# Set a retirement target you can achieve

**_BUSINESS/PERSONAL-FINANCE/FINANCIAL-PLANNING/FINANCIAL (/BUSINESS/PERSONAL-FINANCE/FINANCIAL-PLANNING/FINANCIAL)_**

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It is “unrealistic” for members of many employer-sponsored retirement funds to expect to retire on 70 to 75 percent of their pre-retirement income, according to a Harvard professor and a local actuary.

Professor Robert Merton, a finance professor at the MIT Sloan School of Management and emeritus professor at Harvard University, and Shaun Levitan, the chief operating officer and co-founder of investment manager Colourfield Liability Solutions, say many South Africans who belong to defined-contribution funds believe they will receive this level of income in retirement, because it is referred to so often.

(At retirement, defined-contribution funds provide members with their contributions, those of their employer and the investment growth on these contributions.)

However, just as many people believe the Great Wall of China can be seen from space, although it cannot, the reality is that most fund members will not retire on 70 to 75 percent of their pre-retirement income, Levitan says.

The percentage is known as the replacement ratio, because it tells you what percentage of the income you earn before retirement will be replaced with a pension in retirement.

Levitan and Merton say that achieving a replacement ratio of 65 percent will be “challenging” for most members of defined-contribution funds.

You may not be on track to retire on 70 to 75 percent of your pre-retirement income, but there are things the trustees of your fund can do to ensure you have a greater chance of achieving an appropriate income target, and they can enable you to make meaningful decisions about the income you want.

Levitan and Merton will present a paper to the Actuarial Society of South Africa's annual convention later this month in which they will:

* Argue the case for members of defined-contribution funds to focus on the income that their retirement savings will provide, rather than the capital they will have accumulated by the time they retire.

Merton wrote an article, "The crisis in retirement planning", for the *Harvard Business Review*, in which he outlined the problem that has arisen as a result of the global move from defined-benefit funds (that guarantee a pension based on pre-retirement income) to defined-contribution funds.

* Outline how trustees should set a default investment strategy that takes into account your age, accumulated savings, contribution rate, salary and years to retirement, and that will provide all members of the fund with an appropriate income in retirement.

* Recommend that you be given the information you need to make decisions about your required income in retirement.

Levitan and Merton's paper points out that four things determine your income in retirement:

* How much you and your employer contribute to your fund;

* The investment returns your savings earn;

* How long you save for; and

* The cost of buying a pension (annuity) at retirement.

They say the Alexander Forbes Benefits Barometer shows that the average annual contributions (excluding group life premiums) by both employees and employers to most private sector employer-sponsored funds is between 12.1 and 15.7 percent of pensionable income.

Levitan and Merton say you can earn a real (after-inflation) average annual return of two percent on government inflation-linked bonds and 5.5 percent on local equities (assuming investment costs are met by any market out-performance).

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Given that regulation 28 under the Pension Funds Act prevents retirement funds from investing more than 75 percent in equities, Levitan and Merton say you can reasonably expect your retirement savings to earn a real return of 4.6 percent a year over your working

life.

Most retirement funds calculate their replacement ratios by assuming that members will contribute to the fund for 40 years – that is, start at age 25 and stop at 65 without withdrawing any of their savings if they change jobs.

Merton and Levitan believe it is more likely that a member will contribute for 35 years, mainly because most members start saving when they are about 30, but also because some members retire before 65.

They say you also need to take into account what it will cost to provide an income in retirement. They argue that an inflation-linked guaranteed annuity is the most appropriate pension, because this product:

* Provides an income that increases in line with inflation each year, which protects the buying power of your income; and

* Pays a pension for life, which means there is no risk of you outliving your savings, as there is with an investment-linked living annuity.

Using these assumptions, Levitan and Merton have calculated that, at a contribution rate of 12.5 percent for 35 years and assuming a real return of five percent a year, you will achieve a replacement ratio of only 54 percent.

If you and your employer contribute 15 percent, your replacement ratio will be 65 percent.

If your returns are closer to four percent, your replacement ratio will be lower.

Levitan and Merton say the replacement ratio is a good measure of how on track you are to reaching your targeted retirement income.

However, instead of setting an income target for the hypothetical member, trustees should tailor a replacement ratio for each member, based on the likely number of years of fund membership and possibly his or her gender. (Women tend to live longer than men in retirement and will therefore pay more than men of the same age for a guaranteed annuity.)

They say your personalised income goal should take into account how much you have already saved for retirement, how much you are

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contributing and the cost of buying an income at retirement.

If you join a fund at, for example, the age of 40, the trustees should reduce your income goal, because you have saved in another fund for the previous 10 years. However, if you did not save for those 10 years, or you didn't preserve all your savings, you could increase your contributions within the permitted tax deductions, which will increase next year for most members if tax amendments are implemented.

Alternatively, you could, within the limits set by regulation 28, expose your savings to more investment risk with a view to earning a higher return.

As you approach the level of income you require, your assets should be moved out of a portfolio aimed at achieving investment growth and into one that protects your required income.

Levitan and Merton argue that your fund trustees should assume that you need an inflation-linked income in retirement, which only an inflation-linked annuity can guarantee. The cost of this annuity, however, changes over time.

They say the way to protect yourself from a mismatch between the income you thought your retirement savings would provide and the annuity you will, in fact, be able to buy at retirement is to move your investments into inflation-linked bonds as you approach retirement. This approach is contrary to the one used by many retirement funds, which is to move your savings into cash or nominal bonds as you approach retirement – a strategy known as life-staging.

In their paper, Merton and Levitan show that, although moving your retirement savings into cash will protect your lump sum as you approach retirement, it will not protect your ability to buy a particular level of pension.

## EMPOWER YOURSELF: TRACK YOUR RETIREMENT INCOME

Scary calculations showing that achieving a retirement income of 75 percent of your pre-retirement pay is impossible can make saving for retirement seem futile.

But, as Andrew Davison, the head of implemented consulting at Old Mutual Corporate, says, taking control of your financial future is the first step on the road to financial security.

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In an article in Collective Wisdom, a publication included in Finweek magazine, Davison says messages that are intended to scare us into better financial habits can become negative reinforcement or frighten us into doing nothing. For example, we are constantly told that we don't save enough, make bad financial choices, borrow too much, don't preserve our savings when we change jobs, switch investments at the wrong time, driven by fear and greed, or are underinsured on everything from our golf clubs and jewellery to our own lives, he says.

To achieve financial security, you have to educate yourself, be aware of changes in your circumstances, and exercise restraint, he says.

Colourfield actuary Shaun Levitan says your retirement fund can help you by providing you with an annual benefit statement that shows the income you are on track to receive in retirement and not just your total savings or fund credit. Showing you only your fund credit is like showing you a bank statement and can promote wrong thinking and even bad behaviour on your part, Levitan says.

In a paper written with Harvard professor Robert Merton for the Actuarial Society of South Africa's conference later this month, Levitan gives the example of Lindiwe, aged 55, who receives a statement saying she has R1 million in her retirement fund.

"Lindiwe is thrilled to have R1 million in her account. She believes she is on track for a great retirement. This is largely based on her perception that R1 million is lot of money. The reality is that her account balance does not provide Lindiwe with any insight into her likely standard of living in retirement. She has a potentially false sense of comfort over her retirement provision," he says.

Lindiwe, like most members, is unable to determine whether the amount in her fund will be sufficient for her to maintain her current standard of living in retirement.

Instead, Lindiwe should receive a statement showing that her savings are sufficient to provide her with a pension in today's values of R6 100 a month increasing with inflation and guaranteed for the rest of her life. Her future contributions until her retirement age of 65 are likely to result in her having a further R1 100 a month (in today's rands) as a pension increasing with inflation (that is, a total of R7 200). Now, Lindiwe is in a position to decide whether or not this income is sufficient.

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If Lindiwe tells her fund she needs R8 000 a month in retirement, her

future statements will reflect that she has saved only 90 percent of her goal income.

Her statement could also provide her with information showing the impact on her future pension if she increases her contribution rate or delays her retirement date.

Her fund could also provide her with an option to adjust her exposure to growth assets in order to help her to reach her income goal.

Levitan says this information would empower Lindiwe to consider her options and would reduce the temptation Lindiwe may have to access her "pot of money" before retirement.

"Before spending millions of rands and hundreds of hours on educating members about financial concepts, we should try to interact with them meaningfully. Members understand information when it is presented to them in a way they already think. Communication in this way reinforces that our retirement funds are to provide for our retirement and that they shouldn't be treated in the same way as a bank account," Levitan says.

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