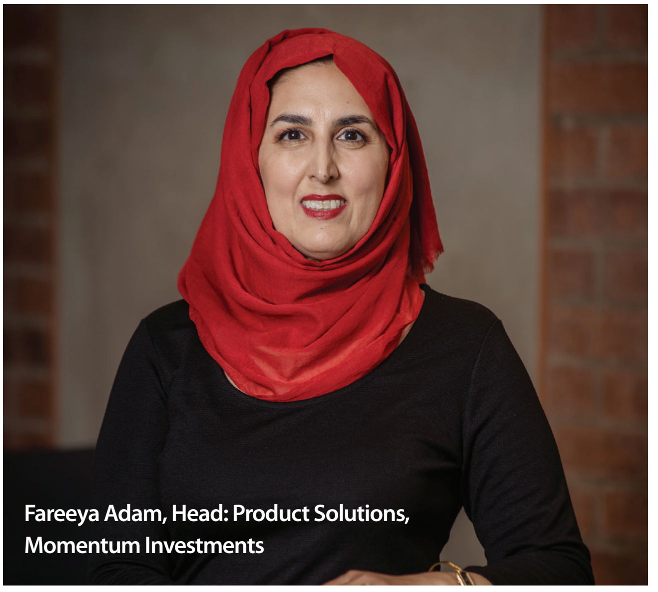
# Retirement income reimagined

Momentum Investments has recently introduced enhancements that can help clients to maximise their chances of receiving a reasonable income stream, for as long as they live. *Blue Chip* unpacks these developments with Martin Riekert and Fareeya Adam.

Martin Riekert, Executive Head: Retail Investments, Momentum Investments



Fareeya Adam, Head: Product Solutions, Momentum Investments

Over the last few years, advisors faced some very difficult circumstances for retired clients in living annuities. Many clients experienced market volatility or lower than expected investment returns, which can impact the future sustainability of their retirement income.

**What options are currently available for clients who are retiring?**
**Fareeya:** People who accumulate money in a pre-retirement savings vehicle must, according to law, use some of this money to purchase an approved income product. The available options, the choice between a living annuity and a life annuity, have been static for quite some time. These products can be well suited for meeting income needs but they come with their respective advantages and disadvantages.

A living annuity is a market-linked investment that gives pensioners a regular retirement income, while at the same time giving them an opportunity to grow their retirement savings.

Living annuities offer flexibility of income and the freedom to choose investment components to suit specific investment strategies. But a client essentially takes on all the investment and longevity risk. So, if markets don't perform as expected or if a client lives longer than expected, the client is at risk of running out of money to pay for even the bare necessities. A life annuity, on the other hand, pays a regular guaranteed income for life to the pensioner and could include their dependants. The client does not take on any risk of investment markets or living longer than expected. But there is also no upside potential from market growth and no remaining capital when the client passes on.

**What has the trend been between these two types of products?**
**Martin:** Five years ago, the split between living annuities and life annuities was roughly 90:10. Recently it has been closer to 70:30. This shows that retired clients and their advisors are starting to see the value of the guaranteed nature of a life annuity, especially in the context of the pandemic which ushered in a period of high volatility.

At Momentum Investments we saw many retired clients invested in a living annuity experience reduced investment values and then switching out of their investments, thereby locking in capital losses. Over R3-billion was switched on our Retirement Income Option over the last two calendar years, resulting in an average behaviour tax of 5%.

**What, in your opinion, is the true need in retirement?**
**Fareeya:** What clients really need from retirement income is to match their expenses during retirement. However, not all expenses are the same, and we think about life expenses and living expenses differently. Basic life expenses would include things like having a place to live, medical aid, groceries and other regular essential spending. These are generally quite predictable. Ideally, a client should be certain about being able to meet this minimum level of expense matching. Living expenses include things like paying for a holiday, starting a small venture and paying for a special life event. These expenses tend to be more variable in nature, and while they

are also important in a person's life, they can be considered after the life expenses are taken care of.

**Why is it so difficult to make the right choice?**

**Martin:** The key decision that is being made is about the sharing of risk. In a living annuity the client takes on all the reward but also all the risk. On the other side of the spectrum, in a life annuity the client outsources all risk to the insurer. In most cases, this decision is made at a single point in time – a once-off decision that affects the income that a client should receive for the rest of their life.

**What is Momentum's reimagined retirement income solution?**

**Fareeya:** We have reimagined our living annuity product to become a "hybrid annuity". The client and advisor can use some of the retirement savings to purchase a Guaranteed Annuity Portfolio inside our living annuity. The Guaranteed Annuity Portfolio will pay a guaranteed income into the living annuity for as the long as the client lives, thereby allowing clients to protect a portion of the future income they receive.

Clients can then invest the rest of the money in various investment components to potentially increase the capital value and offer more flexibility of income. The more it grows, the more optionality a client has both for drawing income and for leaving a legacy. The growth portion has the same functionality as it currently does on the Retirement Income Option and the advisor can choose from any of the underlying investment components available.

**The Retirement Income Option provides the option of protection and potential for growth**

| | | Underlying components |
|---|---|---|
| Protected portion | Pays a guaranteed income, irrespective of market movements. Can be personalised using guarantee terms, yearly income increases and joint-life option. | Guaranteed Annuity Portfolio |
| Growth portion | Potentially increase capital value through investment choice. Flexibility of income level. | Unit trusts<br>Model Portfolios<br>Personal Share Portfolios |

**This sounds like one solution with both sets of benefits. Is that correct?**

**Martin:** That's right, one contract includes all these benefits. The protected portion of the Retirement Income Option can be a very good match for a client's life expenses. At the same time, the balance can cater for a client's living expenses and inheritance needs through investing in growth assets. The balance between growth and protection becomes customisable for each client.

Advisors can follow the normal processes for the living annuity, even when they choose to use both types of components. We have incorporated the Guaranteed Annuity Portfolio into our Retirement Income Option, so the proposal and application forms are all integrated. The client will have one contract, will receive one statement, the same review process, making it much easier to manage their income during retirement. The Guaranteed Annuity Portfolio is effectively an investment component that is available on our platform specifically for the living annuity.

**Please outline the fees.**

**Fareeya:** There are generally three types of fees associated with living annuities. Firstly, there are investment management fees charged by the fund manager for managing the assets. These typically average between 1.25% and 1.5% every year. The Guaranteed Annuity Portfolio component already has all fees priced into it, so on this part of the living annuity, there are no explicit investment management fees charged.

The next category is administration fees. At Momentum Wealth, the administration fee is a calculated according to a tiered structure, so the higher the investment, the lower the percentage fee applied. The maximum fee charged is 0.3% every year for Momentum-managed investment components and 0.5% every year for investment components managed by other investment managers. Again, because the Guaranteed Annuity Portfolio component already has all fees priced into it, there will be no administration fees charged on this part of the living annuity.

The third category is advice fees which are negotiated between the advisor and the client. It includes an upfront advisor fee and an ongoing fee payable on an annual basis. There are product limits in place, but the levels depend on the agreement between the client and advisor. There could be fees associated with bespoke components like offshore, personal share portfolios and model portfolios where these are selected. The effect of fees on a particular contract is shown and explained in detail in the proposal document.

**What are the key benefits of including the Guaranteed Annuity Portfolio in the living annuity?**

**Martin:** Our view is that this hybrid structure will introduce three important benefits. Firstly, enhanced advice opportunities for financial advisors.

Then, given that it is effectively introducing a new asset class into the retirement profile, there are diversification opportunities for the remaining part of the market-linked assets to consider. And thirdly, including a Guaranteed Annuity Portfolio directly affects the sustainability of the client's retirement income profile.

**In what way does this enhance advice opportunities?**

**Martin:** If one considers traditional solutions, in many cases the relationship between the advisor and client reaches the end phase once the client purchases a life annuity. There is a single point in time where advice is required.

Contrast this with a world where client needs can be better met with a blend of a living annuity and a life annuity. In this structure, the life annuity becomes one of many components within a living annuity. An advisor can therefore continue to be involved in advising clients during their retirement years, for example, about how to manage expenses in the context of returns, when to protect income, and how much income to protect. These all require ongoing advice.

The new structure of the living annuity provides the flexibility for a client and advisor to decide when to share risk and how much risk to share. And at the same time, the client can retain some exposure and some possibility of upside potential on investment growth.

Because the Guaranteed Annuity Portfolio is a new component and not a new product, it means that advisors can make these decisions, not only for new clients but also for existing living annuity clients. It is simply a switch instruction.

We have also aligned advisor fees to be relevant for this ongoing advice opportunity and the continued value that can be added.

**What are the returns that a client can expect from a Guaranteed Annuity Portfolio?**

**Fareeya:** The Guaranteed Annuity Portfolio, as part of a living annuity, introduces a very different type of asset class with a very different type of return profile. It is an insurance contract, so the underlying return is a function of both the guaranteed return and how long the client lives and not only the investment return that we are familiar with for other asset classes.

For example, let's consider a 65-year-old client in a guaranteed income product where the income increases at 5% every year. This client will receive the investment amount back after 10 years or by age 75. Thereafter, the client will receive the investment amount back again every two to three years. Someone who lives until 95 will have received income more than five times the amount that they initially invested. This translates to an internal rate of return of more than 12%.

**A client who lives less than 10 years would not receive his capital back in income. Is there a way to mitigate this?**

**Martin:** That is also true, which is why life annuity products have the guaranteed term feature. Basically, a guaranteed term is the minimum period for which the income is paid, regardless of how long the client lives. So, for example, if the same client chose a guaranteed term of 20 years, the minimum return would be around 2.5 times the initial investment amount, which translates into an internal rate of return of around 9.3%. Of course, the client and advisor will need to consider this in the context of the decrease in income that a guaranteed term introduces, which depends on the client's age.

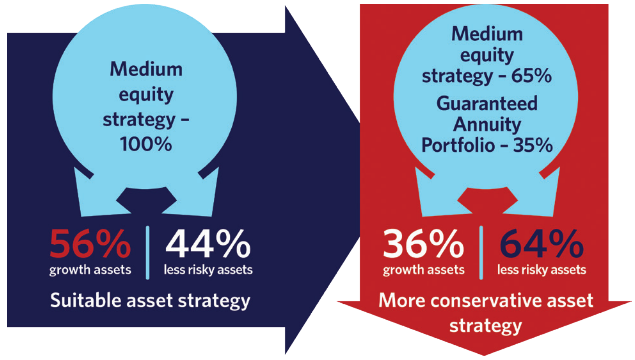
**You mentioned diversification as a benefit. How does an allocation to the Guaranteed Annuity Portfolio achieve this?**

**Fareeya:** A life annuity should be viewed as a separate asset class with unique risk and return characteristics. By including a Guaranteed Annuity Portfolio in a client's portfolio, financial advisors can formulate a different view on the risk capacity on the balance of the assets. The best way to explain the potential impact is by using an example.

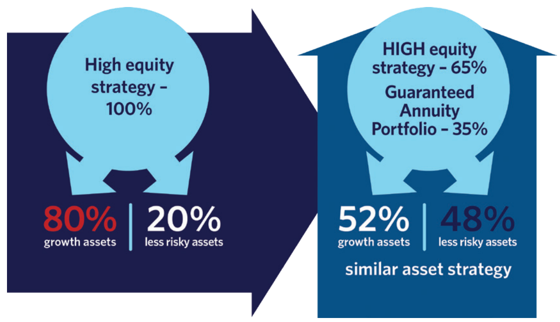
Let's assume that the suitable asset strategy for the client is a medium equity investment. This typically has 56% invested into equities and property, with the balance invested in bonds and cash.

Let's further say that the advisor and client decide to protect some of the income by using 35% of the capital to purchase a Guaranteed Annuity Portfolio within the living annuity. The balance of 65% is invested into a medium equity investment.

If one recalculates the exposure, seeing the Guaranteed Annuity Portfolio as a different asset class, the overall allocation to growth assets in the living annuity drops from 56% to 36%. This is likely to be overly conservative for this client.




If the advisor combines a higher equity investment portfolio with the 35% investment into the Guaranteed Annuity Portfolio, the exposure to growth assets becomes roughly similar, at 52%, to the medium equity scenario. So, by introducing protection on a portion of the income, the advisor can now choose to pursue a more aggressive asset strategy on the market-linked assets, with a view to potentially achieving higher growth rates on that part of the investment.



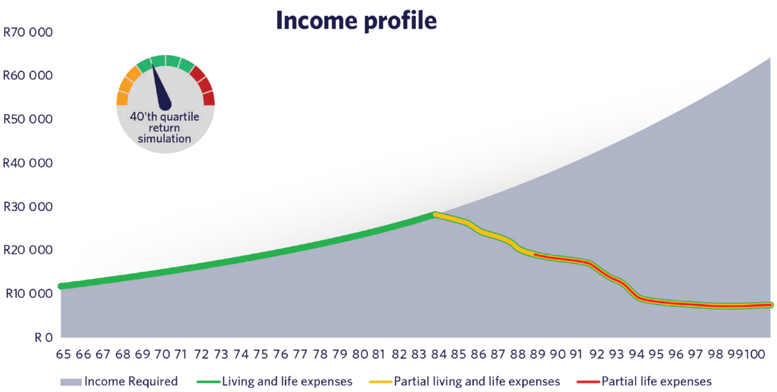

**We have discussed advice and diversification. You mentioned a third benefit being the sustainability of retirement income. Is sustainability the definition of success in retirement?**

**Martin:** Investing is personal and success in retirement is different for each client. For very high net-worth clients, the aim is likely to increase the capital value and draw the minimum income so that they can leave a legacy. But for most clients, successful retirement means being able to receive an income for as long as they live and ideally have the income increase with inflation. The reality is that many clients have not saved enough for retirement. Combine that with a low-return environment and it becomes very difficult to be confident of a successful retirement.

A protected income means that a client will never run out of money. On at least a portion of the income, the client can be certain of the outcome. Including a Guaranteed Annuity Portfolio in a strategy introduces a floor below which a client's income will not be at risk. And the results of our analysis show this quite strongly. The Momentum Investments' analysis shows that including a guaranteed portion can increase the sustainability of a client's income by as much as 10 years.

**That is quite powerful. Tell us more about these results.**

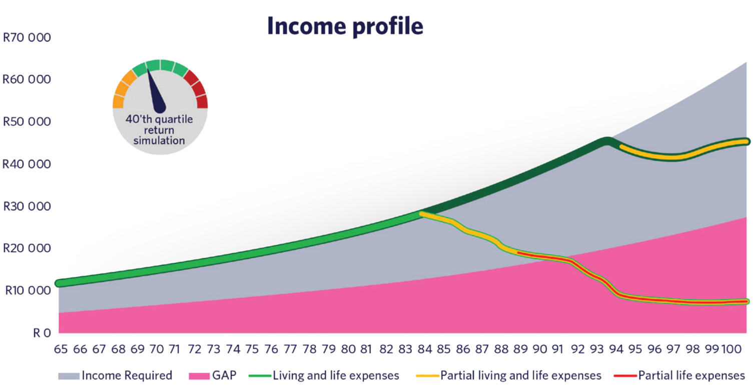
**Fareeya:** We used an average case study where the client is 65-year-old with R2-million to invest in a living annuity. We assume that the client needs an income of 7% (or R140 000) in year one and that the income has to increase by 5% every year. Let's also assume that half of his expenses are fixed life expenses, and that the client invests in a medium equity strategy.




Our marketing actuary, Martiens Barnard, ran 2 000 return simulations that showed that in 40% of cases, the best-case scenario would be that the client's required income can be met until age 83. Thereafter, the income starts to drop.

From age 89 onwards, this client's income will have dropped to less than half of what is required. This means that from age 89, the client will not be able to cover even the basic life expenses that they have.

He then assumed that 35% of the capital was used to purchase a Guaranteed Annuity Portfolio inside the living annuity and re-ran the results.




There are two important effects to observe after the Guaranteed Annuity Portfolio was added. Firstly, instead of starting to reduce at age 84, the income only started to reduce at age 94. So, there were 10 more years that this client could receive the full income required.

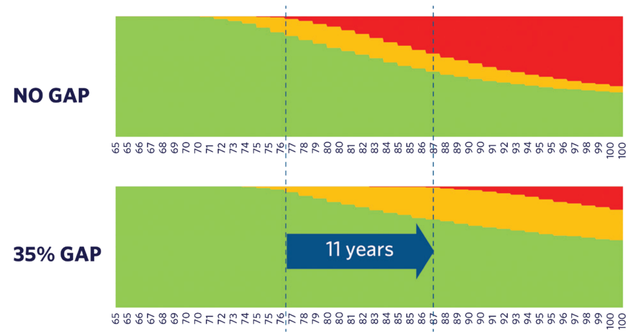
Secondly, there is no red line in the graph. This means that even though the income reduced at these older ages, it was always more than 50% of what was required. The consequence of this is that the client was always able to meet the essential life expenses.

So, based on our earlier definition, the chances of a successful retirement increased.

**Does the inclusion of a Guaranteed Annuity Portfolio mean that a client will always have a successful retirement?**

**Martin:** Including a Guaranteed Annuity Portfolio in a living annuity does not mean that a client will always receive the income that he requires. There will still be situations where a client has not saved enough for retirement and the income that he can expect to receive will reduce.

The outcomes map shows the result of the 2 000 simulations in a medium equity portfolio. The green shaded area is the safe area where the client can meet all the income needs. The yellow shaded area is the part where the client's income is between 50% and 100% of what was required, and the red area is where the income is less than 50% of what was required. The first picture illustrates the effect of 100% invested into a medium equity portfolio. The second picture assumes 65% in a medium equity portfolio and 35% in a Guaranteed Annuity Portfolio.




Depending on the scenario, the inclusion of the Guaranteed Annuity Portfolio can have two effects: firstly, it can extend the time before the income starts to reduce, and secondly, even when it does fall, the extent of the fall will be limited. This is illustrated in the graph by the green area becoming bigger and the red area shrinking.

**What do you think will be the key differentiator on this solution?**

**Martin:** Overall, we believe that our living annuity product with the inclusion of a Guaranteed Annuity Portfolio, offers advisors the best possible solution for growth and protection over a client's lifetime. It is one unique structure and not two separate solutions. So, an advisor can provide holistic advice about balancing risk and enhancing diversification. The structure also allows for appropriate advisor remuneration.

We have taken away the pressure of making this decision once off. Advisors can choose to protect some of the client's income at the time when it makes most sense for that client's circumstances. It's another way that we at Momentum Investments are making retirement income choices very personal. ■