INVESTMENT REPORT

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THE LEGACY DEBATE: LIVING VS GUARANTEED ANNUITY

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When you enter the final phase of your working life, you should start thinking about how to position your nest egg to best take care of your needs in the golden years.

The first step is to align your pre-retirement investment strategy with your annuity choice. This may require restructuring your investment portfolio to increase or decrease risk, but also weighing the pros and cons of life annuities and living annuities up against each other to ascertain which product fits your profile.

An important consideration for many is making provision for a financial legacy for beneficiaries. It is extremely helpful for the advice framework to distinguish clearly between 'financial dependents' and 'other beneficiaries' in this regard, as the way to address those needs are different. Most people pull all of these out of the same hat.

A financial dependent in most cases is the last surviving spouse and, in a few cases, will include a dependent child (due to disability or for whatever other reason). Here the objective is clear and can be quantified with great accuracy and planned for more precisely.

In the case of financial dependents, a joint life annuity is arguably the most optimal solution as you can specify the level of income (for life) relative to the standard of living required, with future inflation and longevity protection. In a nutshell, it is payable for life: the issuer must ensure that the funds last your whole life and you can provide for a spouse's pension. This policy will expire at death of the joint lives.

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> "Choosing between the two products should not be based on financial legacy."

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A LIVING ANNUITY IS NOT A SUITABLE VEHICLE FOR LEAVING A FINANCIAL LEGACY.

Not only is it the most expensive life cover one can buy, but the amount at death is not known and may not resemble the level of cover required – meaning that you cannot plan properly for that contingency. The sad reality is that people will probably run out of money often and will depend on support from their family – and not the other way around. This is not well understood and should be highlighted much better in advice frameworks.

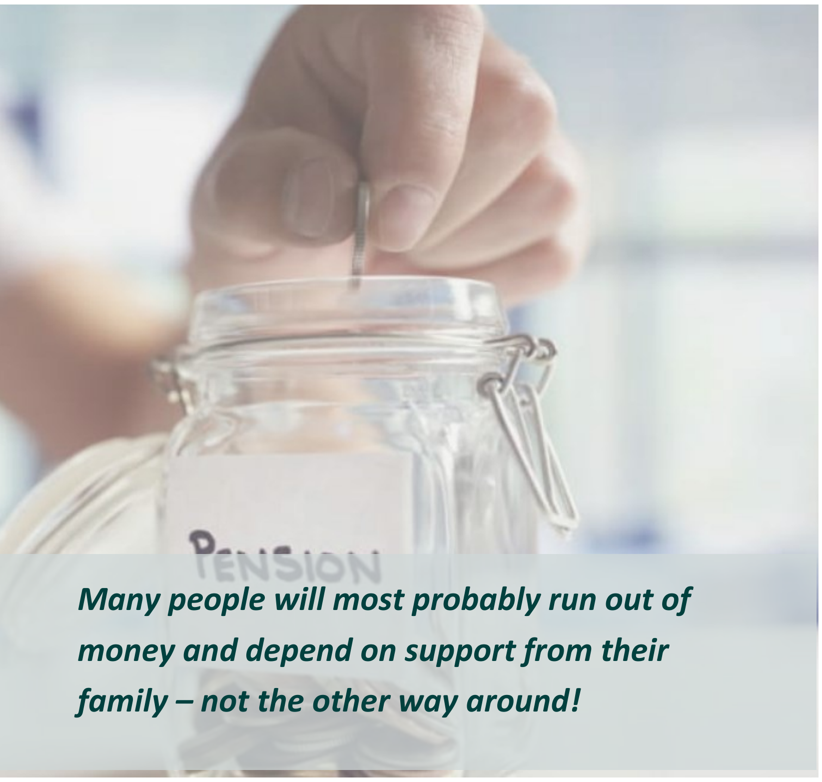
For example, R1 million life cover for a male aged 65 could cost an annual premium of R50 000 for that cover i.e. a rate of 5% per annum and this is considered very expensive (compared with the rates they were used to when they were younger of course). In contrast, in a living annuity, the only reason a retiree can leave a legacy of R1, is because they did not consume that R1 in retirement. This is a rate of 100% – and it cannot get more expensive than that. In fact, if you take the fees into account, you actually paid more than R1 for that cover.

I think very few people in retirement should have an explicit need to leave something to beneficiaries (except of course to provide for the longest surviving spouse or a special-needs child). This is because they don't have other financial dependants at that time because the kids are generally grown up and are providing for themselves. ***So, you must ask yourself, why do you want to leave anything behind for your grown children who are earning money of their own? Can you afford to leave something behind? Should you not rather consume more in retirement or improve the protection for your financial dependents?***

The long and short of it is that the choice between a living annuity and its guaranteed counterpart should not be based on financial legacy. It should be based on the perceived poor value for money of a life annuity on early death.

Why buy a guaranteed annuity if the insurer 'takes all your money on death' if you can buy a living annuity and leave it to your family? In doing the comparison against a guaranteed annuity people also underestimate the value of a spouse's annuity (if joint life) and a guarantee period.

However, people can still appreciate the value of adding these features to provide a legacy. The benefit after death is limited to the spouse, which makes this a very good way to provide for this need. The benefit is specified in income terms (as opposed to a lump sum) which also makes it easier to understand what the value of the benefit is. Most people will not know what standard of living a spouse will be able to secure with say, R1 million at a future date.



Many people will most probably run out of money and depend on support from their family – not the other way around!

In my experience, for most people, due to not having enough saved up, leaving funds behind for ordinary beneficiaries is simply a luxury that retirees cannot afford.

CONCLUSION

If a cashflow projection indicates that you are either (1) at risk of running out of money, i.e. your drawdown rate is too high; or (2) if you are deliberately under consuming in your living annuity in an attempt to leave a positive investment value for "other beneficiaries", then you may need to consider a move to a guaranteed annuity.

INTRODUCING: MARISE SMIT, CERTIFIED FINANCIAL PLANNER®

MARISE SMIT joined the Brenthurst team in April 2015. She is an experienced Certified Financial Planner® with a demonstrated history of working in the financial services industry. She is a strong finance professional with a Bachelor of Commerce in Investment Management and Bachelor of Commerce (Hons.) in Financial Management from the University of Pretoria.

She also completed her Postgraduate Diploma in Financial Planning from the University of the Free State.

Marise is also a member of the Financial Planning Institute of South Africa and is fully qualified to give advice on all investment matters.

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