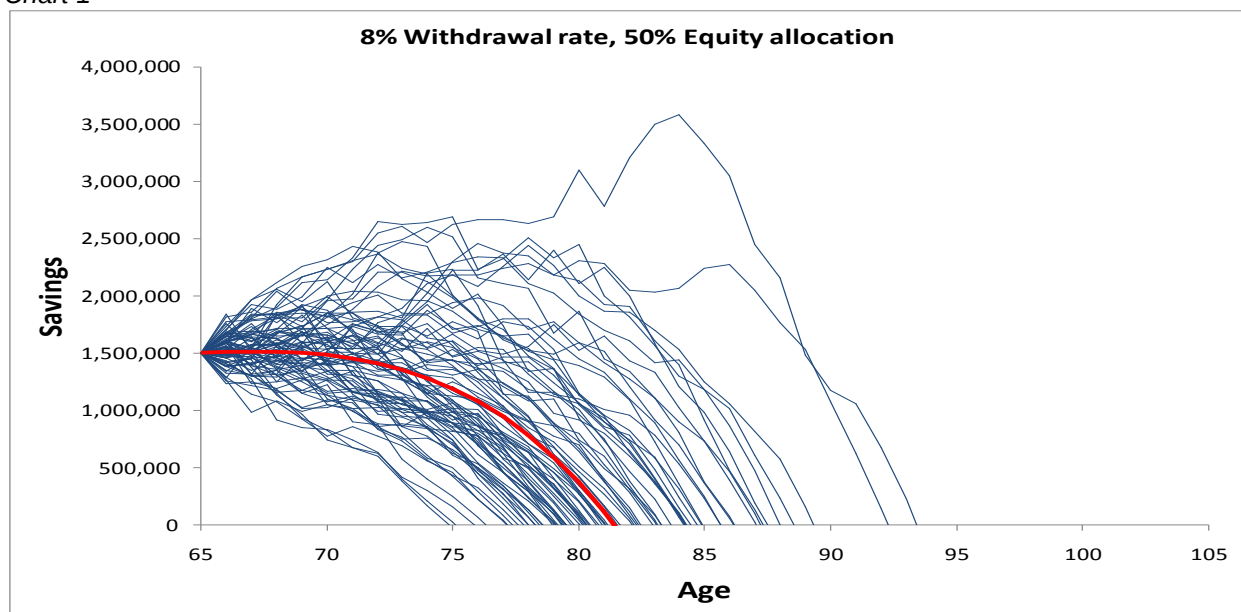
There are a number of factors that influence a living annuitant's likelihood of running out of money:

- life expectancy (the longer you live, the more capital you require)
- level of income (the higher your income requirement, the more capital you require)
- return on invested assets (the lower your return, the more capital you require)
- volatility of returns (the higher the volatility of returns, the greater the chance of running out of money)
- path of returns - This means that it is not only the returns that are generated by the underlying investments that matter, but also the order in which returns happen to be generated. Generally speaking good returns in the early years are preferable to good returns in later years
- costs (the higher the costs, the more capital you require)

Importantly, all of these factors interact with one another, and should not be considered in isolation. We believe the most appropriate way for living annuitants to improve the odds of living a comfortable life is to get an understanding of the likely outcomes they may experience. The only factor that can be directly controlled by annuitants is the withdrawal rate (reasonable fees should be sought at outset, but generally these won't change much). It is, therefore, the withdrawal rate that may need to be adjusted through time as market conditions dictate.

The following chart, again using realistic assumptions, shows a few of the infinite possible scenarios that a couple, both aged 65, with savings of R1.5m and a pre-tax income requirement of R10,000 per month (8% withdrawal rate), may experience once they retire. This couple is 50% invested in equity.

Chart 1



Source: Nedgroup Investments

The red line represents the outcome if all assumptions turn out exactly as expected. Under this scenario, this couples' savings is expected to last to age 82.

The blue lines represent some of the possible scenarios that could occur, given that we know the future is uncertain. As can be seen from the chart, the range of likely outcomes in reality is much wider – the money may last only to age 75 or as long as age 93. Some rare scenarios may be even more extreme. The volatility of the underlying investments (particularly the equity component) creates a wider range than is desirable. However, by not taking on the risk of equities, the odds of this couple running out of money increase (see Table 1).

It is clear that continual planning is required for annuitants. It is not sufficient to fix your withdrawal at the outset and hope for the best. It is important for investors and advisors to manage the process as they go along. It is dangerous to take a higher withdrawal in years when investments produce good returns. In years when the underlying investments do poorly it is prudent to try and decrease the withdrawal rate, or not to increase the required amount by the full rate of inflation. To highlight the power of spending less, by decreasing the withdrawal rate from 8% to 6% per annum, the couple's money is likely to last for more than five years longer.

Living annuities are useful vehicles because they allow investors to control the underlying investments, and the withdrawal that they take. However, they carry risk as there are no guaranteed cash flows. This risk is not significant if the retiree is of reasonable means (ie does not require a very high withdrawal rate from their savings). But, for retirees that require a large withdrawal rate relative to their asset base (say, 8-10% or more), the risk is uncomfortably high that they will run out of money. Careful financial planning, keeping an eye on costs and the ability to cut back when required may help the situation.