Wealth Building

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Four key retirement risks

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Avoiding the pitfalls that could derail your golden years.

JOHANNESBURG – The primary financial objective of retirees is generally to sustain a certain standard of living throughout retirement.

But while this may seem like an easy enough goal to reach, the reality is that many pensioners find themselves unable to manage their finances in a way that would provide a stable, inflation-linked income for life, that would also allow them to take a holiday or leave money as an inheritance.

Understanding the risks that can have an adverse impact on your income in retirement and planning accordingly can go a long way in overcoming the challenges many retirees face.

Speaking at the recent Ready Set Retire Conference hosted by Alexander Forbes and Personal Finance, John Anderson, managing director of Alexander Forbes Research & Product Development, highlighted four key risks that investors should be aware of:

1. Longevity
Anderson says the likelihood that the average pensioner aged 60 or their partner will be alive at the age of 90 is 50%.

By 2075, this percentage is expected to increase to 85%.

Anderson says on average there has been an improvement of 1% per annum in mortality from the age of 76 over the last 21 years in South Africa.

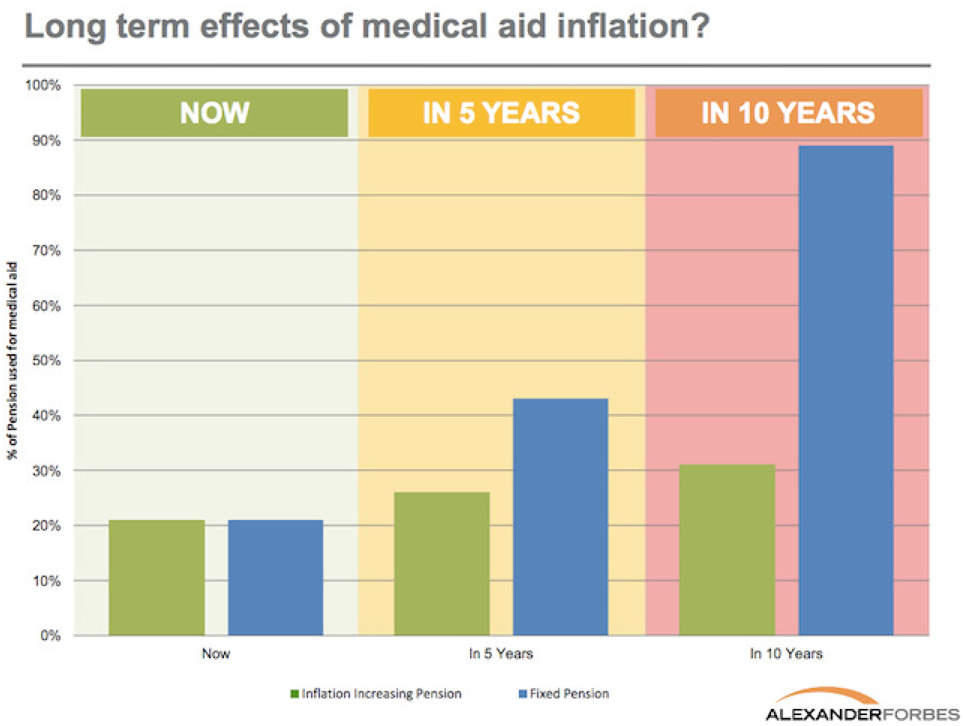
That means that every year the new generation of 76-year-olds is living 1% longer than the previous generation.

Anderson says this means the investors need to manage the risk and make sure that their retirement plan will be sustainable for longer and longer periods of time.

2. Inflation
While inflation will generally have an eroding effect on the goods and services that pensioners would be able to buy, medical inflation is especially important.

Medical inflation in South Africa has sustainably increased by between two and three percentage points per annum more than the consumer price index (CPI).

Anderson explains that the average individual starting off with a pension today will use around 20% of his or her pension towards healthcare, which is fine as it leaves around 80% of their income to cover all their other expenses (see graph below).



Source: Alexander Forbes

However, if the individual received a pension that increases with inflation, he or she would spend 25% of every rand towards healthcare (as a result of medical inflation outpacing CPI) after five years. After ten years, the individual would spend 30% of their pension on healthcare.

The situation is even worse if the pension is fixed (and doesn't increase in line with inflation).

Anderson says after five years this individual would pay almost 45% of their pension towards healthcare and almost the entire pension after ten years.

He says many retirees experience this situation and stop contributing towards medical aid at the point they need it the most.

It is therefore important to account for your personal inflation rate in planning for retirement but in particular for medical inflation, he says.

3. Consumption risk

Historically, international research has suggested that people would need between 70% and 80% of the gross income they earned immediately prior to retirement in retirement to sustain their standard of living [replacement ratio]. In some countries this could be higher depending on the support provided by government.

Anderson says in South Africa historically a rule of thumb of 60% to 75% was used. The rationale behind it was that people would spend less in retirement due to reduced expenses (for example they wouldn't need to travel to work and will pay lower taxes).

However the majority of people observed in a 2011 study on retirement adequacy targets for South Africans spent more or less the same in retirement as they did prior to retirement.

Anderson says this suggests that the old rule of thumb does not actually apply. Although retirees may spend their income on other types of things, the expenditure won't necessarily come down, but may even go up.

Although many people use the 75% replacement ratio as a rule of thumb, the reality is that there is "no one number". Investors have to look at their budget and retirement plan and need to take into account factors such as whether they will work in retirement to supplement their income and if they will have family support.

The actual target depends on individual factors such as household composition, income as well as home ownership.

4. Income conversion

In most instances, pensioners will need to convert their accumulated savings into an income at retirement.
At this point, the pensioner may choose a life annuity and buy a pension with an insurance company for life or a living annuity (in very basic terms a savings account that you draw down, but that can run out of money).

Life annuities
Anderson explains that the cost of life annuities, depending on the option taken, is linked to interest rates. The cost of life annuities has gone up over the last number of years as interest rates have decreased.

Investors need to take into account that if they buy a life annuity at the point where interest rates are very low, [the cost of annuity will be higher and pensioners will receive a smaller monthly income], they will be locked into the annuity for life.

Living annuities
Anderson says there are three risks associated with living annuities – an inappropriate investment strategy, emotional switching in response to markets and a drawdown rate that is too high.

If a person's pension is R1, typically 23c comes from contributions made over 30 or 40 years, while 36c comes from the returns generated while working. Forty-one cents of every rand comes from the returns generated after retirement.

Anderson says that is the point when the assets are the most significant and retirees can therefore expect the greatest returns.

However, it is also the point at which volatile markets can have a detrimental effect and objectives have to be balanced.