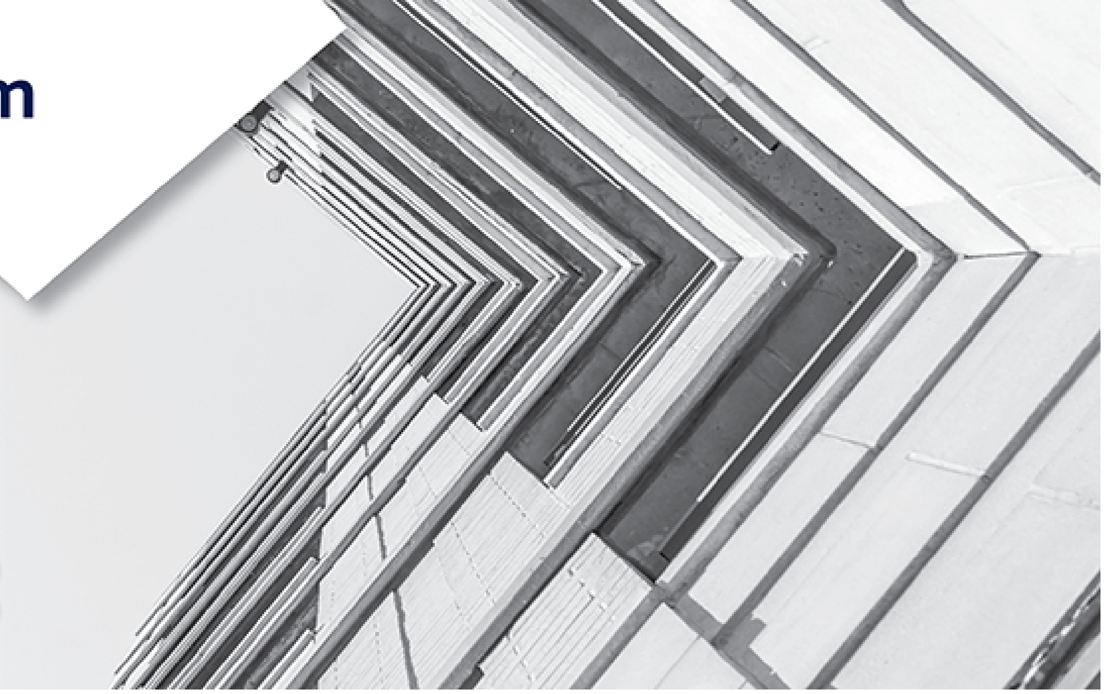
momentum
investments



IN THE
moment

Lifestaging being tested by COVID-19

The South African retirement savings market moved to defined-contribution arrangements well ahead of many of even its developed country counterparts. It is therefore more sophisticated in terms of helping its members manage the investment risk they now must bear. The fall in the investment market due to health and economic concerns over the effect of COVID-19 have shown that retirees in this treacherous time could actually have benefitted.

We adopt an outcome-based investing philosophy, where we construct portfolios aiming to achieve the investment goal a member is targeting. One of the key components in building an investment strategy is the tradeoff between risk and return. The longer the investment horizon, the greater risk one is generally able to take. As our clients and members of retirement funds approach retirement, funds slowly start to derisk their investments to make sure the asset classes at retirement look like the income profile (annuity solutions) clients will buy.

The failing of many in the market is the focus on the capital at retirement, but the key question is what income that capital could buy. The annuities are priced on the expected returns of those assets available in the market. Aligning the investment strategies to those assets ensures protection from the investment risk.

As an example, we used 1 January 2020, as the point before the COVID-19 crisis, and 31 March 2020, as the point after there was a significant drop in the market (April has recovered) for comparison purposes.

The Momentum Investments Enhanced Factor 7 Portfolio was not spared in this three-month period and lost 19.7% in this short period. A reduction of this magnitude would be calamitous to any retiree. Even the Momentum Investments Enhanced Factor 3 Portfolio, which is the most conservative in the range, designed to deliver its outcome in the shortest term, lost 9.5%. However, in this same period, with the fall in the market came a significant increase in long-term interest rates (due to the extra return required by investors for taking on this risk).

This means that for a typical retiree*, annuity prices fell by a significant amount too, as they are priced on long-term interest rates. A level annuity cost 15% less, an inflation-linked annuity 14% and an annuity increasing at 6% yearly dropped 24% in these three months. A with-profit annuity, which is aimed at providing smoothed equity growth participation for its duration, dropped 12%. The consequence of this is that the majority of retirees were actually able to buy higher levels of income at the lowest point in the crisis than before it.

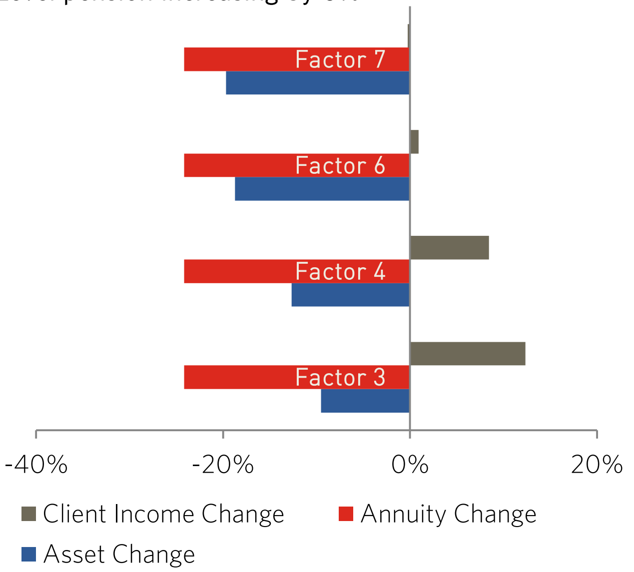
The change in income, three months later, depending on the portfolio, is set out in the table below:

**The annuitant above is assumed to be 65 years old, his spouse is 60 and receives half his pension should he predecease her.*

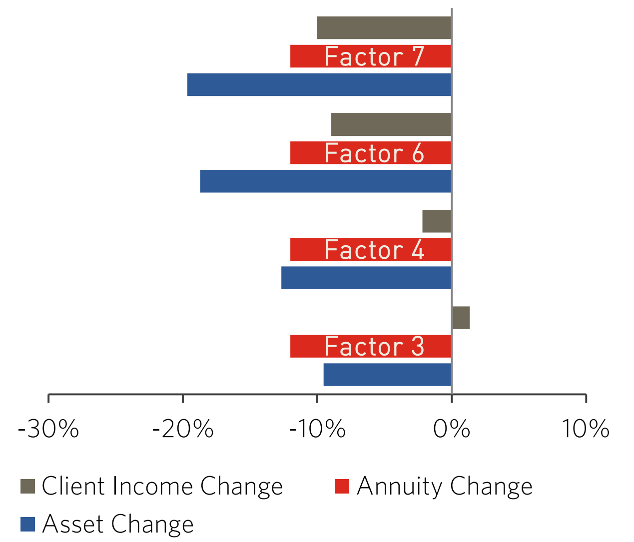
Annuity purchased	Factor 3	Factor 4	Factor 6	Factor 7
Level pension	3,9%	0,3%	-6,6%	-7,7%
Fixed 6% increase	12,3%	8,4%	0,9%	-0,3%
Inflation increase	3,2%	-0,4%	-7,3%	-8,4%
With-profit annuity	1.4%	-2.2%	-8.9%	-10.0%

Being in the most conservative multi-asset-class factor 3 portfolio would have enabled a client with a fixed lump sum to buy a 6% increasing income, which was 12% higher than at the start of the year. The effect of the change in the asset and the liability (annuity) price is more intuitively represented in the charts below:

Level pension increasing by 6%



With-profit annuity



Typically, in a retirement fund or in an investment plan devised by a financial adviser, a client would switch from factor 7 (the most-aggressive construct possible in terms of the prudential pension fund investment guidelines), through a typical balanced fund (factor 6) every two years to end in factor 3. This eight-year transition then potentially misses out on returns on growth asset classes.

The following table assesses the outcome of four different investment strategies for the eight years before retirement.

Strategy 1	Remain in the most aggressive portfolio (factor 7)
Strategy 2	Lifestage systematically from factor 7 to factor 3 every two years
Strategy 3	Switch eight years ago into the factor 4 portfolio (more conservative – normally a living annuity strategy proxy)

Despite a reasonably subdued investment market, up to December 2019, strategy 1 delivers retirement capital eight years later that is 3% higher than strategy 2 and 20% higher than strategy 3. This changes significantly by the end of March 2020, where the lifestaging gives protection over the fall and delivers an 8% higher benefit, and the conservative portfolio halves the deficit to 10%.

Continuing to work for three months and retiring on 31 March 2020 as well as immediately buying an annuity would have resulted in the following different outcomes:

Annuity purchased	Strategy 1	Strategy 2	Strategy 3
Level pension	-7%	4%	1%
Fixed 6% increase	0%	13%	9%
Inflation increase	-8%	3%	0%
With-profit annuity	-10%	2%	-2%

So, it is clear that being invested in growth asset classes meant the client was worse off (or the same, buying an annuity increasing by 6%). A typical lifestage solution presented a better outcome on all three life annuity options, as did the factor 4 portfolio, but with less protection (than factor 3, which is the end point of the lifestaging).

There are clients who, in March 2020, may have elected to remain in their growth portfolio and select a living annuity. These individuals would only experience a loss should the market not recover to previous levels. They will need to select an annuity draw down level that sustains their living expenses as well as an investment strategy that delivers future returns sufficient to provide that income stream for the client's life.

There are many who are critical of defined-contribution funds and the investment risk passed to individual members. We have just experienced one of the most significant market disruptions in the last fifty years, yet defined-contribution retirees, due to considered benefit design and investment portfolio construction, have weathered this storm and may in fact have benefited.

Other than the fixed-increase annuity, all other annuity purchase prices largely tracked the change in the underlying annuity purchase price change.

If there is anything we could learn from this exercise is that the previous assumption that the South African market is very volatile and, therefore, requires a longer lifestaging transition, probably needs to be shortened. Investing in a growth portfolio (factor 7) until retirement is not a good match for the annuity decision and some element of derisking is required, unless the intention is to continue with this strategy in a living annuity.

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