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INTRODUCTION
You spend your life working and saving to ensure that one day you can retire comfortably. There is a lot of advice to be found about how to save for retirement, but what about advice at the point of retirement?

At retirement age, there are two main decisions faced by any retirement fund members and retirement annuity holders:
1. How much of the savings should be taken as cash, and
2. What type of annuity should be purchased, and from where?

The answers to both questions will depend on each individual’s circumstances. In this booklet, we aim to provide you with information which will hopefully make these two decisions a bit easier.

SEEK ADVICE
No one can be an expert at everything. During your long career, you have become and expert on many things, but retirement planning was probably not one of them. And that’s OK. That’s why there are professionals who specialise in this field.

You wouldn’t self-diagnose an illness; you would seek the advice of a doctor. The same should be true for your financial planning, both pre- and in retirement, to ensure your financial decisions are healthy. So whereas this booklet is in no way intended to replace face-to-face consultations, we hope that it will help you understand the range of advice that may be presented to you to help you make the right decision.

MEET MR DLMANI
Before we proceed, we would like to introduce Mr Dlamini. He is about to retire at the age of 65 and has just over R1 million in his defined contribution retirement fund. Mr Dlamini is happily married and all his children are financially independent. He is also in fairly good health and looking forward to playing a bit of golf and spending lots of time with his grandchildren.

Being a savvy man, Mr Dlamini has made several enquiries into what options are available to him. This is what he has found out:

CASHING IN
If you are a member of a Pension Fund, you have the option of taking one third of your investment in cash and will need to invest the remaining two thirds in an annuity product of your choice.

Pension Fund options:

Provident Fund options:

There are different factors that will affect the amount you wish to take in cash at retirement. Generally, the two biggest factors will be the amount of tax that is payable and your level of debt at retirement.

The taxation of your cash benefit will dictate how much of the benefit can be taken without incurring a penal amount of tax – too much tax might make you reconsider the cash lump sum as “just not worth it”.

Life is full of uncertainties. Luckily, when it comes to your retirement, most of the uncertainties can be managed through planning. Like with anything else, to be able to manage it, you first need to name it.

There are two important uncertainties (or risks) that each retiree needs to consider:
1. The possibility that you live longer than your money lasts (known as the longevity risk).
2. The possibility that the income you receive cannot keep pace with your living expenses (known as the inflation risk).

These risks can either be avoided or at least reduced by taking out an annuity. The degree to which these are mitigated will depend on the kind of annuity you purchase and this is why it is so important to understand all your options.
It is often more advantageous to convert your savings into a pension, from a tax perspective. This is something your financial adviser should work out with you, based on the latest taxation tables.

As for your levels of debt, it often makes financial sense to use a lump sum to cancel any existing debt immediately at retirement, especially if that debt is at an interest rate higher than the rate that can be earned on the retirement assets. This also provides peace of mind that comes with knowing that all debts are settled.

Mr Dlamini’s house is paid off and he does not have any other major debt, so he decides to maximise his pension and forego the cash lump sum.

With living annuities, there are no underwritten guarantees. However, if managed well, these annuities can provide a higher level of income in retirement. The choice really depends on your individual circumstances.

**SINGLE LIFE GUARANTEED ANNUITIES**

These annuities are insurance contracts and cover the insured pensioner only, for life. These come in several variants.

**LEVEL GUARANTEED LIFE ANNUITY**

This is a “traditional” type of an annuity, with absolutely no bells or whistles. A life insurance company takes a lump sum payment at the date of retirement in exchange for regular level monthly payments made to the life insured – in this case, Mr Dlamini. Payments are guaranteed for life of the pensioner.

The advantage of this annuity type is that no matter how long Mr Dlamini lives (and he expects to live long!) his monthly income is guaranteed. The technical jargon for this is: the investment and the longevity risk are passed onto the insurer.

The disadvantage to the member is in the word “level” - the income level does not increase. In technical terms, there is an inflation risk, which is borne by the pensioner.

Because the pension is non-increasing (level), but the cost of living is continually increasing, the net effect is a reducing purchasing power of the level pension.

Think about how much it cost you to go to the movies and buy popcorn 10 years ago and how much it costs you now. You are purchasing exactly the same thing, but the price has multiplied.

Put differently, your R100 ten years ago was “worth” a lot more than it is today. Similarly, R100 today is worth a lot more than R100 in ten years’ time. Your purchasing power will decrease, unless your income keeps up with inflation.

In addition, there are no benefits for surviving dependants after the death of the pensioner. Under this arrangement, Mrs Dlamini would not receive any income, should Mr Dlamini die before she does.
Mr Dlamini, wanting to know all his options, approached an insurer to provide him with a quotation for a level guaranteed life annuity.

The insurer’s actuaries used their best forecasts for mortality rates of 65-year-old South African males to determine how long they expect to have to pay the monthly pension. They estimated the returns on assets (most likely to be bonds) that they expect to earn in that time. The insurer then added margins for expenses, contingencies and profits, etc., and arrived at an annuity rate.

These rates are usually expressed as an amount of monthly pension that R100 000 lump sum can purchase.

Let’s say that the monthly annuity rate calculated per R100 000 lump sum premium for a male aged 65 (and based on the assumptions listed above) works out to roughly R910 per month.

Since Mr Dlamini has R1 million to deposit with the insurer as a once-off premium, his monthly income will be R9 100. This is a GROSS pre-income tax amount.

This amount will not increase, and it will remain at R9 100 for the rest of Mr Dlamini’s life.

When Mr. Dlamini dies, there will be no further payments – his wife will not receive a spouse’s pension.

Mr. Dlamini decided that this type of annuity was not suitable for him, because he worries about the ever-increasing prices.

**Escalating Guaranteed Life Annuity**

In order to cover the increasing costs of living, Mr Dlamini investigated further and he found out all about escalating guaranteed life annuities.

Again, the insurer will take a lump sum premium at the date of retirement and in return it will pay monthly pension amounts. However, these pension amounts will increase each year, at a pre-determined rate.

There are several ways in which pensions can increase. The increase can be fixed, e.g. 5% per annum. But what if inflation far outstrips this level?

An alternative is for the pension to increase in line with some index of inflation, such as the Consumer Price Index (CPI). The increase can be at full inflation, i.e. at 100% of CPI; or it can be as a function of the inflation index, for example:

- 80% of CPI, or
- CPI up to a maximum of 6% per annum.

An escalating annuity protects the pensioner’s income against the adverse effects of rising prices, but this comes at a cost. The insurer now picks up the inflation risk, and therefore has to set aside more money to ensure they can deliver on the inflation promise later on.

The more generous the inflation protection to the pensioner, the more severe is the inflation risk to the insurer. So an annuity that guarantees 100% of inflation increases will be more expensive to purchase than an annuity that guarantees the inflation increase in part, such as 80% of inflation.

There is still, however, no protection built in for Mrs Dlamini, in case of Mr Dlamini’s early demise. Nonetheless, being a thorough person that he is, Mr Dlamini decided to investigate this option further.

**Example 2**

Mr Dlamini thinks R5 000 per month as an initial pension is just not enough to retire on. The adviser therefore suggested that Mr Dlamini should consider a less expensive escalation option.

Mr Dlamini follows financial news and is aware of the 3-6% inflation target in SA. He therefore believes that inflation should continue at no more than 6%. So he requested a quote for a guaranteed annuity that increases at a fixed 5% each year.

This annuity rate works out to be R600 for every R100 000 premium, which would mean a starting pension of R6 000 per month.

On the flip-side of this is the fact that the pensioner now takes on some of the inflation risk, if Mr Dlamini’s prediction of future inflation does not pan out.

**Enhanced Single Life Annuity**

As mentioned, cost of an annuity depends on many assumptions, one of them being how long the pensioner is expected to live. The longer the life expectancy, the more payments the insurer will have to make and therefore the higher the total cost to the insurer.

Of course, the reverse is also true – if the person applying for a pension is in poor health, then it is safe to assume that he will not live as long as his healthy counterparts. If the insurer expects...
to make fewer annuity payments, the cost will be lower. So a person in poor health can get a higher monthly pension (subject to submitting proof of this).

As Mr Dlamini is in good health and quite active on the golf course, this option does not apply to him.

Spouse’s reversions can be attached to level, escalating or inflation-linked annuity arrangements.

Of course, the spouse’s reversion will carry a cost. This cost will depend on several factors which are used to determine the expected payment period or the level of the payment:

- Gender of the main annuitant – for example, women tend to live longer than men, so adding a female spouse onto the policy means that the insurer, in most likelihood, will have to make a greater number of payments, pushing the cost of the policy up.
- The age difference between the spouses – the younger the spouse, the longer he or she will live, again driving up the number of payments and therefore the cost.
- The reversionary percentage – the higher the reversion, the higher the cost.

**Example 4**

Mrs Dlamini has her own pension benefits due to her once she retires, so she will not be left without any income. However, living on her pension alone would not be sufficient to maintain their family home.

So Mr Dlamini calculated that a 50% reversion should be sufficient. That is, should he die before his wife, she would get her own pension, plus 50% of what Mr Dlamini was receiving.

Mr Dlamini requested the same pension as in Example 3 (that is a guaranteed life pension with increases at 5% each year) but now he asked that a 50% spouse’s reversion be added on.

The insurer, after finding out Mrs Dlamini’s age to be 60, has quoted an annuity of R 5 200 per month.

To illustrate how the survivor pension would work, let’s assume that Mr Dlamini lives to age 75. With an annual escalation rate of 5%, in the 10 years since his retirement, his pension would have increased to just over R8 470 at his time of death.

Mrs Dlamini would then receive 50% of this in the following month, being R4 235. Her pension would continue to be paid every month and also to increase at the same rate of 5% per annum for the rest of her life.

**GUARANTEED AND THEN FOR LIFE ANNUITY**

A guarantee period is a common feature of life annuities and would need to be specified at the time of retirement.

**Example 5**

Let’s say Mr Dlamini chose a guarantee period of 10 years. Then his full pension will be paid for the first 10 years after retirement whether or not he is alive. This ensures that should Mr Dlamini die shortly after his retirement, a meaningful benefit is still paid for his R1 million purchase price.

So a guarantee period makes no difference at all if the pensioner lives beyond the guarantee period.

If, however, the pensioner dies before the guarantee period is over, the pension will continue to be paid in full until the end of the guarantee period.

If the pension arrangement had a spouse’s reversion option as well, then the spouse will receive 100% of the pension until the end of the guarantee period and only after the guarantee period has expired, will the pension reduce to the pre-specified reversionary percentage (e.g. 50%).

**Other Features Available on Guaranteed Annuity Contracts**

Until now, we have only talked about single life annuity types, i.e. only the pensioner was insured and there were no other added features. There are, however, several features that can be added to all of the above-mentioned annuity types, and these are listed in this section.

**Joint and Survivorship Life Annuity**

What would happen to Mrs Dlamini should Mr Dlamini be struck by lightning on the 18th hole? He would like to ensure that his wife does not have to worry about a thing if he dies, and so he goes on to find out about joint life pensions.

Joint life pensions ensure that the last surviving member of a couple will have a pension for life. So no matter who lives longest, he or she will have an income for life.

The focal feature of these is what is called a reversionary percentage – which is how much of the original pension payable to Mr Dlamini would Mrs Dlamini get after his death? The usual reversionary percentages are 50%, 75% or 100%, but it could be anything, so long as it is specified up-front when purchasing the contract.
People can live in retirement for well over 30 years and therefore taking a long-term view can lead to better long-term returns.
Mr Dlamini has found out that this is a relatively new kind of an annuity. Under this arrangement, the pension payments are not guaranteed. This is because there is no insurance contract. The lump sum from the retirement fund is invested, rather than paid over as a premium.

The choice of investment is up to the pensioner. This is why these arrangements are most suitable for financially astute individuals. The initial portfolio selection is not set in stone and switches into other portfolios are allowed.

The portfolio earns a return – be it positive or negative, depending on how the underlying assets are invested and how the markets are performing. This is similar to the way the pre-retirement savings were invested. Therefore, your underlying investment will fluctuate up and down with the movements in the investment markets.

In technical terms, this means that the pensioner takes on the investment risk. This is the distinguishing factor between guaranteed and living annuities. Under a guaranteed annuity, the investment risk is passed onto the insurer, at a premium.

The pensioner “draws down” on the investments by taking a small chunk each month as pension. The amount of drawdown allowed by South African law is limited to between 2.5% and 17.5% of the value of capital invested, per annum.

EXAMPLE:

As we know, Mr Dlamini has just over R1 million to invest. If he chose a living annuity, in the first year from retirement his pension would be permitted to fall in the following range:
- Minimum: 2.5% of R1 million is R25 000 per annum, or R2 083 per month; and
- Maximum: 17.5% of R1 million is R175 000 per annum, or R14 583 per month.

The above monthly amounts would, as always, be subject to income tax.

As you can see, the living annuity allows great flexibility with respect to how much pension is drawn.

In the following year, the drawdown would be calculated as a percentage of the capital value of the investment at that point in time. This will be R1 million originally invested, less the sum of drawdowns taken out of the fund, plus returns earned on the investment (positive or negative).

The obvious problem with this type of annuity is – what happens if the drawdown depletes the pot of money while the pensioner is still alive? In this case, there is no protection - once the pot has run out, there is simply no more money.

EXAMPLE:

Remember how for guaranteed annuities, the insurance company had to make certain assumptions? With linked life annuities, this is up to you.

Mr Dlamini is sticking to his inflation view point, that is, that inflation will more or less average at around 5% per year for the rest of his life. So this is the increase he would like to receive to his pension each year.

In addition, having spoken to his financial adviser and having considered an appropriately diversified portfolio, Mr Dlamini believes that his investments should earn an average of 4% per year over and above inflation.

What drawdown should Mr Dlamini start with? The adviser took him through a few options. Remember, the minimum he can take per month is R2 083 and the maximum is R14 583.

So, if Mr Dlamini starts by taking only R3 000 per month (before tax) and this increases at 5% each year, he will never run out of capital, and will even leave some money for his spouse or children. But that’s just not enough monthly income for Mr Dlamini.

If he decides to go large and drawdown R10 000 per month in his first year and wants this to increase at 5% each year, he will run out of funds completely by the time he turns 75 and 5 months. Mr Dlamini, as mentioned before, is in good health and expects to live well into his 80s, like his father did. This option will therefore deplete his capital too soon.

They then looked at an option of drawing a pension of R6 000 per month, escalating at 5% each year, which is similar to what the insurance company offered him. At this rate, his capital will run out at age 89 years and 5 months. Mr Dlamini feels comfortable with this.
When going through such illustrations, it is always important to remember that assumptions are just that – assumptions. Real life could turn out quite differently, so running a few scenarios is always advisable.

**If you believe that you have enough investment savvy to manage your living annuity in retirement and you can deal with the risks involved, then there are clear upsides to a living annuity:**

### Possible Better Value for Money

The underlying assets can be invested more aggressively than those underlying traditional annuity contracts issued by insurers. People can live in retirement for well over 30 years and therefore taking a long-term view can lead to better long-term returns.

If managed well, a living annuity can provide better value for money, because the underlying assets will, on average, grow at a faster rate. This will in turn allow for higher monthly payments and/or higher benefits to surviving dependents.

### Combining Different Annuity Types

Mr Dlamini does not want to be a burden on his children if he or his wife outlives their money. His adviser then suggests that he could take a combination of two or more types of annuities. For example, he could take:

- a basic guaranteed annuity (increasing or level) to guarantee the minimum level of income each month, and
- invest the remainder of the capital in the living annuity, with the hope of achieving higher income in the long run.

This way, the basic standard of living is insured, taking away the major risks of running out of money all together. The balance invested in the living annuity could be seen as a way of optimising the invested capital.

### Mitigating Disinvestment Risk

The disinvestment risk is a question of poor timing and is best illustrated by a scenario when the pre-retirement Fund Credit suddenly devalues due to a market fall. Cashing in such a devalued Fund Credit in order to purchase an annuity product would lock in these market losses, leaving the retiree permanently worse off.

In investments we know that markets eventually recover, so if we wait a while (months or years) then the value of the Fund Credit would eventually recover. However, retirement fund rules usually do not allow members to leave their money in the fund after they retire. The Fund Credit has to go somewhere.

Living annuities can be converted to a conventional guaranteed annuity at a later stage (up to the age of 80). Therefore, investing in a living annuity with equity exposure could be a solution to this conundrum. This way, the pensioner’s assets are exposed to equities, which we bought cheaply (remember, the market fell!).

The pensioner can draw-down the required monthly amount and wait until such time that the equity markets have sufficiently turned around. The pensioner can then choose to purchase a guaranteed pension with a larger pot of money.

### An Alternative to the Enhanced Life Annuity

These annuities may also provide best value for money for individuals with short life expectations – if an individual does not expect to live long past his retirement age, and there are no dependants to look after, then a high drawdown would provide for a high standard of living, and perhaps could pay for expensive nursing care if need be.

Refer to example 7 – if Mr Dlamini did not expect to live much longer than 10 years in retirement, he could have opted for a R10 000 a month drawdown.

### Balance of Assets Goes to Dependents

Another feature of the living annuity is that whatever money is left in the investment at the date of death of the pensioner, is payable to the dependants or nominees specified by the pensioner.

### In Summary

There is no one-size-fits-all annuity type that will work in every situation for every pensioner. The optimal annuity will depend on the individual circumstances of the retiree, as well as the prevailing economic climate.

*All figures and numbers used in the above examples are purely fictitious and for illustrative purposes only. Any resemblance to real-life annuity rates is purely coincidental.*
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