Outliving your capital: Pension drawdown

Even though a guaranteed annuity is one that guarantees a pension for life, according to the Association for Savings & Investment SA (Asisa), almost 85% of assets at retirement flow into living annuities. The main reasons for this seem to be threefold: the capital benefit which, upon death of the pensioner, is preserved for dependants; the dependence on living annuities to provide a sustainable income; and, a perception of a better investment return than that offered by a guaranteed annuity.

The predicament with a guaranteed annuity is that although it can be inflation-linked, unless the initial investment sum is significantly sizeable, the income received from inception is unlikely to ensure an income that can sustain one's lifestyle. Hence, the attraction of a living annuity where pensioners have more control in terms of the drawdown rate and the resultant income they elect to receive.

But, many living annuity pensioners are drawing high percentages of their capital, some even the maximum of 17.5% at outset, eroding their capital and putting them at risk of outliving a sustainable lifestyle income. While Asisa gives an average drawdown figure of 6.77%, even this 'lower' percentage is likely to put strain on your capital given longevity trends.

Often the drawdown percentage decision by retirement fund members is made with little, if any, financial advice, a fact clearly revealed in the 2013 *Sanlam Benchmark Survey*. The survey revealed that a whopping 63% of retirement fund members felt that advice was too expensive. Given this outcome, it's no wonder that 43% had never made use of the services of a financial adviser even though 47% of them did not understand their benefits statements.

"It's worrying that many retirement fund members do not see the value in getting advice from a Certified Financial Planner on an issue as critical as retirement, and in this case, the drawdown percentage of their capital, often to their detriment. Possibly this is due to ignorance surrounding the perceived high cost of financial advice, a cost which is actually between 0.5% and 1%," says Certified Financial Planner Ricky Williams of Anfield Investment Planning. "This should not be confused with additional costs such as fund manager's costs of around 1% and administrator's costs in the region of 0.5%. But the focus should not be on cost alone, when the ultimate objective is the highest after cost and after tax sustainable income," he emphasises.

"Assuming an annuity fund growth of around 8%, pensioners should not elect to receive more than 5% of their annuity income to ensure that the capital growth in the fund grows by at least 3%," says Williams. "This will not only allow for capital growth within the fund, it will also go a long way towards ensuring that they do not run out of funds when possibly, at a later stage in life, they are forced to draw down a higher percentage. Obviously, this is also a precautionary measure for those not holding a guaranteed annuity, to ensure the pensioner does not outlive his capital. For those pensioners in a position financially to afford to only draw the minimum of 2.5%, this would put them in an even better position further into their retirement," adds Williams.

Lionel Karp, a retirement specialist with Chartered Wealth, says that the minimum drawdown of 2.5% is also especially important for those pensioners who may still be working part-time or may have income from another source such as rental or interest income. By drawing a smaller annuity, the pensioner's tax will be lower, as SARS

TABLE 1: Key design features of living annuities and guaranteed annuities

	Annuity	
	Guaranteed	*Living*
Longevity risk	Insured	Not insured
Value at death (life insurance)	No	Yes
Investment risk	No	Yes
Interest rate risk	At retirement	Within investments
Investments	Matched	Choice
Drawdown	1 annual payment	2.5%-17.5%

SOURCE: Mayur Lodhia & Johann Swanepoel


Lionel Karp

combines all the pensioner's income and then taxes the full income as one.

"It would never be a good idea to draw more than was needed from a living annuity," cautions Karp. "Nor would I advise a client to draw more and invest the funds in another investment if they did not need the income. This would put the pensioner in a far worse position, firstly by paying tax on income they do not need, and, secondly taking income from a fund that is growing tax-free, to another investment that might be subject to tax on the growth. If lifestyle requirements change, the pensioner may change their drawdown amount at a later stage as withdrawals may be changed annually on the anniversary date of the living annuity," adds Karp. "In the past, when a person retired they often ended up having two or more living annuities, each with different anniversary dates. Latest amendments now allow the pensioner to combine all the living annuities into one and only have one anniversary date for them all. Makes financial planning a little simpler," quips Karp.

Drawing a smaller annuity amount allows your funds to last longer, adds Karp. He cites the following as a simplistic example: "If the fund is growing by 10% and the pensioner is drawing 2.5%, the fund will grow by 7.5%. The opposite would apply if the pensioner was drawing 12% and fund was only growing by 10%, thus eroding the fund value by 2%."

What is significant is that once the capital is being eroded, even at maximum drawdown, annual income will reduce each year (see Table 2). For those electing to draw down the maximum of 17.5% at inception and thus eroding capital from year one, by year 10 they can probably expect to receive around one third of the income that they received in year one. This is an alarming picture for pensioners who face reducing income especially in light of the fact that the second half of retirement (from around age 75 onwards) is a much more difficult time financially owing to increased medical expenses. And it is a scenario that, with knowledge and advice, can often be avoided.

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The benefits of drawing less from your living annuity:
- Capital growth of the fund
- Growth of capital is tax-free
- Lower likelihood of running out of funds further into retirement
- Less tax paid

TABLE 2: Years before your income will start to reduce

Annual income rate selected at inception	Investment return per annum (before inflation and after all fees): 2.5%	5%	7.5%	10%	12.5%
2.5%	21	30	50+	50+	50+
5%	11	14	19	33	50+
7.5%	6	8	10	13	22
10%	4	5	6	7	9
12.5%	2	3	3	4	5
15%	1	1	2	2	2
17.5%	1	1	1	1	1

SOURCE: Asisa

Note: The table above assumes adjustment of percentage income selected over time to maintain the same amount of real income (i.e. allowing for inflation). Once the number of years in the table above has been reached, income will diminish rapidly in the subsequent years.