Advisory process for Living Annuities

Living annuities are popular investment vehicles that offer flexibility to retirees. However these types of investments require frequent servicing, to ensure that capital is not eroded. In light of current market conditions, clients run a greater risk of capital erosion and advisers are encouraged to review all clients currently invested in Linked Life Annuities.

Many of you will have noticed recent commentary in the financial media that recommends that investors in Living Annuities take extreme caution, especially in the current market conditions.

This is based on the fact that, unlike Life Annuities issued by a life assurer which provide a guaranteed income for life, pensioners who elect to receive an income through a Living Annuity are exposed to **three key risks**:

i. **Longevity Risk**: The risk of them outliving their capital (as there is no "pooling" of longevity risk with other pensioners) which will leave them without an income at some stage in their lives.

ii. **Investment Risk**: Pensioners who invest through a Living Annuity take the full investment risk, benefiting when returns are good but also seeing their "capital" reduce in periods of poor returns, which in turn impacts on the level of income they receive.

iii. **Income Variability Risk**: As the pensioner is bearing the investment risk in a Living Annuity, volatile investment returns from year to year means that their income from year to year is also volatile (assuming that they do not increase drawdown rates to "adjust" for this impact which increases the risk that they will outlive their capital).

The income drawdown rate selected on a Living Annuity, together with the investment performance of the underlying assets over time (and hence the asset allocation decisions made), are the two critical areas that need to be actively managed under a Living Annuity in order to mitigate these risks. We believe that in the current volatile markets, it is important for you to review these two areas with your clients to ensure that they remain appropriate.

This communication sets out the Liberty Group's views regarding markets and asset allocation, as well as product features that may be appropriate in the current circumstances.

Living Annuity parameter 1: Income drawdown rates

Liberty and STANLIB's Living Annuity new business quotes include a table showing the maximum recommended drawdown rate at different ages, and highlight on the quote where an income drawdown rate of greater than this level is selected.

This table of maximum recommended drawdown rates is shown below, and is loosely based on the income that can be secured by purchasing a Life Annuity with a 5% p.a. (proxy for inflation) escalation rate. This is appropriate as a guide since it reflects the cost of securing that income for life with an assurer given the pensioner's current age. Drawing an income of greater than this level is not prudent because it then assumes that:

- investment returns will exceed those that an assurer will earn on the assets backing its Life Annuities, and / or
- that the pensioner's expected longevity is less than the "average" for their age.

	Income as a % of capital	
Annuitant age	**Male**	**Female**
55 – 60	5.5%	4.8%
60 – 65	6.2%	5.4%
65 – 70	7.3%	6.2%
70 – 75	8.7%	7.3%
75 – 80	10.7%	8.9%
80 – 85	13.5%	11.2%
85 and older	17.5%	14.6%

Where your clients exceed this recommended drawdown percentage, we recommend that you review their financial needs and highlight the risks of outliving their capital.

However, it is important that you understand the context of the information displayed in the table above and apply it appropriately to the particular situation. For example, it is important that in assessing the appropriateness of the income drawdown rate to also consider other sources of income that the pensioner is receiving. Depending on the size of these relative to that being drawn from the Living Annuity, different decisions on the income drawdown rate may be appropriate.

To assist you in this regard, from February the annual communication to pensioners with a Living Annuity will highlight where their income drawdown rate is higher than that advisable in order to provide an income for life. This can be used as the starting point for this discussion.

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Living Annuity parameter 2: Asset Allocation

In reviewing the appropriate asset allocation strategy for pensioners with Living Annuities, we believe that there are three areas that advisers should consider:

i. The view on markets over the next 12 to 24 months
ii. The tax status of investment returns on different asset classes within a Living Annuity
iii. The appropriate long term strategic asset allocation appropriate to the individual

Each of these is discussed below.

STANLIB's view of markets over the next 12 months

Domestic View

We believe that a significant decline in short term interest rates will have a positive impact on the market, especially in the financial and cyclical industrial sectors. This is, however, offset by the risk that the global slowdown could last longer than anticipated and our local economy could also slow down more than expected. We could potentially also see base commodity prices remaining flat and precious metals such as platinum may be more sensitive to world growth than previously thought. Both latter estimations would be dire for a resource heavy index like the JSE.

We believe that there will be significant pressure on corporates this year, with a recovery into 2010, and as a result we currently expect equity market returns of between 0 and 15%. Within the equity sectors, we are overweight Financials; neutral Industrials and underweight Resources.

In the current environment it would be prudent to remain cautious on equities in the short-term (6 months). However, there is good reason to look to increase exposure to the equity market as the year progresses and it becomes clearer that the global economic recovery is taking hold.

Offshore View

The uncertainty about offshore stock markets over the next year or two is the highest in living memory. Ongoing market turmoil along with weak fundamentals such as soaring unemployment makes forecasting in this environment extremely difficult.

There is only likely to be a muted recovery at the beginning of 2010, with housing remaining under pressure until 2011. But despite this, so far the MSCI World Index remains 8% higher than its November 2008 low.

So, we expect the MSCI World Index to put in a performance of between -15% and +15%. We anticipate that offshore bonds will produce a return of 0% to 10%, and cash will return 1% this year.

It would be advisable to remain cautious on all foreign asset classes due to their current volatility over the short term. This is supported by the fact that the Rand is currently undervalued. As the global economic recovery starts to take hold and the Rand looks to be at more consistent levels, it would be recommended to start increasing your foreign exposure in order to maintain a truly diversified portfolio.

Tax status of asset classes under a Living Annuity

Under Living Annuities, pensioners do not pay tax on net rental income and gross interest received as they do within other investment vehicles such as endowments. This makes asset classes such as property, bonds and cash relatively more attractive under a Living Annuity when compared to equities.

This does not mean that equities are not a key component of an investment strategy under a Living Annuity, but rather that you should look to include weightings of property, bonds and cash in the strategic asset allocation put in place under a Living Annuity because the "tax disadvantages" of rental and interest income don't exist under this vehicle. By including these asset classes, investment risk is diversified, resulting in more stable returns from year to year.

What does this mean for asset allocation decisions?

Pensioners with LLAs are at the "disinvesting" stage of their life. This should influence their investment strategy as they cannot afford to lose capital and they want to restrict volatility so that they are not redeeming units at reduced market values just after a market fall in order to provide their income.

In determining a long term asset allocation for Living Annuities, Financial Advisors should look at two issues:

- How do they ensure that the pensioner's Living Annuity portfolio at least grows in line with inflation from year to year in order to ensure that income also grows in line with inflation? This requires exposure to "real" assets such as equities and property.
- What level of volatility in annual income can the pensioner accept from year to year? The less volatility in income that can be accepted, the greater the asset class diversification that should be put in place, and the greater the weighting to more "stable" asset classes such as unlisted property and cash.

Regulation 28 of the Pension Funds Act sets out parameters that trustees must adhere to in structuring the assets of retirement funds. In structuring a long term asset allocation for Living Annuities, these parameters are well worth revisiting, especially the following:

i. A maximum allocation to equities (local and offshore) of not more than 75% of the total assets.
ii. A maximum allocation to offshore assets (cash, bonds, equities and other asset classes) of not more than 20%.

In reviewing existing Living Annuities administered by Liberty Life and STANLIB, it is evident that many advisers have applied these parameters in their Living Annuity portfolio construction.

However, there are policyholders who have exceeded these limits, and we feel that it is appropriate that those financial advisers whose clients are in this position revisit these decisions with them and make changes where appropriate.

What other options exist for policyholders with Living Annuities?

Investors in a Liberty or STANLIB Living Annuity have until now had the option to convert their Living Annuity to a Life Annuity (where a life assurer takes the investment and longevity risk) at each anniversary of the contract.

Given the ongoing market volatility, Liberty and STANLIB have now decided to make this option available **at any time** during 2009. This will also enable you and your clients to take advantage of attractive annuity rates whenever they arise, since they are not always attractive at the anniversary date.

You should also consider an annual escalation in advising an appropriate Life Annuity construct. Inflation erodes the purchasing power of money very quickly, so do not ignore this very important consideration.

Please take this opportunity to review the situation of those of your clients who have invested in Living Annuities and to advise them accordingly.

If you have any questions, please contact your investment advisory team:

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