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Index shows income of new retirees severely impacted

South Africans about to retire were hit by a double whammy in 2008. Not only are equity markets at long-time lows, but interest rates are also volatile. The sharp changes in interest rates resulted in the Sanlam Asset Liability Index (SALI) – an index of retirement pension cost approximating the price of pension annuities – recording its highest-ever monthly return in July this year.

Head of product development at Sanlam Investment Management (SIM) Johan Redelinghuys, explains that equity markets only affect the capital available at retirement, but this capital amount still has to be converted to a fixed monthly retirement income. “The cost of this income is determined by the level of long-term interest rates, and any changes in the level impacts on this conversion cost”

Not only did the person about to retire have less capital available due to the fall in the equity markets, but the July SALI return means that the cost to lock in a particular monthly pension rose by 23.2 percent in one month – the proverbial “double whammy”. “Practically this means that instead of retiring on R10 000 per month, for example, an individual will now only receive R7 680 per month, an amount locked in permanently.”

The new high came as a result of lower future inflation and interest rate expectations as Brent crude oil eased its tremendous rally, dropping from USD145 to USD124 per barrel at the time.” Redelinghuys also attributes the increased SALI return to dramatic changes in long bond yields, as seen in a drop in the ten-year bond yield from 10.7 percent to 9.2 percent.

“Over a one year horizon, the cost of retirement as measured by SALI is still frighteningly volatile with a standard deviation of 17.56 percent per annum. Compare this to equity markets which are known to be volatile, with a standard deviation only marginally higher at 19.61 percent per annum.” This is illustrated in the graphs at the end of this release which show the returns given by SALI (Mature) and the FTSE/JSE All Share, backdated to 1988.

Looking ahead, Redelinghuys said that economists predicted the overall economic situation could improve in 2009. “They were expecting a marked deceleration in inflation through next year led by slowing food and petrol price inflation and ultimately lower core inflation in response to a more stable rand. However, the recent volatility in the exchange rate may have a negative impact,” he said.

Redelinghuys advises, “As with all investment planning, the individual should not be concerned with short-term volatility when investing with a long-term horizon. However, as one approaches retirement date the asset allocation should be changed periodically, with a view to reducing volatility and, consequently, risk to both equity markets and interest rates.

“Traditionally this has involved reducing the exposure to equities, which was perceived to be the only risky investment. However, we have hopefully demonstrated that the volatility of interest rates and the impact on retirement income cost demands as much attention, and investors should consider increasing exposure to longer dated bond type assets (such as SALI) at the same time”, he concludes.