Dividend funds may help illa pensioners

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Sometimes it is wise to be happy with steady progress that does not aim at breaking records.

Recently, Personal Finance dealt quite extensively with the dangers facing pensioners with investment-linked living annuities (illas) who, in an attempt to maintain their standard of living, draw down too much money, particularly in their early years in retirement, while ignoring the long-term consequences. Once they realise they do not have enough money, too many of these pensioners try to shoot the lights out by choosing high-risk investments, because this is the only way – in their often hopeless quest to receive a higher income – they will be able to increase the value of their capital.

Pensioners who fall into one or both of these traps are normally desperately trying to make up for a shortfall in retirement savings at the time of retirement.

Recent figures collated by the Association for Savings & Investment SA (Asisa) on the drawdown rates of illa pensioners, as well as research by Alexander Forbes, shows an upward trend in drawdown rates.

Illa pensioners are entitled to draw down annually between 2.5 and 17.5 percent of the capital value of their retirement savings.

Research undertaken by a number of people over the past few years has shown that an initial annual drawdown rate of more than five percent of the capital value of an illa is likely to result in a pensioner depleting his or her capital before death.

The Asisa figures showed that the average annual drawdown rate was almost seven percent.

The Asisa and Alexander Forbes research did not deal with underlying investments, which in the past have also been a problem, with annuitants taking big bets with their savings, often when investment market bubbles have peaked, such as happened with information technology stocks at the turn of the millennium.

Financial advisers, however, seem to be doing their best to restrain over-exuberant illa pensioners, particularly since the advent of the Financial Advisory and Intermediary Services (FAIS) Act, which makes it obligatory for advisers to act with due care and diligence, and with the establishment of the office of the FAIS ombud, who can order compensation for bad advice.

However, there are still pensioners who believe they can outsmart the markets and increase their retirement capital.

The wise, on the other hand, consider a range of factors, in particular how to earn the best return on their capital while preserving its value.

One factor all illa pensioners should take into account is that, as they reach their seventies, traditional guaranteed annuities definitely start to look attractive, because they can offer even better yields than you could expect from an illa. The reason is that life assurance companies base their assumptions for guaranteed annuities on how long a pensioner will live on average. So the older you are, the more the life assurance company will pay.

It is also good to see that some product providers are increasingly dealing with reality and not trying to sell unsustainable investment returns. One such company is Marriott Asset Management (the company that sponsors the rugby referees), which promotes itself as the “income specialists”.

In a recent media release, Marriott pointed out that, unlike most general equity unit trusts, the mandate of its soundly performing Marriott Dividend Growth Fund makes no mention of trying to provide greater investment growth than the FTSE/JSE All Share index, the most commonly used performance benchmark.

The stated objective of the fund is simply to provide investors with an acceptable dividend yield and growing levels of dividend income.

Marriott says the Dividend Growth Fund’s good performance can be attributed to “its income-focused investment style, highlighting that investment value growth is ultimately driven by income – the drivers being income yield and income growth.

“Re-investing income allows for the accumulation of additional capital. Income growth results in capital value growth. The combination of the two is what increases the rand value of any investment.”

Marriott points out that when it comes to equity investing, income growth is generally the biggest contributor to investment value growth over the longer term, providing income growth in excess of inflation. And the more reliable the income growth, the more predictable the growth in investment value.

Illa pensioners would do well to consider such funds, because their potential higher yield and reliable income may assist in avoiding capital erosion, and they could well produce income growth in excess of inflation.

But again it will also come down to not withdrawing an excessive pension.