FOOD FOR RETIREMENT THOUGHT

Ask anybody in formal employment who is within, say, 15 years of retirement what his or her biggest asset is. Their response is very likely to be "my house / farm / holiday house" and sometimes even "my car"!

Very few realise that the banks and finance houses often have a bigger stake in these "assets" than they do as the registered owners of these assets.

Of course, the smart people may answer "my pension fund" and the really smart people may also answer "my ability to earn an income" who being smart in the first place (or more likely having had access to a good financial adviser) have no doubt taken care to insure this valuable asset with life, disability and severe illness cover.

Like it or not, there are only two sources of income. People at work or money at work. When you stop working you effectively become employed by your capital that you have built up over your working lifetime.

You would not like to work for an employer that has cash flow problems and struggles to pay your salary and benefits each month. An employer that is likely to go bust at any moment leaving you unemployed.

Likewise at retirement if you effectively become employed by your retirement capital, you would like the capital accumulated to be sufficient to give you some sort of financial freedom and well being for the rest of your life.

These days people are spending a longer time in retirement, their medical expenses are increasing and interest rates are low. Therefore, as a rule of thumb, if a man plans on retiring at age 55 he will need at the very least about 16 times his annual salary as a capital sum by the time he retires; 14 times at age 60; and 12 times at age 65 to have a reasonable chance of maintaining his standard of living. Because statistically females live longer than males the multiples would be more like 18,16 and 14 respectively. At today's interest rates, R1m of capital buys you a monthly income of about R5 400.Bear in mind that you are taxed on your income, which further reduces the amount you will have to live off.

The exact amount needed will however always depend on things like your income need, whether you want your income to escalate with inflation, your age when you retire and how long you expect to live thereafter, prevailing interest rates at the time of retirement and whether you will belong to a medical scheme after retirement. It is therefore important that you work with a financial planner in this regard.

How do you achieve financial security at retirement?

Your pension fund may be one of your biggest assets but the chances are very good that it will not be sufficient by itself to provide for all your retirement needs. Nevertheless, pension funds have formed the backbone of the retirement savings for South Africans and many a person may have been destitute in their old age had it not been for their pension savings.

So why have pension funds been successful in accumulating long term retirement capital? If we can learn any lessons here and apply them to our discretionary money we might have a better chance of retiring financially stronger.

The answer may just lie in three main reasons:

- Most occupational pension funds are compulsory and contractual by nature. You have to belong to the fund as part of your conditions of employment. You are thus forced to save. Most important … you never miss one contribution whilst in the employ of the company!

- Your savings into your pension funds are inflation linked because as your salary increases, so do your contributions and those of your employer. In this way you enjoy “inflation-proofing” your savings
- You cannot dip into your pension money to fund your lifestyle. Your savings are locked away for long periods and you get to benefit from the “8th Wonder of the World … the compounding effect of interest growth! The benefit of compound interest will come to an end when you leave your employer, die or retire. And, of course, if you squander the savings when leaving your job, you will put yourself back to square one. (If you withdraw from your employer’s fund you should ideally preserve the benefits).

In short, a successful savings strategy is about:

- Committing yourself contractually to save;
- For a long period of time; and
- Increasing your contributions to keep up with inflation.

It is not so much about trying to continually chase the best returns, but rather about the basic principles of investing!

So if these three factors have contributed to you at least having some money for retirement, what should you be doing to ensure a financially secure retirement?

You need to have a simple plan and need to start saving for retirement as early as possible.

For example, a straightforward and very effective plan is simply to put 15% of your salary away each month when you start working over and above any pension fund contributions into a market-linked investment such as general equity unit trust fund, to reinvest the income and not to touch it until you approach retirement. The miracle of compound interest will do the rest for you.

Over a working lifetime of 30 or 40 years, you will have accumulated a significant amount of capital. There are many different investment vehicles you can use to give you access to the markets such as unit trusts, endowment policies and retirement annuities.

Why then, if it is so simple, do only but a select few have financial freedom in retirement? There are a number of reasons that are mainly behavioural based that lead to people executing this simple plan poorly:

- They start saving too late and bail out too early. In short, they underestimate the power of compound interest.
- They lack discipline. It’s a much better feeling to spend now and get instant gratification rather than saving for something that is a long way off, like your retirement.
- They choose all sorts of exotic investments that promise “shoot-the-lights out” returns.
- They switch in and out of funds because they chase yesterday’s winners and today’s fashions. They try to time the markets and invariably buy and sell at the wrong time.
- They act on information, emotions and gossip around the braai instead of getting help from a competent financial adviser.

In general, far more attention is paid to fund choice, investment surveys, the advisers commission, charges and fees than to the way investors behave. It’s a sad reality that investment returns will always be more dependent on investor behaviour than fund performance. History shows that most people need to be protected from their own bad savings habits when it comes to long-term savings for retirement. Many a retirement plan has been shipwrecked on the rocks of good intentions.

So it’s ironic that while the recurring premium contractual retirement annuity was designed for successful savings it has been discredited recently in the media and by the determinations of the Pension Funds Adjudicator because of perceived high costs and poor early disinvestment values. Nevertheless Old Mutual’s well-published statistics show that for those that stayed the course to their end of their chosen contract term, RAs have offered good relative value for money. (The average 20-

year term smooth bonus OM RA maturing in November 2006 has given a real after-inflation rate of return of 5.3% a year without even taking the tax concessions into account).

So if you are self-employed and pay tax, you should consider contributing 15% of your taxable non-retirement funding income into an RA because then your entire contribution will be tax deductible. If you are a member of a pension fund and wish to top up your retirement savings, you can put R1 750 a year into an RA. Bear in mind that you and your spouse both enjoy the tax benefits in your own right depending on your taxable income situation.

A positive development in the life industry is that life assurers are looking at making its RA products more flexible in order to provide better early termination values in future.

Now is not the time to stop saving or to procrastinate. Do not fall into the trap of endlessly debating which is the absolute best product/fund on the market for retirement and do nothing about getting started. Very often the comparison is not about best vs. good but about having something in place for retirement instead of having nothing at all. A retirement annuity is a specialised tool designed for retirement, which gets the job done if you allow it enough time to do so. You can choose the underlying funds in line with your risk profile and age.

People also underestimate the value that an adviser can add by just showing them why they need to save for retirement, how much they need, what it will cost, working out a budget, getting them started and then helping them stay committed to a simple plan by doing annual reviews. Often this is much more valuable than the miracles that the public expect advisers to perform, especially for those who only start thinking about retirement after age 45.

Recent evidence of poor consumer behaviour is borne out by the fact that the generous personal tax cuts given to taxpayers over the last few years have almost all gone into consumption spending and have not boosted savings rates.

The recipe for success therefore is to start early, have a plan and keep it simple. Work with a good adviser and be disciplined about saving. If you are like most of us and struggle with the discipline of saving on a regular basis look for an investment vehicle like an RA or endowment policy and commit to paying regular monthly contributions via a debit order on your bank account with contributions increasing in line with inflation.

Understand that saving for retirement is not a 100-metre dash based on a “get rich quick scheme” but is more like running a marathon. You need to plan accordingly. Stay committed and get used to living on a budget that allows you to make the necessary contractual contributions to save for your retirement. Let compound interest do its job and you will be pleasantly surprised about what can be achieved over the average working lifetime. In order to make your retirement goals a reality, you need to stick to your plan and not get sidetracked by all the noise out there.

Peter Stephan
Manager Retail Legal Services
Old Mutual

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