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POST RETIREMENT ANNUITIES

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INVESTMENT CONSULTANT

Investors are educated throughout their careers on how to best prepare for their retirements. But what investment options are available at retirement or post retirement (by replacing one product with another)?

If you are a member of a Provident Fund or a Provident Preservation Fund, you are allowed to commute your full fund value, subject to tax, as a lump sum withdrawal at retirement; most investors will, for reasons of tax efficiency, transfer the full or a portion of their fund to either a "conventional annuity policy" or a "living annuity" or a combination of the two. If you are a member of a Pension Fund, a Pension Preservation Fund or a Retirement Annuity Fund you are allowed to commute a maximum of one third of the fund value, the balance of which would need to purchase either a "conventional annuity policy" or a "living annuity" or a combination of the two.

This article sheds light on the different types of compulsory annuities available at retirement.

"A thriving new beginning can be and should be a time for amazing engagement, growth, connections, contributions, and amazing possibilities." – **Lee M. Brower**

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A French ballet term describing a dance step requiring dancers to move **forward** and **onwards.**

COMPULSORY ANNUITIES

Compulsory annuities can be broken down into two main categories namely conventional annuities (guaranteed or life annuities) and living annuities.

A. GUARANTEED ANNUITIES

A guaranteed or life annuity, purchased from a life insurance company, provides income to the annuitant until death, unless it is a joint annuity which will only cease on the death of the surviving spouse. In effect, the annuitant gives up his/her capital investment to the life insurer and in return, the annuitant receives a guaranteed income payment until death. When the annuitant dies, the remaining capital, if there is any, is retained by the insurance company. This can work against the investor's estate if he or she dies prematurely but can also work in the annuitant's favor if he or she outlives the actuarially estimated life span.

A critical aspect of a guaranteed annuity is that there is no point of return. Once the annuity is purchased, it cannot be sold or disinvested; unlike a living annuity which can be sold and reinvested into a guaranteed annuity. For this reason there are 'wise' and 'less wise' periods in which one should consider purchasing a guaranteed annuity. Since the beginning of the year annuity rates have increased with 10%. This presents retirees in living annuities with a window of opportunity to replace a portion or all of their living annuity with a guaranteed annuity. There are different ways of doing this and there has been some innovation in the market. Allan Gray for example offers a guaranteed annuity within a living annuity in partnership with Just Retirement as the annuity provider.

Before investing in a guaranteed annuity, it is extremely important to understand the different guaranteed annuity options and how they can be structured. For example the starting income from a level annuity can look very attractive, but due to the annuity not growing with inflation, investors are left destitute in time as the value of their pension is eroded by inflation.

Below is information about different types of guaranteed annuities.

Level Annuities

The monthly income received remains constant until death. The major problem with this type of annuity is that the real purchasing power of income reduces as inflation increases over time. This annuity is mostly suited to those with a lower life expectancy as it pays the highest starting income of the annuity options.

Fixed Escalation Annuities

These annuities offer an annual increase of income, either inflation linked or fixed percentage (normally between 1 and 10%), and are suited to those expecting to live longer. Should you choose a fixed rate, the greatest risk is that inflation may increase significantly above the percentage of increase selected.

Joint and Survivorship Annuities

These annuities pays a monthly income until death of the assured, thereafter an income will be paid to for the remainder of the surviving spouse's life. At inception, the life assured will select what income his or her spouse will receive on the death of the assured and the selected rate will determine the starting income of the life assured.

"An investment in knowledge pays the best interest."
- Benjamin Franklin

With-Profit Annuities

A with-profit annuity is a combination of a guaranteed annuity and profit sharing investment. Income is guaranteed and any increases will raise the guaranteed income. It must be noted that increases are not guaranteed as they are dependent on the after cost returns the life assurance company can achieve through its investments. A popular strategy in this regard is that of the 'smoothed bonus' allocation. The investment company will hold back any excess returns during market out performance to cater for periods of low growth, the result is a less volatile rise in income over longer periods.

Fixed Term Annuities

At inception the investor chooses a specified income period. A monthly income is therefore guaranteed for a specific number of years. Should the investor die before the end of the specified period the monthly income will be paid to an elected beneficiary for the remainder of the period. The longer the guaranteed period, the lower the initial monthly income.

Capital Backed Annuities

The purpose of this annuity is ensure that a capital payment will be made to the annuitant's nominated beneficiaries. This option consists of two parts:

- An annuity portion which ensures an income stream for the annuitant; and
- A life assurance policy which can be taken without underwriting.

Part of the annuity income will be used to cover the cost of the life assurance policy. Depending on age, the income stream can be greatly reduced as the cover may be deemed expensive if the annuitant is elderly.

B. LIVING ANNUITIES

Unlike guaranteed annuities where the life assurance company bears the risk of the annuitant out living the capital invested, living annuity investors bear the risk of out-living their capital. Living annuities are widely regarded as the optimal choice of retiring South Africans, especially the affluent, as they allow members to retain control of assets housed within the structure. These living annuities are also not governed by Regulation 28 of the Pension Funds act which means investors can invest their capital as aggressively or as cautiously as they desire. For these reasons these structures suit more informed investors and those who can get by withdrawing at low rates. However, history has shown that most people are uninformed and have failed to adequately save for retirement which means many need to withdraw at higher rates. This brings us to the biggest threat facing living annuitants: the possibility of withdrawing all capital before death.

"Know what you earn and know why you own it."
- Peter Lynch

The **main characteristics** of a living annuity are that:

- The annuitant may draw between 2.5% and 17.5% against capital invested, the rate can be reviewed once a year; income is not guaranteed and the onus is on the investor and financial adviser to plan and implement accordingly; failure to do so can result in capital depletion prior to death.

- A beneficiary can be nominated to receive the benefits at the death of the annuitant. If no beneficiary is nominated, the benefits will be paid the to the deceased's estate.

The **benefits** of a living annuity are that:

The annuitant can begin by drawing as close to the minimum of 2.5% as possible, this allows for greater capital growth in the earlier years which will translate to higher income growth during the later years of retirement.

At death, the capital value is not lost but it is transferred to a beneficiary.

Living annuities are fully transparent. The values are easily ascertainable and fees and commissions are fully disclosed.

There are a wide range of underlying funds to be invested in and switches can be made easily at any time. One is able, as an example, to have an income component to provide retirement funding as well as a growth component from which income will not be drawn but rather compounded to facilitate income growth down the line.

A living annuity can used on a temporary basis and can be transferred to a guaranteed annuity.

The living annuity itself is not subject to income tax but annuity payments are taxed at the marginal tax rate of the annuitant.

Living annuities are not estate dutiable.

The **disadvantages** of Living Annuities:

- Income is not guaranteed, misinformed decisions can result in capital depletion;

- A massive array of portfolio choices can be stressful, it is therefore imperative to seek advice from a reputable financial adviser.

"Planning is bringing the future into the present
so that you can do something about it now. "
- Alan Lakein

SUMMARY

Understanding one's options is critical when deciding where to take one's retirement benefit. Increased competition in the market benefits investors, which is a good development, however there still remain fundamental differences between product options. For this reason it is of great importance that all retirees seek financial advice from a reputable advisor when considering options at retirement.

We have a stable of accredited and highly experienced financial planners at GraySwan who know how important your dreams are.

Contact us today!

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Sources:
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