

14 November 2008

VOLUME 517

## ***Have you thought about doing this with your ILLA?***

Albert Botha – Glacier Research

The reason we save and invest is so that we may have enough money at a point in time for a particular goal. This may be saving for retirement; to buy a new house or car; to go on holiday or for children's education. Much time and effort is spent on analyzing how, when and in what to invest. But not much energy is spent on thinking about the method of withdrawal from your investment.

Over time, most people's life expectancy has increased. People also aim to retire earlier. So with longer lives and earlier retirement, investing for and during retirement becomes a tricky proposition.

There is no simple solution because every individual's needs and constraints differ, but the choices available (e.g. an ILLA or traditional life annuity) need not be mutually exclusive. A well thought out combination of products may achieve your goals more efficiently. Currently, an ILLA is a very popular product for income provision during retirement. The ILLA is more suited to high net worth individuals who prefer greater investment flexibility or those who wish to leave an inheritance. By investing in an ILLA however the client takes on several risks that traditionally belonged to the insurer.

The obvious risks are longevity risk and investment risk. There is a risk that an individual may live longer than expected and so run out of money. This is known as longevity risk. In a traditional annuity the life company assumes this risk by providing the insured with a guaranteed income till death. Investment risk is another risk usually assumed by the life company. This is the risk that the investment will perform poorly and not meet the liabilities of the annuity.

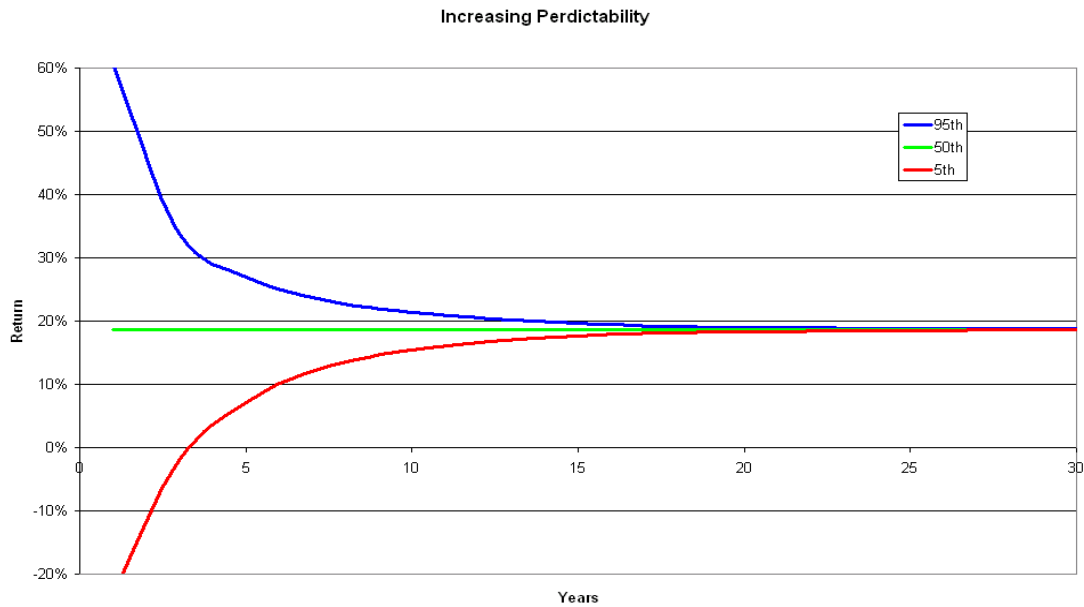
The upside for an ILLA owner is that he/she may be more than adequately compensated for taking on these risks through good investment performance.

The less obvious risks require some thought too.

Volatility in the underlying investments has the potential to critically diminish the available capital, especially if the investor is forced to sell undervalued assets to provide income for the annuity. For example, in a buoyant market, only 50 shares are sold to provide an income of R x. If the market falls, suddenly 75 shares are needed to provide the same income. Thus more shares are sold at lower prices – the reverse of Rand (Dollar) cost averaging.

The problem is that in order to keep pace with inflation and meet the income needs of the annuitant, some of the capital will probably need to be invested in more risky asset classes like shares. These asset classes tend to exhibit high volatility and this is exacerbated the shorter period of the investment.

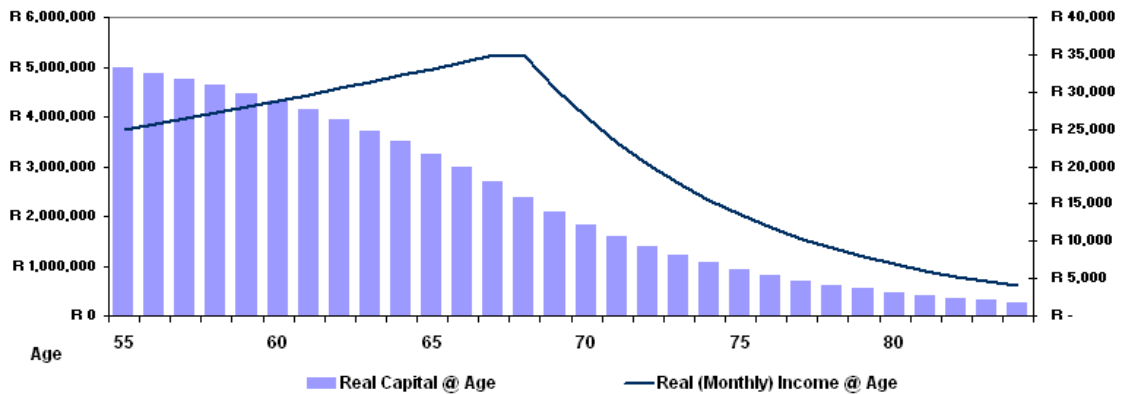
History tells us that 95% of 12 month expected equity returns lie between -22% and 60%. Take that out to 3 years and gap narrows to -2% and 34% per annum. At 20 years it shrinks further to between 18.33% and 19.05%. The inverse is also true for shorter periods. While the average return for a year may be 18%, it is not uncommon for the index to have a 2% change in a day.



“Best”, “Worst” and Average expected performance over time – Glacier Research

The bottom line is that the longer the time period, the more predictable the returns on risky assets tend to become.

But the largest risk when drawing a long term income is inflation which could see an investor’s income and capital deteriorating in real terms. To combat this investors often increase the percentage of capital they withdraw annually. The annual withdrawal rate is limited by legislation to a maximum of 17.5%. If an investor is withdrawing the maximum amount, they are faced with two problems. They can’t increase the withdrawal rate any further and they are probably eating into their capital. Once an investor has reached this cap the situation could be very dire. They cannot draw more than 17.5% of their capital to increase their income and due to the high withdrawal rate they are eating into their capital.



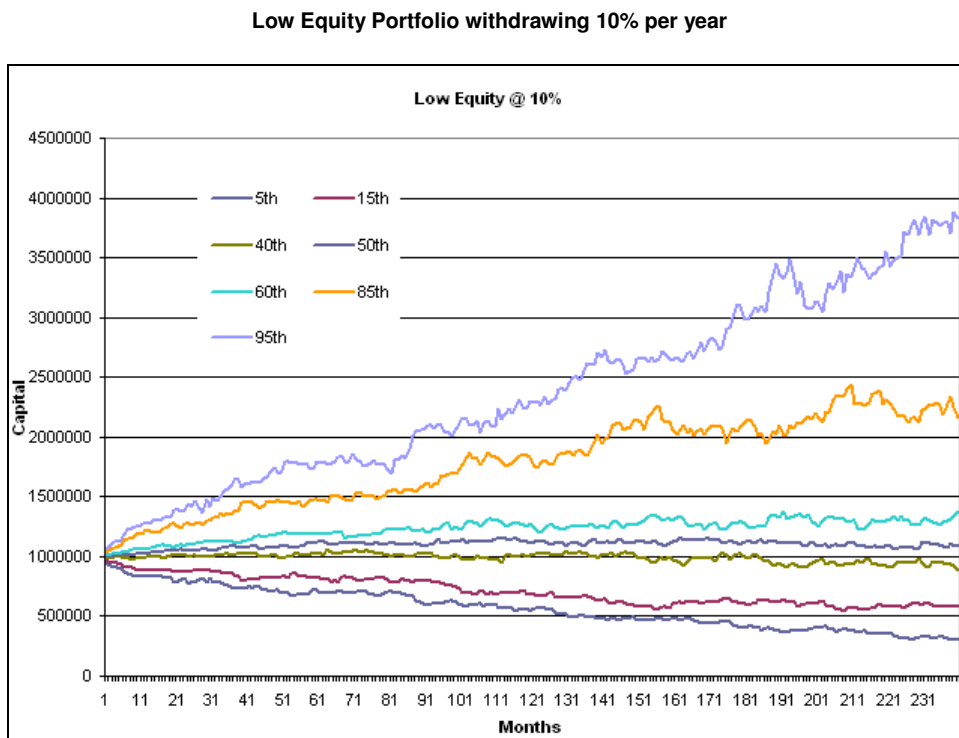
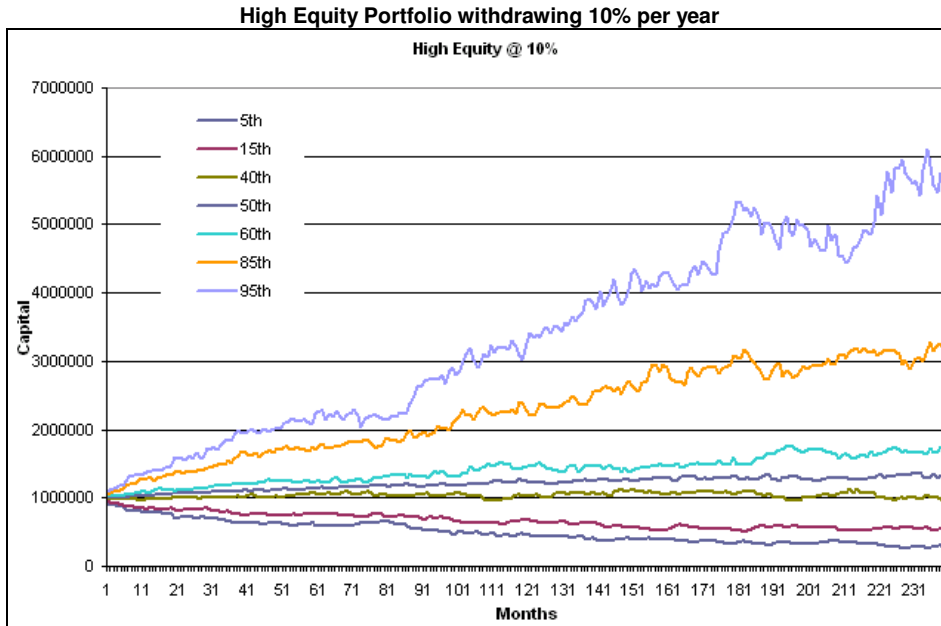
Capital and Income before and after hitting the 17.5% cap – Glacier Research

So we all know that you should try and draw as little as possible from your ILLA to protect capital, but have you given much thought to where you should withdraw from and whether your conservative asset allocation is really meeting your needs? Contrary to popular belief, investing in a more aggressive portfolio should provide you with a better outcome in most instances. As we’ve said, inflation is a significant risk within long term income providing investments, and while cash is safe, it does not provide inflation protection. Especially not when drawing an income.

### More Risky Portfolio

To illustrate the point, we investigated two scenarios. In both instances we used a 10% withdrawal rate. We looked at withdrawing from a low equity portfolio (30% RSA equities) and a high equity portfolio (60% RSA equities) through a range of economic scenarios. In 90% of the scenarios, the high equity portfolio has a higher final capital value.

The high equity portfolio also provides the investor with a higher probability of maintaining capital over the long term with the added benefit of significant possible upside in favourable economic circumstances. Below you can see the different outcomes for both the high and low equity portfolios.



Clearly the high equity portfolio provides you with a greater probability of maintaining capital. The table below summarises the result and details the difference between the various percentile outcomes. The expected (50<sup>th</sup> percentile) outcome, has the high equity portfolio outperforming the low equity one by R627'959 over 20 years given an initial capital value of R1'000'000.

Capital after year 20			
	High Equity	Low Equity	Difference
5th	R 288,971	R 339,010	-R 50,039
15th	R 522,570	R 489,940	R 32,629
40th	R 963,677	R 701,554	R 262,123
50th	R 1,394,060	R 766,100	R 627,959
60th	R 1,748,610	R 864,389	R 884,222
85th	R 3,244,200	R 1,214,014	R 2,030,186
95th	R 5,591,738	R 1,714,151	R 3,877,587

### Withdrawing only from cash

Investing in a high equity portfolio will make your capital value more volatile, thereby increasing the risk of destroying value by selling undervalued assets when withdrawing.

One way to combat this is to change where you withdraw from. Often investors sell assets proportionately as they are represented in his/her portfolio. While the cash remains stable, all other asset classes tend to fluctuate, thus exposing the investor to the risk of increased volatility.

The alternative is that an investor puts several years (3-5) worth of income into cash and only withdraws income from that fund. The rest of the capital can then be invested in assets that should give you higher long term returns.

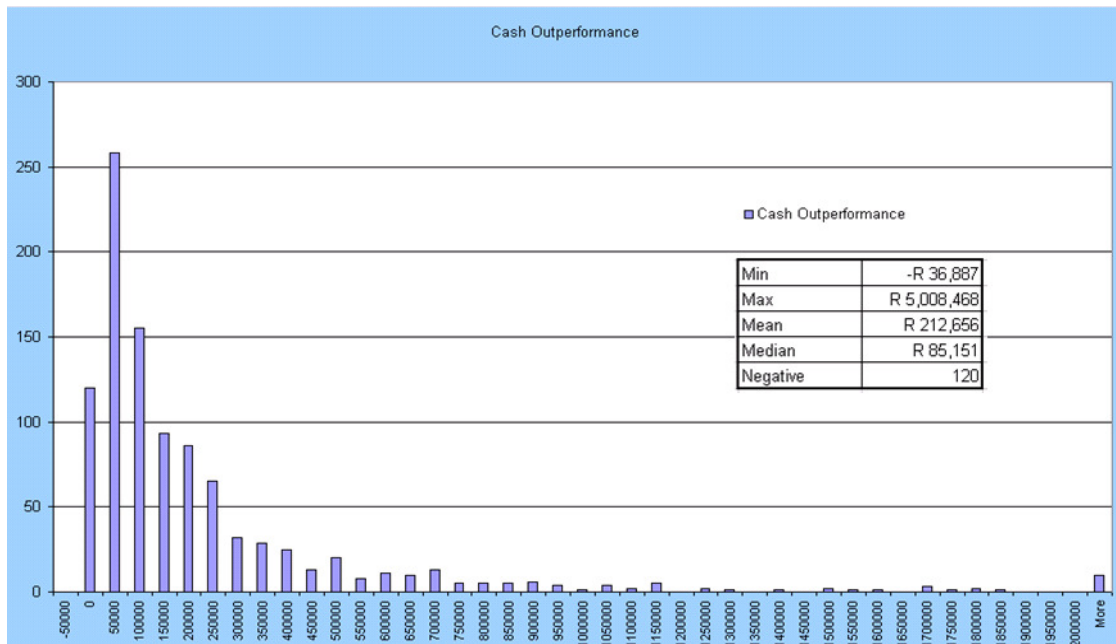
By doing this the client can withdraw an income for several years without being forced to sell undervalued equities, because equity returns become more predictable as the time horizon increases, the probability of having equities undervalued for the entire period is low.

Another benefit is that while the market remains undervalued and the investor uses cash to produce an income, the portfolio actually becomes more aggressive due to a lower cash proportion. While this may seem to be too much of a gamble it is exactly what investors are always trying to accomplish. Increasing risk exposure when the market is undervalued.

The problem comes with timing the rebalance of your portfolio. Simulations suggest that even relatively crude rebalancing rules such as, rebalance every two years, have a statistically significant effect. If these rebalancing rules are refined to rebalance if equity outperforms cash, in a certain inflation scenario, the result becomes more pronounced.

The graph below shows the average outperformance of two identical portfolios (High Equity) where one is withdrawing income solely from cash and the other withdraws income proportionately at 6% per annum. Both portfolios are rebalanced on a bi-annual basis. It is clear that in most cases (88%) withdrawing from cash is the better option.

**Average Outperformance of cash withdrawal over proportionate withdrawal**



While it is very understandable that individuals panic in difficult economic circumstances, it is imperative that their emotions do not negatively influence their actions and hence their investments. It is vital that investors remember that the term of an ILLA could be up to 30 years or more and hence is a long term investment in the truest sense of the word – a short term focus could be disastrous to the continued provision of an adequate real income.