A lighthouse at night with beams of light shining out against a dark sky. The lighthouse is illuminated from below, and its light beams fan out across the dark night sky. The base of the lighthouse and surrounding buildings are also lit up.

Your guide to understanding your options at retirement

 STANLIB

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Introduction

You have spent your life working and saving at the same time to try to continue to protect your lifestyle in retirement. At the point of retirement, the decisions faced by any retirement fund member are two-fold:

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 the member's individual circumstances.

There are two important issues that you need to consider:

- The possibility that you live too long and run out of money (known as the longevity risk)
- The possibility that the income you receive cannot keep pace with your living expenses (known as the inflation risk)

These risks can be avoided or at least lessened by taking out an annuity policy.

One should always seek professional financial advice when undertaking financial decisions. It is hoped that this brochure will help you understand the range of advice that may be presented to you to help you make the right decision.

Cash Option

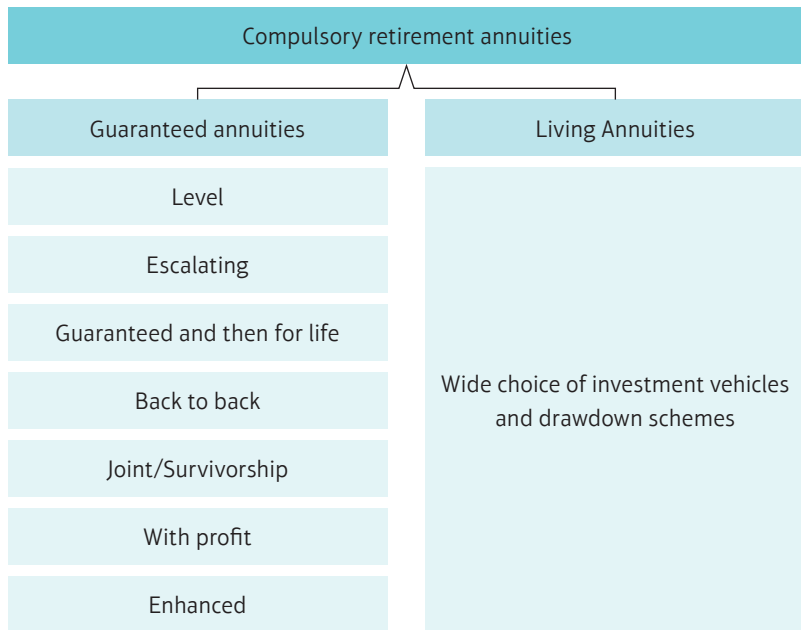
Provident funds allow you to take your full benefit in cash at retirement. Pension funds allow a maximum of a third of the benefit to be taken in cash. Generally the amount you take in cash will be dependent on the tax that is payable and your level of debt at retirement, as it makes financial sense to use any savings to cancel existing debt immediately.

Buying an annuity may be more advantageous from a tax perspective relative to taking cash as the tax is spread at a lower rate over your remaining lifetime.

Annuities, from A to Z

Let's assume that appropriate financial analysis has already taken place to determine the amount of cash that the member will need. What annuity should then be purchased with the remainder of the retirement savings? There are numerous options, broadly split into two categories: Life or guaranteed annuities, and living annuities.

The choice can be mind-boggling, and this booklet will attempt to explain and unpack the different options available, and who they might be suitable for.



Introducing Mr. Dlamini

Before we proceed with the detailed explanations of all of the above annuity types, let us introduce Mr. Dlamini. Mr. Dlamini is about to retire at the age of 65. He has accumulated just over R 1 million in his defined contribution retirement fund, and based on his particular circumstances, he has decided to use this entire amount to purchase an annuity. 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 types of annuities are available to him. This is what he has found out:



Single life guaranteed annuities

Level guaranteed life annuity

This is a “traditional” type of an annuity, with absolutely no bells or whistles. A life insurer takes a lump sum payment at the date of retirement in exchange for a 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 obvious disadvantage to the member is that the income level does not increase. In technical terms, there is an inflation risk, which is borne by the member. 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. In other words, a pension which is level in Rand terms, is effectively a reducing pension in real terms.

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.

Numerical Example 1:

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 uses 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 for. They estimate the returns on assets (most likely to be bonds) that they expect to earn in that time. The insurer then adds margins for profits, etc,

and arrives at an annuity rate. These rates are usually expressed as an amount of a 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 R900 per month.

Since Mr. Dlamini has R1 million to deposit with the insurer as a once-off premium, his monthly income will be R9,000. This is a GROSS pre-income tax amount. This amount will not increase, and it will remain at R9,000 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 annuities.

Again, the insurer will take a lump sum premium at the date of retirement, and in return it will pay monthly pension amounts. The pension amounts will however increase each year.

There are several ways in which the pension can increase. The percentage level of 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.

So 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. This will be built into the annuity rate as a risk margin. The more onerous the inflation protection to the pensioner, the more severe is the inflation risk to the insurer, and therefore the higher the risk margin becomes. 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, 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:

Numerical Example 2:

Mr. Dlamini thinks 100% inflation protection is just the ticket! That way he is certain that his standard of living will be maintained, no matter what happens in the economy. Thus he requested a quote from the insurer for this option.

As before, the insurer will need to make all sorts of assumptions, but in addition to the assumptions listed in example 1, they will now need to come up with their best long-term inflation forecast.

As a result of the fact that there will be future increases and these have to be guaranteed, the initial starting pension is much lower. But in time the pension will increase above the starting fixed pension amount.

Put differently, every R100,000 will be able to purchase a much lower annuity to start with. Mr. Dlamini's quote comes out at R500 per month for every R100,000. So with a lump sum premium of R1 million, his starting pension would be R5,000.

Numerical example 3:

Mr. Dlamini thinks R5,000 per month as an initial pension is just not enough to retire on. The insurer therefore suggested that Mr. Dlamini should consider a less expensive escalation option, for example 80% of the rate of inflation,

For example, if annual rate of inflation is 5%, then the increase granted would be 80% of 5%, which works out to 4%.

Let's say that in this case, the annuity rate works out to be R700 for every R100,000 premium, which would mean a starting pension of R7,000 per month.

On the flip-side of this is the fact that the pensioner now takes on some of the inflation risk, and gradually, some of the purchasing power of the pension will be eroded.

With-profit life annuity

This is another form of an increasing annuity. It is, however, not quite so straight forward! Under a with-profit arrangement the annual increases are linked to the performance of the underlying assets, and not to an inflation index.

Which means what? Well, when the underlying investments run up in value, one can expect above-inflation pension increases, but when they are low, the annuity increase could lag behind inflation. However, over time, a with-profit annuity is likely to increase at a rate better than inflation, because a proportion of the underlying assets of the investment portfolio are invested in asset classes that typically provide returns that are well ahead of inflation.

So yet again, there is a trade off – you give up the guaranteed link with inflation for a possibility of better long-term returns, but with the added risk that in some years, inflation might be higher than the increases on your pension. The question is, are you happy to take this risk?

Mr. Dlamini has found out all of the above, and he was quite intrigued, so he went on to enquire further. He found out that when buying a with-profit annuity, there are two issues to consider.

First issue to check for is the initial pension level. Now this gets a little complicated, as the initial level of pension will be affected by the so called “purchase discount rate”. Without going into a technical definition, the way that the purchase discount rate works is thus:

- The higher the purchase discount rate, the higher the initial pension will be, but the lower future pension increases will be.
- The lower the purchase discount rate, the lower the initial pension will be, but the higher the future increases will be.

For example, if the underlying investments deliver 10% and the purchase discount rate is 4%, the pension increase granted to Mr Dlamini will be 6% (10% - 4%).

Therefore, when comparing two with-profit annuities, it is important to make sure that they are both quoted at the same purchase discount rate, otherwise you will not be comparing like with like!

The second aspect of a with-profit annuity that you should check is the “bonus history”. “Bonuses” refer to the annual increases granted on the basic pension. Future bonus rates will depend on the likely future investment returns, which in turn depend on the way the investments are managed, and the ability of the manager. The past track record of bonuses does give some indication of this.

Numerical Example 4:

There are numerous options here with different discount rates and bonus schemes possible. As an illustration, a with profit annuity Mr. Dlamini could buy for his R1 million is about R6000 per month. This is expected to increase every year, but not in line with inflation.

Back-to-back guaranteed life annuity

This type of policy has two parts – a life annuity, as well as life assurance. So how does it work? The annuitant receives a monthly pension, as before, but now part of the monthly annuity goes towards paying for the life insurance premium – which basically means that the insurer retains part of the monthly pension and pays out a smaller amount each month. The pension is payable for the life of the insured.

The difference between this and a traditional annuity is at the time of death. Single life annuities (as described in 1 and 2) payments cease on death of the annuitant. With the back-to-back life annuity, there is a lump sum death benefit payable.

Of course, there will be a trade off – the higher the death cover, the higher the monthly cost of cover, the lower the actual pension payments will be.

These arrangements can be level, escalating or inflation linked.

Numerical Example 5:

Mr. Dlamini would like to be able to provide for his wife, should he be the first one to die. So he requested an inflation-linked back-to-back life annuity. He asked for the quote to be done on the same escalating basis as in example 3 – with increases at 80% of CPI. He would like the lump sum death benefit to be R250,000, which would also escalate each year at the same rate.

The first “prong” of Mr. Dlamini’s benefit would be the same as in Example 3 – an inflation linked pension of R7,000 p.m. But now there is also a cost of the life insured benefit. Let’s assume that the insurer quoted a cost of R750 per month for this death cover. This means that Mr. Dlamini’s actual monthly gross income will be the difference between the two – R6,250.

Enhanced life annuity

As mentioned before, the cost of an annuity will depend on a host of 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. And, 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, and so there will be fewer annuity payments, driving the cost down.

So a person, provided that they can prove they are in poor health, can get a higher monthly pension.

As mentioned before, Mr. Dlamini is in good health and quite active on the golf course, so this does not apply to him at all.

Other features available on annuity contracts

All of the annuity types discussed above were basic single life annuities – which means that 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

In all the previous examples we dealt with a pension for Mr. Dlamini, but what about Mrs. Dlamini? What would happen to her should Mr. Dlamini be struck by lightning on the 18th hole? This is a matter that is very close to Mr. Dlamini's heart.

He has already considered the back-to-back annuity, which would provide his wife with a lump sum on his death, but what if this lump sum is not sufficient? Also, Mr. Dlamini does not want to burden his wife with having to find a suitable investment vehicle to invest the lump sum to ensure that she can maintain her standard of living.

No, Mr. Dlamini would like to ensure that his wife does not have to worry about a thing when he dies, and so he goes on to find out about joint life pensions. Under these arrangements, the intention is to ensure that the last surviving member of a couple will have a pension 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.

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

In this case, Mrs. Dlamini has her own pension benefit due to her, so she will not be left without any income. However, living on just her own pension 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.

Numerical Example 6:

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.

Mr. Dlamini requested the same pension as in example 2 (that is a guaranteed life pension with inflation linked increases) but now he asked that a 50% spouse's reversion be added on. The insurer, after finding out Mrs. Dlamini's age, has quoted an annuity rate of R600 per R100,000 premium. So Mr. Dlamini's starting pension would be R6,000 per month.

To illustrate how the survivor pension would work, let's assume that Mr. Dlamini lives to age 75. In the 10 years since his retirement, his pension increased at an average rate of 5% p.a., to R9,733 just before his death. Mrs. Dlamini would then receive 50% of this in the following month, being R4,887. Mrs. Dlamini's pension would continue to be paid every month, and increasing at the same rate as inflation (limited to 7%) every year for the rest of her life.

Guaranteed then for life annuity

A guarantee period is a common feature of most life annuities. A guarantee period would need to be specified at the time of retirement. Let's say that the chosen guarantee period is 10 years. What this means is that the pension will be paid for those 10 years at its full amount per month, whether or not the pensioner is alive. This is to ensure if Mr. Dlamini dies 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 to the payments made 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, at 100% of its level, until the end of the guarantee period. If the pensioner has beneficiaries or dependants, this pension will be paid to them. If there are no dependants, the pension will be paid into the estate.

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%).

Living annuities

Mr. Dlamini has found out that this is a relatively new type of an annuity. It is also known as an investment-linked living annuity.

Under this arrangement, the payments are not guaranteed. There is no insurance contract, but rather a pure investment contract. The Fund Credit from the retirement fund is invested with the insurer. The choice of investments used is up to the pensioner. This is why these arrangements are most suitable for financially astute individuals.

So the money is invested in a portfolio chosen by the pensioner. This initial selection is not set in stone, however, and switches into other portfolios are allowed (at a cost).

The investment earns a return on the assets – be it positive or negative. This is akin to the way the pre-retirement Fund Credit was invested, and it is thus subject to all of the market's caprices. Therefore, your 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 guaranteed annuity arrangements, the investment risk is passed onto the insurer.

The pensioner "draws down" on the investments by taking a small chunk each month as pension. The amount of draw-down allowed is limited to between 2.5% and 17.5% of the value of capital invested, per annum.



Numerical Example 7:

Let's consider Mr. Dlamini's situation. As we know, he has just over R1 million to invest. So if he chose to take out a living annuity, in the first year his draw-down could fall in the following range:

- 2.5% of R1 million is R25,000 per annum, or R2,083 per month – that is the minimum that he would be required to take; and
- 17.5% of R1 million is R175,000 per annum, or R14,583 per month – that would be the maximum amount he could withdraw each month.

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

In the following year, the drawdown would be a percentage of the capital value of the investment at that point in time. So it will be R1 million originally invested, less any cash flows taken out of the fund, plus any returns earned on the investment (positive or negative).

Which investments to choose is also a vital decision, and therefore these products are better suited to financially astute individuals, or people who have more than enough money to be able to take the risk and still have sufficient other sources of income to live on – so called high net worth individuals.

The problem with this type of an annuity is – what happens if the draw down 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! Money can be depleted either due to adverse market conditions, such as a market crash, or due to draw downs that are too high or simply that Mr or Mrs Dlamini live too long. In technical terms, this is called a longevity risk – the risk that a person outlives their money. This is another distinguishing feature of living annuities – again, under guaranteed annuities, the longevity risk is passed onto the insurer.

If you believe that you have enough investment savvy and can deal with the underlying risks involved, there are a few up-sides to a living annuity!

First, the assets can be invested aggressively, which means that over the long term (and people can live in retirement for 30 years plus!), the returns will be greater than on the more conservative assets underlying a traditional annuity. So 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 dependants.

Mr. Dlamini does not want to be a burden on his children if he or his wife outlive 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 playing the market to achieve 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.

It is important to note that living annuities can be converted to a conventional guaranteed annuity at a later stage (up to the age of 80). So the money can be invested without any guarantees for a while, and it can later be used to purchase an insured guaranteed annuity.

As an example, the above scenario can be put into practice when the pre-retirement Fund Credit is invested predominantly in equities, but the equity market has suffered a fall. In this case, the value of the underlying equities will be low. But we know that equities eventually recover, so if we wait a while (months or years?) then the value of the equities would go up, making the Fund Credit more valuable! However, the retirement fund member cannot leave his money invested in the fund after (s)he retires (this is most often not allowed by the fund rules). Therefore, instead of cashing in his low-value investments and therefore locking in the losses, the Fund Credit can be invested in a living

annuity with an equity exposure. The pensioner can draw-down the required monthly amount, until such time that the equity markets have turned around, the investment value has increased and/or the annuity market has become more favorable – then the pensioner can opt to purchase a guaranteed pension of his choosing for the rest of his life, thus maximizing his value for money.

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 draw-down would provide for a high standard of living, and perhaps could pay for expensive nursing care.

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.

Mr. Dlamini has read up about all this, but because all the issues are so complex, he has decided to rather seek financial advice from an accredited adviser. The adviser did a risk appetite questionnaire and subsequently advised Mr. Dlamini, taking into account his unique circumstances.

Mr. Dlamini concluded that he does not want to manage his own investments once retired and would much rather spend time with his grandchildren than watching the investment market. The adviser therefore suggested that Mr. Dlamini should rather take out a guaranteed annuity of his choice.

*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. No real-life annuity rates were hurt during the compilation of these examples.

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. This is why obtaining financial advice before going on retirement is so vital.

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