WHAT YOU SHOULD (AND SHOULDN'T) DO TO PROTECT YOUR RETIREMENT SAVINGS

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The single-biggest investment of most employed people is their retirement savings. And the closer you are to retirement, the bigger the pot is likely to be, particularly if you have saved throughout your working life.

The market chaos sparked by over-greedy American bankers has slashed about one-third off the value of the JSE since its peak in May this year.

As a result, your pension fund and retirement savings are, to a greater or lesser extent, going to feel the pain, because most retirement funds have stock market investments.

Every retirement fund member and pensioner is probably asking the following questions:

- Should I be worried?
- What can I do, if anything?

Obviously, you should be worried, particularly as we do not know how all this is going to play out. Over the past 12 months, many commentators have said "this is the end of the fall".

My view is that the contagion is still spreading and that things may still get worse before they start to get better.

However, the extent to which you should be concerned, as well as what you can and should or should not do, will be determined by how close you are to retirement and the type of retirement fund to which you belong, and, if you are retired, what type of pension you have.

In answering these questions more precisely, I have divided this column into three areas: the build-up to retirement; near or at retirement; and in retirement.

IF YOU ARE AT LEAST 10 YEARS FROM RETIREMENT
Should you be worried?

During your working life you will witness numerous booms and crashes in investment markets. These bear and bull cycles have been getting shorter and shorter, and the overall trend in equity markets has been up.

If you are a member of a defined contribution fund, the current market crash can, surprisingly, be to your advantage. The reason is that your contributions are being used to buy shares relatively cheaply. This will be to your benefit when investment markets start rising again, because you will own a lot more shares than you would otherwise have owned had share prices not fallen. So although your pension is not guaranteed at retirement, you could well be better off in the end than you may expect.

If you are a member of a defined benefit retirement fund, you have even less reason to worry. Your pension is defined and guaranteed, based on the number of years to which you belonged to your fund and your final salary at retirement.

What you should or should not do

If you have money to save and you can derive a tax advantage by saving, you should consider saving more through a retirement annuity (RA) or by increasing your contributions to an RA. You will be investing in a cheap, tax-incentivised investment.

But two words of warning about RAs:

- Don't commit yourself to a contractually inflexible, recurring-contribution life assurance RA. Rather go for a contractually flexible unit trust-type product where you can stop or reduce your contributions at any time without incurring a penalty.
- Only invest money that you will not need. You cannot withdraw your money from an RA until the age of 55.

If you have debt, rather use the extra money to pay it off. With the current high interest rates, the interest you will not pay on repaid debt is probably the best guaranteed tax-free return you can receive at the moment.

IF YOU ARE AT OR NEAR RETIREMENT
Should you be worried?

You could have a problem if you are a member of a defined contribution (DC) retirement fund.

If you are a member of a defined benefit (DB) fund, you obviously do not have a problem, because your pension is guaranteed.

If you belong to a DC fund, the extent of your problems could be determined by how far you are from retirement, your underlying investment choices and the type of pension you intend to purchase.

- **Retirement date.** The further you are from retirement, the more likely it is that the markets will recover in time for your savings to regain the ground they have lost since May. The closer you are to retirement, the greater the problem, because there is less time for a recovery. If your savings have lost value, you will currently receive a lower pension than would have been the case if you had purchased it in May, when your savings were worth more.
- **Underlying investment choice.** Most retirement funds offer a choice between at least a market-linked or related investment, which will rise and fall in value in line with the underlying investments, and a portfolio (product) that is fully or partially guaranteed.

No retirement fund is allowed to have more than 75 percent of its assets in equities. This reduces the risk, even for market-linked retirement portfolios. The extent of your problem depends on what percentage of your savings is in equities. Some of the sting will have been taken out of the equity market crash if your underlying investments were made through what is called a lifestage fund where, to reduce risk, the holdings in the underlying asset classes are gradually adjusted (your exposure to equity markets is reduced) as you approach retirement.

A guaranteed portfolio is likely to be either a life assurance guaranteed product or a cash portfolio.

If you have a guaranteed product, you are better off today than if you were in a market-linked portfolio. But guaranteed products are not without their potential problems, particularly if the meltdown is long term.

* A capital-guaranteed, smooth/stable bonus product. These products are based on retaining a portion of the profits made in the good years to pay out bonuses (returns) in the bad years. Although you are protected today from the market crashes of the past two months, you will feel the effects in the longer term, particularly if the downturn is sustained.

If the drop in value is significant and sustained, there could be a number of consequences, including lower future bonuses. This is because the returns on the underlying investments are low, it will be necessary to rebuild bonus reserves and any non-guaranteed returns (non-vesting bonuses) from past years could be removed. This last tactic is rarely used.

* A cash portfolio. Although you are protected from the failed markets, your main danger is inflation.

Money market accounts are currently paying about 12.5 percent, but the inflation rate is now at 13.6 percent. This means your money would be losing value, albeit not nearly as quickly as it would be if you were invested in shares.

The one danger you do not have to worry about is that South African banks or life assurance companies are at risk of collapse, as are their counterparts in the United States.

Although our local banks have done their share of irresponsible lending (hence our high interest rates), they are not directly exposed to the subprime home loan pandemic. The life assurance companies are also not exposed to the pandemic and have capital adequacy requirements well beyond the required minimum.

The type of pension you intend to purchase. You essentially have three pension choices:

* A fully guaranteed pension, which could be a level pension for life or one that increases to cancel out the effects of inflation;

* A with-profit pension that is guaranteed, but the annual pension increases are dependent on the returns of the underlying investments made on your behalf by a life assurance company; or

* An investment-linked living annuity (Illa), where you take all the investment risk and must draw down a pension equal to between 2.5 and 17.5 percent of the annual value of your retirement capital.

Your now depreciated capital means you will receive a lower pension than you would have a few months ago. A guaranteed pension of any type will cost you more. So you will be locked into a lower pension for life.

One thing going for you is the current higher interest rates, because guaranteed pensions lock in the prevailing long-term interest rates.

With an Illa, you have less money than before the market crashed, so your returns are likely to be lower. Once again, you will receive a lower pension than you would have a few months ago.

What you should or should not do

If you belong to a DB fund, you do not have to do anything. You will be paid your defined pension. If you are a member of a DC fund, your best option is to delay your retirement.

If you have reached your official retirement date and are forced to retire, you should consider an Illa as a first choice. You will be buying the equity portion of your underlying investments at comparatively cheap prices, which means you will have an advantage when prices recover.

You should not ignore equities. If you avoid equities altogether, it is likely that you will miss out when markets recover. Market recoveries are often more rapid than crashes.

Research both in South Africa and abroad shows that you should be at least 40-percent invested in equities if your capital is to provide a pension for life. Although it is the most volatile asset class, equities have historically provided superior returns.

IF YOU ARE ALREADY ON PENSION
Should you be worried?

The extent of your worries will depend on the type of pension you have. If you receive:

- **A life assurance guaranteed pension**, your pension and any guaranteed increases will not be affected. Your enemy is lower-than-inflation increases.
- **A life assurance guaranteed, with-profit pension**, the pension you are receiving now is guaranteed but future increases are under threat. Increases to with-profit pensions are determined by the returns the life assurance company receives. A portion of the underlying investments will be in equities and so will have been affected by the equity market crash. If the market does not recover in the short term, the returns in the underlying investment portfolio will drop and with them the potential for any pension increases.
- **A pension from a defined benefit pension fund**, your pension is not under threat, but, depending on how soon equity markets recover, you may receive a smaller increase than in recent years or no increase. Fund trustees award increases on the basis of how well the fund's investments are performing. Most funds aim to provide pensioners with increases that are at least equal to 75 percent of inflation.
- **An investment-linked living annuity (Illa)**, you could be in for a bit of a rough ride, particularly if equity prices stay where they are for any length of time. If you maintain your current withdrawal levels, you will be drawing down on your capital at a faster rate than you were a few months ago.
- **What you should or should not do**
  If you have a guaranteed pension or receive a pension from a defined benefit pension fund, there is nothing you can do. If you face no or lower-than-inflation pension increases, you will be forced to reduce your retirement lifestyle. Among other things, you may need to consider downsizing your home. It does not matter if you sell during depressed housing market conditions, as you will be buying in a depressed market.

- If you have an Illa, you must not panic. If your investment decisions - particularly about how much to invest in each asset class (equities, bonds, cash and property) - were based on sound reasoning, they are still valid. The steps you should take are:

  ***** Calculate the percentage increase in your pension relative to your retirement capital. For example, if at the last anniversary date on which your percentage drawdown is based, you were withdrawing an annual amount equal to five percent of your retirement capital, you may find that you are now withdrawing eight percent. Remember, in rough terms, in order for your capital levels to recover to where they were before the crash, you will need to earn double the investment growth that you have lost for the same period of time as the market downturn lasts.

  * If you have a versatile Illa that allows you to draw down from a particular part of your asset base, you should draw from the cash element and leave the equity element well alone until it recovers.

  * Consider withdrawing a lower pension and cutting your monthly spending. This includes deferring any major expenditure, such as purchasing a motor vehicle or taking an overseas holiday.

  * If there is still some time to go until your Illa's annual anniversary, when you can change the percentage you may draw down as a pension, you should still consider reducing your monthly expenditure and keeping aside what you save. On your Illa's anniversary, you can reduce your percentage drawdown for the next annual cycle and use what you have put aside to increase your monthly income, thereby reducing the pressure on your capital. The important thing is to take action now and not to postpone what will become the inevitable if this turns out to be a medium- to long-term market downturn. No one knows whether we have reached the bottom or how long this downturn will last.