spotlight

retirement annuities: old school or new generation investing?

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According to recent research, only approximately 6% of South Africans will be able to retire and be able to maintain a lifestyle that they have become accustomed to. If one also considers the advances in medical technology which allow people to live longer, then it becomes paramount that a proper retirement strategy should be structured at a very early stage in life.

In his 2014 Budget Speech, Finance Minister Pravin Gordhan held that government will introduce more initiatives to ensure that South Africans can retire, and thus reduce the burden on the State through additional welfare grants. Legislation was also passed by Parliament to improve governance over pension and provident funds and to further align the rules and tax treatment of pension and provident funds whilst still protecting vested rights.

In essence, the two main vehicles for generating wealth are **discretionary investments** and **retirement annuities**. Retirement annuities, or RAs, are contractual savings plans set under the South African pension legislation.

With regards to the latter, National Treasury has further increased the tax-free 1/3rd lump sum amount paid from retirement annuities and pension funds to R500 000 and has also increased the annual tax deductible allowance to 27.50% of all income earned - with an annual limit of R350 000. Any excess contributions to the annual cap may be rolled over to future years. There is also no maximum entry age and one may thus use these vehicles even after the retirement age of 55 to reduce potential income tax burdens.

Retirement annuities further allow for ideal estate planning as any benefits from such a structure may be paid directly to beneficiaries. Retirement annuities likewise allow for protection against creditors as these investments may not be encumbered.

In the South African industry it is rather difficult to compare retirement products. The reason for this is that a lot of investors still own ‘old style’ retirement annuities. This is in theory a ‘life house’ retirement annuity or an insurance-based RA.

These ‘life house’ RAs differ from ‘wrapper’ RAs, which allows an investor to choose his own underlying investments. This could consist of a selection of unit trust funds, which allows for full transparency in terms of fees, pricing and performance numbers, thus making the tracking of one’s investment simple. This product was unfortunately not available until the late 90’s and we are regrettably still finding a lot of investors locked into ‘old style’ retirement annuities that do not offer sufficient performances or investment options to combat the erosive effects of inflation. In most cases, these older structures do carry rather hefty cost structures and any reduction or even cancelation of regular contributions could lead to severe capital destruction due to potential penalties. Such penalties are not applicable when selecting the new ‘wrapper’ options. Ad hoc contributions could also be more actively managed in a ‘wrapper’, thus increasing the potential investment yield from this structure.

A recent analysis of a client’s ‘life house’ RA showed the following:

The retirement policy was initiated in February 1990 and ran to late October 2014. Total contributions amounted to approximately R213 000 and the end value amounted to approximately R1.6 million, thus equating to approximately 700% in 25 years. This sounds fantastic, but if the same investment had been allocated to a ‘wrapper’ then the value of this portfolio could have exceeded the R3 million mark.

Selecting a pool of funds is not simple. As retirement annuities are regulated by the Pension Funds Act, one has to take cognisance of the limitations set out in the Act. Regulation 28 of the Act, for example limits the exposure to equities to 75% in total, whilst offshore exposure is limited to 25%. One therefore has to understand the workings of a selected fund, and when selecting a portfolio of funds, what the impact of each fund’s asset class exposure to these prescribed limitations may potentially be.

Balanced funds and Stable funds by nature do comply with the Act and so too do Money Market funds.

If one however considers that a pure Money market investment strategy may only yield approximately 6-7% per annum and that inflation is measured at around 6-7% per annum, then the real annual return from such a strategy is effectively nil. It is thus imperative that a defined investment strategy is applied in one's retirement portfolio in order to allow the portfolio to create sufficient wealth for retirement and not to merely select one or two balanced, fixed interest or stable funds with a single specialist fund as the core of the portfolio.

At Global & Local we have structured our own 'house view' of funds. This 'house view' selection has been structured to comply with the regulations set out before and therefore offers our clients not only a well-balanced and diversified portfolio, but also allows for rather competitive returns over the medium to long term without taking unnecessary risk on board. Regular reviews of this selection further allows us the benefit of recommending changes to our clients' portfolios in order to maintain optimal returns - even when markets react somewhat irrationally.

If you have an 'old style' retirement annuity, or even a new 'wrapper', whether it be active or inactive (paid up), may we take this opportunity to invite you to contact our IFAs so that your portfolio can be independently analysed and recommendations be made so that you will be able to eventually retire comfortably.