

# RA is still the best option

With their transparency, retirement annuities provided by unit trusts are recommended, writes BRENDAN PEACOCK

**A**RE retirement annuities (RAs) still worth investing in, particularly with world markets in the doldrums?  
Lingering perceptions of a lack of flexibility and transparency in retirement annuities, coupled with the recent promotion of do-it-yourself retail investments such as exchange-traded funds, might have you wondering whether you could get better returns — and personal control — elsewhere.  
But, when you consider the tax breaks and enforced discipline involved with RAs, experts say, you are still better off going this route for retirement savings.  
According to a study by 10X Investments, South African equity, bond and cash returns have been well above the norm — typically inflation plus 5% — for the past 15 years.



■ VIGILANT: Steven Nathan

“Those who have contributed regularly and who have preserved their retirement funds on changing jobs have been well rewarded,” said 10X Investments CEO Steven Nathan.  
Nathan added that local investors should expect lower returns in coming years, with moderate to below-

average returns possible. This is where investors with RAs start to worry about fees and the underlying structure of their portfolios, and rightfully so. However, the new breed of RA products on the market provide both transparency and lower fees, in addition to handy tax breaks.  
“High returns have partly shielded investors from the ruinous impact of high investment costs. Paying 2% per annum in fees is less onerous, although no more acceptable, when the real portfolio return is 9% per annum than when it is 5% per annum — at that rate, you lose almost half your investment returns to fees,” said Nathan.  
According to Nathan the average South African RA fund levies 3% in total fees every year. “The onus is on investors to become ever more vigilant on fees.”  
In the context of most investors aiming for an income replacement ratio of at least 60% at the point of retirement, fees can have a significant impact on your post-retirement lifestyle.  
If many funds charge relatively high fees, why use RAs in the first place?  
“Firstly, there are significant tax advantages you can’t get with a reg-

ular investment. Over the period of a working life, the value of tax savings becomes significant. If you compare two lump sums invested into an RA and another fund, with all else such as fees being equal over the long term till the age of 65, you’ll get 30% more out of an RA at the point of retirement,” said Nathan.  
“The second benefit is that it’s a highly disciplined form of saving. You’re committed and the payout upon maturity at the age of 55 or later is predetermined, where you can take a third of the total value as a lump sum and convert the other two-thirds into a living annuity. I think this is a positive because it ensures that your money will last at retirement and not be taxed, which is what you want it to do,” Nathan added.  
There is a perception that RA performance seldom shoots the lights out. Nathan said it would never be wise to fool with your retirement income, but provided your time horizon was long enough, there was no reason to be in a low-risk portfolio.  
“If you save for 40 years and put

## The tax benefits

**ACCORDING** to Marriott Asset Management, the tax deduction for contributions is based on a number of factors and is currently the higher of:  
● 15% of taxable income, other than from retirement funding employment;  
● R3 500, less pension fund contributions; and  
● R1 750.  
RA earnings and gains are exempt from income and capital gains tax, and income earned (such as dividends and interest) within any RA is tax-exempt.  
However, Marriott points out that while contributions are deductible and returns are exempt from taxation, the annuities drawn, whether sourced from capital or earnings, are included in an individual’s taxable income.

15% of your income into an RA, after fees and inflation you only need to achieve 3% net growth (above fees and inflation) to meet your typical retirement goals for income replacement. You don’t need to beat the market — if you get market-related returns, history shows you’ll be just fine in meeting retirement goals if you’re invested for long enough,” Nathan said.  
“If you have less than five years to retirement, equity markets are risky and there’s a 30% chance of making a loss in the equity markets, no matter what the markets look like. So, that’s the time to go more conservative. However, for any time horizon over 10 years, return expectations can be adjusted higher with up to the maximum of 75% equities, provided they’re properly diversified,” said Nathan.  
Practically speaking, there is little difference between an RA and

investments in other types of funds, according to Marriott Asset Management, which said new-generation RAs are investment-linked.  
Investment-linked RAs give investors the ability to select the composition of their own portfolio from different unit trusts. Marriott also pointed out that you should be aware of layered fee structures —

some RAs charge lower fees charged within the RA itself, but may earn fees from each underlying unit trust within the RA.  
According to Marriott, investors should choose a provider based on level of fees, service and the ability to provide investment choice.  
Galileo Capital director and 2011 financial planner of the year Warren Ingram said in a low-growth environment you should only invest in RAs where the total annual fee is below 2.3%.

“If you can save 1% per year in fees, this will increase your growth by 15%. The total fee includes: the fund cost + the adviser cost + the RA (or platform) cost. History shows us that low-cost investments tend to be excellent performers over long periods of time. I would continue to contribute to my RA in the current economic conditions and would make full use of the tax exceptions that apply.  
“RAs that are provided by unit trust companies are very transparent with regard to fees and the performance of your actual investment within the RA. In addition, many unit trust companies provide the RA at no cost provided you invest in that company’s unit trusts within the RA.  
“You can normally switch be-

*‘Traditional RAs purchased from insurance companies? I would certainly not recommend them to my clients’*

tween unit trusts in your RA at no cost and the service levels are pretty good. I cannot say the same for traditional RAs that are purchased from insurance companies. Their service levels are generally poor and I would certainly not recommend them to my clients,” Ingram advised.  
“There are a massive range of investments available to RA investors and to some extent investors determine their own performance potential in the choices they make within the RA.  
“There are however, some safety measures that have been built into all RAs (called prudential investment guidelines) that limit the percentage of your RA that can be invested in shares. This means that you cannot invest more than 75% of

an RA in shares and the balance needs to be invested in bonds or cash. This is still a very high allocation to shares and should not deter people from investing in RAs,” explained Ingram.  
“I only recommend RAs provided by unit trust companies, and you can invest in these directly through the unit trust company. The total annual fee must be as low as possible (aim for 1.75% a year plus VAT as a total annual cost) and you should not pay any upfront costs for an RA. If you get offered an RA by an adviser who wants to charge an upfront fee, find another adviser. I think younger people can generally select RAs with the maximum exposure to shares (75%) while people who are closer to retirement might reduce their exposure depending on their financial position,” said Ingram.  
“You should never have all your RA invested in cash, at all times you should have a minimum of 35% in shares to get proper inflation protection.  
“If you do not want an RA, but you would still like to invest for the longer term, I would suggest an exchange traded fund — they are excellent, low-cost investments. For cash investors, I suggest the RSA Retail Savings Bonds,” Ingram said.

## Why retirement annuities?

**CAMERON** McCallum, wealth manager at Netto Financial Services, said by using RAs, investors can defer their tax liability from when they are working (and thus tend to have a high taxable income) to when they are retired (and tend to have a lower taxable income).  
“This means that if they are in the 40% marginal tax bracket, they can save tax at 40%, but pay tax at a much lower rate while in retirement.  
“There is also a R315 000 tax-free portion on retirement fund lump sums that investors can

take advantage of when retiring, as well as additional tax rebates available to those over 65, which make it possible to further reduce one’s effective tax rate in retirement.  
“We certainly believe that investors should be making use of new-style unit trust RAs to reduce their tax liability while investing at the same time,” McCallum said.  
“Many of the most popular unit trust funds are now available as new-style unit trust RAs. This allows for complete fee transparency and the ability to switch

between the various unit trust funds.  
“The availability of the unit trust funds and the flexibility with regards to switching between funds depend on the platform that the investor is using.  
“Different administrators have different unit trust fund offerings and switching rules. However, we tend to caution investors against switching funds too frequently as we have seen too often that chasing the previous top short-term performers seldom results in out-performance,” said McCallum.