Vickers & Peters

LIFESTYLE AND ASSET PLANNING

"Around the Table with Vickers & Peters Financial Planning"

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Guiding you towards a comfortable retirement

Retirement is one of the most important life events many of us will ever experience. From both a personal and financial perspective, realizing a comfortable retirement is an incredibly extensive process that takes sensible planning and years of persistence. Even once it is reached, managing your retirement is an ongoing responsibility that carries well into one's golden years.

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While all of us would like to retire comfortably, the complexity and time required in building a successful retirement plan can make the whole process seem nothing short of daunting. However, it can often be done with fewer headaches than you might think - all it takes is an attainable savings and investment plan, and a long-term commitment.

In this issue, we'll break down the process needed to plan and implement a retirement plan that will allow you to enjoy a comfortable retirement.

Why do we need to plan for retirement?

To plan a successful retirement, we need to understand *why* we need to take our retirement into our own hands in the first place. This may seem like a trivial question, but you might be surprised to learn that the key components of retirement planning run contrary to popular belief about the best way to save for the future. Further, proper implementation of those key components is essential in guaranteeing a financially secure retirement. This involves looking at each possible source of retirement income.

- **Banking on your employer fund or a government subsidy**

A social security system relies heavily on a growing work force, making it possible to support the demands of a government sponsored retirement scheme. An ageing population (advances in heath care is increasing life expectancy), and a decreasing working population holds the potential to put significant strains on the system and could

leave governments with no other viable option but to reduce social security benefits or suspend them altogether for all but the poorest of the poor.

Employer pension plans aren't immune to shortcomings either. Corporate collapses can result in stock options or shareholdings being wiped out in the blink of an eye. Defined-Benefit pension plans, which are designed to guarantee participants a specified monthly pension for the duration of their retirement years, actually do fail every now and again, sometimes requiring increased contributions from plan sponsors, benefit reductions, or both, in order to keep operating. In addition, many employers who used to offer defined-benefit plans are now shifting to defined-contribution plans because of the increased liability and expenses that are associated with defined-benefit plans, thus increasing the uncertainty of a financially secure retirement for many.

These uncertainties have transferred the financing of retirement from employers and the government to individuals, leaving you with no choice but to take your retirement planning into your own hands.

- **Unforeseen Medical Expenses**

While the failure of a social security system may not occur, planning your retirement on funds you don't control is certainly not the best option. Even with that risk aside, it's important to realize that social security benefits will never provide you with a financially adequate retirement. By definition, social security programs are intended to provide a basic safety net - a bare minimum standard of living for your old age.

Without your own savings to add to the mix, you'll find it difficult, if not impossible, to enjoy much beyond the minimum standard of living social security provides. This situation can quickly become alarming if your health takes a turn for the worse.

Old age typically brings medical problems and increased healthcare expenses. Without your own retirement fund, living out your retirement in comfort while also covering your medical expenses may turn out to be a burden too large to bear - especially if your health (or that of your loved ones) starts to deteriorate. As such, to prevent any unforeseen illness from wiping out your retirement savings, you may want to consider obtaining insurance, such as medical (in-hospital benefits) and long term insurance (disability and critical illness) to finance any health care needs that may arise.

- **Estate Planning**

Switching to a more positive angle, let's consider your family and loved ones for a moment. Part of your retirement savings may help contribute to your children or grandchildren's lives, be it through financing their education, passing on a portion of your retirement savings or simply keeping sentimental assets, such as land or real estate, within the family.

Without a well-planned retirement fund, you may be forced to liquidate your assets in order to cover your expenses during your retirement years. This could prevent you from leaving a financial legacy for your loved ones, or worse, cause you to become a financial burden on your family in your old age.

- **The flexibility to deal with life's little knocks**

As we all know, life tends to throw us a curve ball every now and then. Unforeseen illnesses, the financial needs of your dependents and the uncertainty of pension and medical aid schemes are but a few of the factors at play.

Regardless of the challenges faced throughout your life, a secure voluntary fund with short term liquidity options will do wonders for helping you cope. Financial hiccups can be smoothed out over the long term, provided that they don't derail your retirement plan in the short term, and there is much to be said for the peace of mind that a sizable emergency fund can provide.

In the 2010 Berkshire Hathaway shareholder newsletter Warren Buffett highlighted the importance of liquidity as a condition for *assured* survival. He included a letter that was sent in 1939 by Ernest Buffett (Warren Buffett's grandfather) to his youngest son Fred (Warren Buffett's uncle). Ernest never went to business school but understood the importance of having cash on hand. The letter can be read at the end of the article on page 10.

Implementing your retirement plan

- **Starting early**

While it's not difficult to understand that building a sufficient retirement fund takes more than a few years' worth of contributions, there are some substantial benefits to starting your retirement savings plan early.

One of the most important determinants impacting how large your retirement fund can get is the length of time you let your savings grow. The reason for this is that the effects of compounding become very powerful over long periods of time, potentially making the duration of your retirement savings plan a much more critical factor than even the size of your monthly contributions.

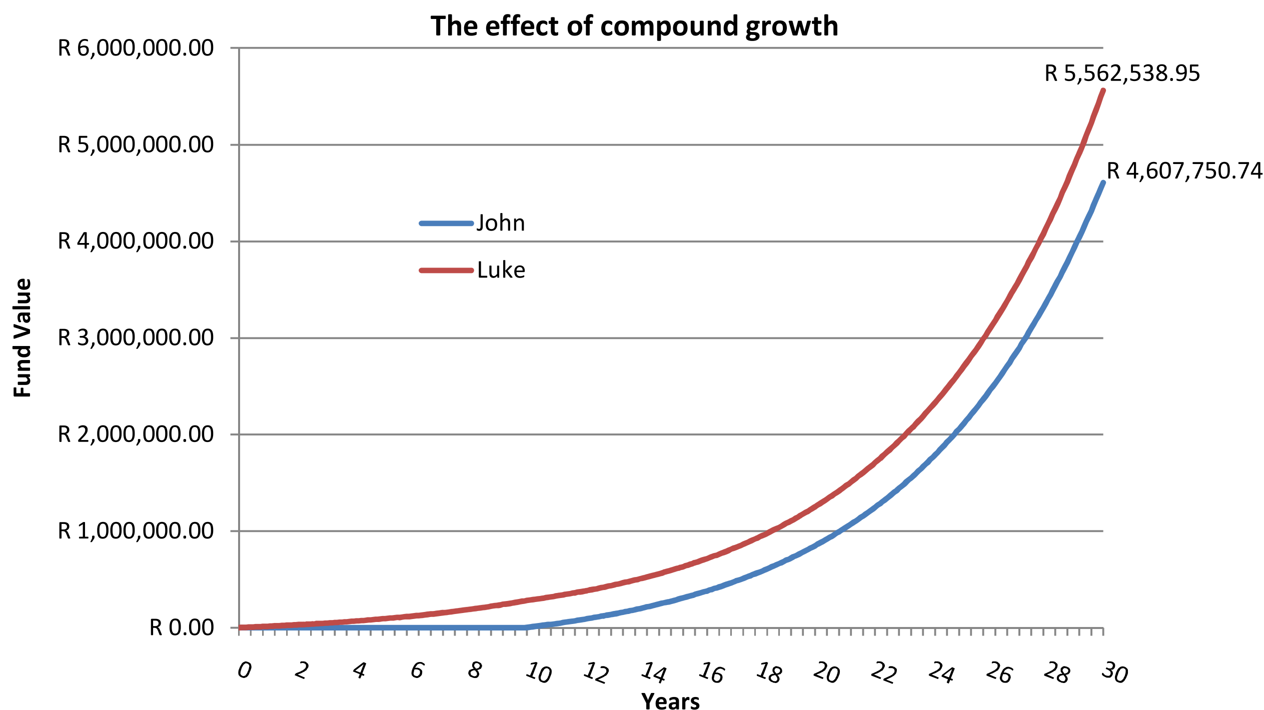
The bottom line is if you don't start saving for retirement early on in your working life, it will be more costly trying to play catch up later on. It's much easier to put aside a small amount of money each month starting from a young age than it is to put aside a large amount of money each month when you are older. Unless you have other serious financial pressure to take care of, such as large credit card debt, you should seriously consider starting to save for your retirement as early as possible.

For example, consider the hypothetical case of Luke and John, two 24-year-olds. Luke makes R1,000 monthly savings contributions for 10 years and then never makes another contribution ever again. John makes no contributions during those 10 years, but then makes R3,000 monthly contributions for the next 20 years. Assuming a 15% constant growth rate for both investors, who comes out ahead?

The answer, somewhat surprisingly, is that even though John contributed three times as much each year for twice as long, he ends up with the smaller fund because he started late!

The graph below tracks their progress, starting at the end of their first working month:

Graph 1



Source: Vickers & Peters Financial Planning (Pty) Ltd

In fact, even if John keeps paying R3,000 monthly (while Luke contributes nothing) until the end of time, he will never catch up to Luke, provided they both earn the same 15% annual growth rate.

Another way of looking at it is how much more you will have to save to get 90% of your salary at retirement. **Table 1** below shows that for every 10 years that you delay your savings, you need to almost double the amount you save!

Table 1

Retirement at Age 60			
Start Age	**25**	**35**	**45**
% of salary you need to save for 90% income at retirement	15%	25%	47%

Source: Liberty

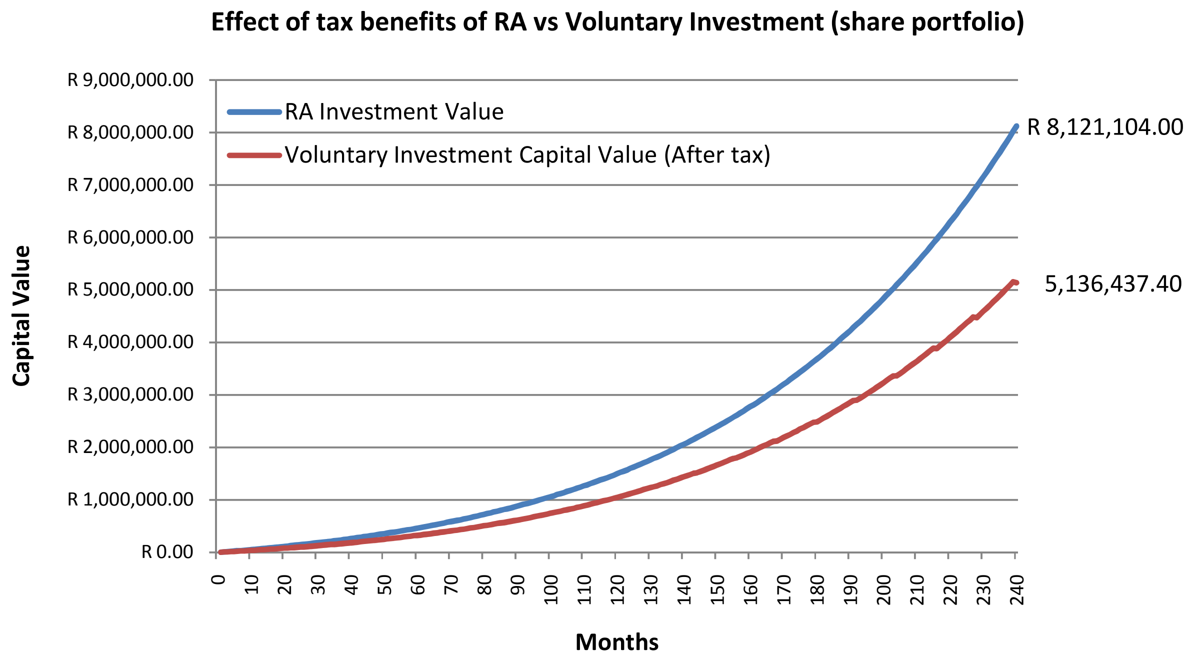
As you can see, it really does pay to start your retirement savings early.

- **Make use of tax efficient savings vehicles**

The power of compounding works when it comes to taxes, too. It's vitally important that you use retirement products such as Pension, Provident and Retirement Annuities (RA) as much as possible while carrying out your retirement plan, since they will afford tax effective benefits. Currently, interest earned and capital gains tax (CGT) is 0% for all retirement products. In addition, creditors cannot claim funds held in any Pension, Provident or RA investment. When you buy an annuity on retirement, creditors also cannot claim the capital value. What may surprise you, however, is how substantial the effects of deferring taxes can be over the long term. Again assuming an annual 15% growth rate on investments, 50% of the portfolio invested in interest bearing assets and an individual marginal tax rate of 30%. Consider two investments of R5,000 invested

monthly for 20 years, one in a tax effective Retirement Annuity and the other in a taxable account such as a share portfolio or unit trust fund. Assume the monthly contribution in the share portfolio is after tax and that taxes are paid each year on all interest earned (after the annual interest exemption of R22 800.00 is deducted). The end result after 20 years is that taxes leave the share portfolio's value well short of what was achieved by the RA. **Graph 2** below details just how much value can be created by utilizing a tax effective retirement product. The bottom line is to begin saving for retirement as early as possible and take full advantage of whatever tax saving opportunities are available for as long as you can.

Graph 2



Source: Vickers & Peters Financial Planning (Pty) Ltd

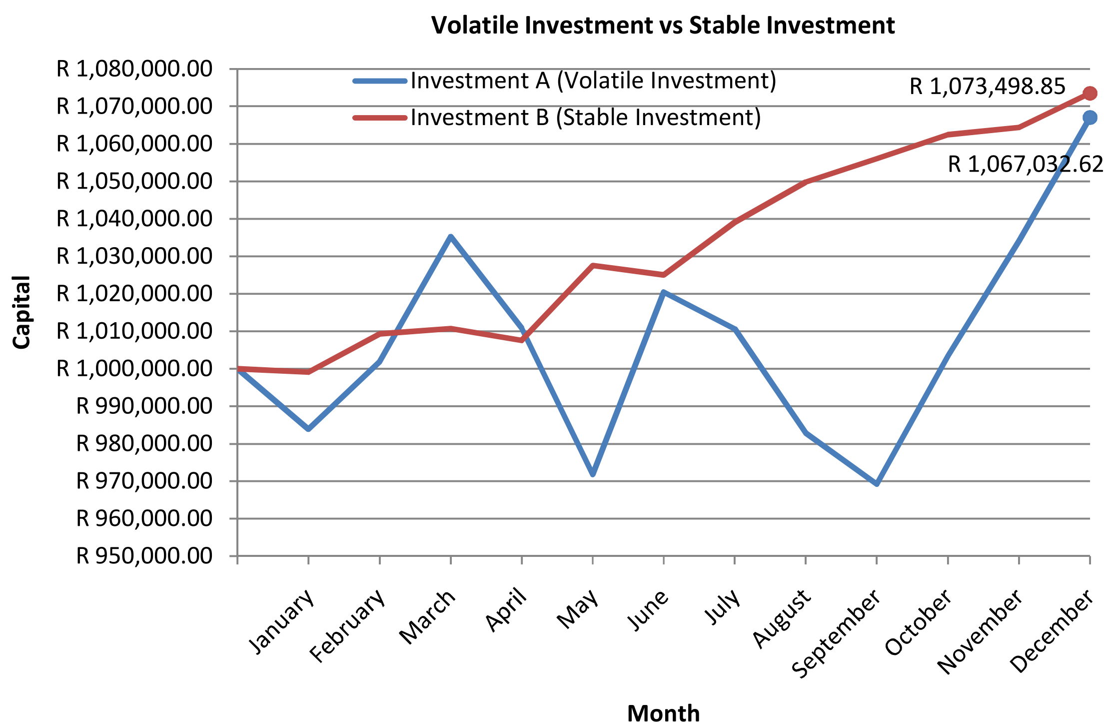
- **Choose a good investment manager that delivers reliable performance**

As a retiree, it's not only the level of return that is important but the manner in which the return is delivered. In other words how much risk was taken by the fund manager to achieve the level of return? Consider the following example illustrated in **Graph 3** below: two investments, Investment A and Investment B, both with a starting capital value of R1 million, both have the same one year return of 12%, both investors withdraw 5% per annum or R4 166.67 per month. Investment A annual return has been achieved with monthly returns ranging between both negative and positive monthly returns while Investment B return as been achieved with only positive monthly returns i.e. no negative months – see **Table 2** below. Although the annual withdrawal and return figures are identical for both investments, the year end capital value of Investment B is higher. The reason for this is simply due to the compounding effect of Investment B having consistent positive monthly returns versus the variable positive and negative monthly returns of Investment A.

Table 2 – Monthly Investment Returns

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
Investment A	-1.20%	2.26%	3.75%	-1.96%	-3.45%	5.44%	-0.56%	-2.33%	-0.97%	3.97%	3.47%	3.58%	**12.00%**
Investment B	0.33%	1.44%	0.55%	0.10%	2.39%	0.17%	1.77%	1.44%	0.99%	1.00%	0.57%	1.25%	**12.00%**

Graph 3



Source: Vickers & Peters Financial Planning (Pty) Ltd

At VPFP we believe the best way to achieve consistent positive returns is by actively managing the client's portfolio asset allocation. By blending the optimal level of growth assets (high return, high risk trade off) with interest bearing assets (low risk, low return trade off) we are able to achieve the investors target return whilst taking the least amount of risk.

For retirees drawing an income, adequate exposure to growth assets is imperative, especially in the early years of retirement i.e. don't be ultra conservative and get stuck in a money market portfolio. The VPFP Funds have an optimal asset allocation mandate set relative to each VPFP funds benchmark, so the investor need not worry about asset allocation decisions, fund manager selections or whether or not the portfolio is sufficiently exposed to growth assets.

Lastly, if you assess your manager's performance over one year, expect to chase your tail. Short term returns are demonstrably random. It is statistically unlikely that an asset manager will not have a good year in a five year period – all managers have good and bad years. Whether good or bad, investment managers have very little control over the outcomes in the short term. What we do look to control is the process of decision-making and making sure that it is sound, sensible and consistently applied. When you assess performance over meaningful periods (5 or 10 years) you will find only a handful of managers who consistently deliver.

- **Don't cash out your retirement savings before retirement**

The current workforce is very mobile. It is estimated that new entrants to the workforce will have an average of seven employers during their careers. An industry survey showed that people cash out their pensions 90% of the time when changing jobs and end up paying tax on their retirement savings. Although most individuals will need to supplement

a retirement shortfall because their employer retirement fund is inadequate, retirement funds remain the cornerstone of an individual's retirement provision. Therefore it is important to see these funds as sacred and untouchable until retirement, despite their accessibility on termination of employment.

If you contribute 15% of your salary to retirement savings for five years, your retirement fund will be roughly equal to about one year's salary. It may seem easy to replace that money, but the missed opportunity of compound growth on that money is what really costs you at retirement:

If one assumes that you will save for 40 years towards retirement, the first five years of saving represents 12.5% (5/40 years) of your total retirement contributions. However, on retirement this amount represents 22% of your total retirement savings due to the compound growth on the investment. So, nearly a quarter of your final investment value is built up from only the first 5 years of retirement contributions.

To replace that value of withdrawal, you would have to increase your savings to 20% for the next 30 years. This becomes more difficult because your available income for savings tends to decrease as your responsibilities (home and school payments) increase.

Withdrawing your retirement benefits also has tax implications, as the amount withdrawn will be taxed immediately and will also be deducted from the tax free withdrawal benefit that you would otherwise have at retirement. The withdrawal option should really be only seen as a safety net and not a slush fund. If a withdrawal has been made you should endeavor to build up the capital that you withdrew in another investment vehicle.

- **Plan for longevity**

Advances in healthcare technology and improvements in nutrition means that people are living longer and therefore life expectancy is increasing. A person retiring at age 60 today, can generally expect to live well into their 80s. Life expectancy is well ahead of where it was 20 to 30 years ago and needs to be considered when planning for retirement. The current South African life expectancy table is shown below:

Table 4

Age	Male	Female
60	81	84
65	82	85
70	84	86
75	85	87

Source: Coronation

- **Inflation anchoring**

A continuous debate in the retirement industry is how we view inflation and what measure should be used when planning for retirement. Headline inflation, as quoted in the media, is based on an average South African basket of goods. For those individuals who fall within the LSM 8, 9 and 10 grouping, there is a disproportionate exposure to healthcare, municipal rates, water and electricity – all of which we know increase annually by a rate far above that of the quoted headline inflation. What this means is that a retired person in this grouping is more likely to experience inflation of up to 10% as opposed to the average South African who currently experiences inflation of around 6%. Inflation is high and often its higher than we think. One therefore needs to be mindful of this when we do any retirement planning.

Note: The SAARF LSM (Living Standards Measure) has become the most widely used marketing research tool in Southern Africa. It divides the population into 10 Living Standards groups, 10 (highest) to 1 (lowest).

- **Late starters and catching up**

If you started late on your retirement savings plan unfortunately there is no easy short cut method we are aware of that can allow you to default to a comfortable retirement. However, it need not be the end of the world if you take the necessary steps to follow a disciplined savings plan and allow enough time for your retirement plan to get back on track.

- **Budgeting -** The first thing to do is create a budget for your current expenses so that you can maximize your monthly contributions to your retirement funding. With budgeting, a little goes a long way, and if you track your monthly expenses you will likely find ways to save money, which can go a long way to boosting your retirement savings. The main goal is to ramp up your savings rate as much as possible.

- **Debt finance -** If you do dig yourself into a deep hole of debt, it's important you deal with the problem as quickly as possible. Create a feasible budget to pay down your debt and stick to it. Consider consolidating your debts into one account - this can lower your overall interest rate and help you pay off those debts quicker.

- **Contractual savings -** set up automatic monthly payments from your bank account into the investment account. This is commonly referred to as "paying yourself first". Once it's set up, each time you get your pay cheque, your desired savings contribution will go from your bank account to your investment account before you have a chance to spend it.

  Automatic savings will make it a lot easier to avoid spending your contributions on things you can realistically do without. And if serious financial problems do crop up that require the use of your investment funds, you can access those that are deposited to an after-tax account (voluntary investment product) without incurring penalties. The point of the automatic contribution is to avoid any instances of spending too much and missing out on your contributions unnecessarily.

- **Investment portfolio –** it's vitally important to assume the correct risk profile from the start. Trying to catch up by simply investing in a high risk portfolio can derail your plan, resulting in another setback that could be irrecoverable. In consultation with your financial advisor the appropriate investment portfolio should be identified by matching your asset and liabilities profile with your retirement objectives. A prudent approach would be to forfeit the liquidity of a voluntary investment product and rather invest in a tax effective retirement product where the tax saving will guarantee a higher level of saving and offset the potential higher returns that could otherwise be achieved by been invested in a high risk portfolio.

- **Adjusting your retirement goals –** delaying access to your retirement funding, revising retirement lifestyle needs, working longer and finding alternative income sources are all options that could be taken into consideration to help implement a sustainable retirement.

Conclusion

Retirement planning is an ongoing, lifelong process that takes decades of commitment in order to receive the final payoff. The idea of accumulating millions of rands in a retirement fund certainly can seem intimidating, but as we outlined above, with a few basic calculations and a commitment to a feasible plan, it's not difficult to achieve.

Please contact your VPFP financial advisor to discuss your retirement plan.

In Summary

Pre-retirement tips

- Start early and invest in tax effective retirement funds (Pension, Provident, RA).
- Start an emergency fund to deal with short term needs.
- Choose a good investment manager and stick with them. Short term performance can be random and basing your investment decisions on recent experiences can be at the cost of future performance.
- Don’t cash out your savings before retirement – you cannot buy back lost years of compound growth and your tax free benefits on retirement will be lost.
- Choose 55 as your retirement age. You can always extend the age and it provides you with more flexibility around structuring your retirement.
- Save your bonus – you can build up your retirement fund by taking advantage of the tax free allowance and saving 15% of each bonus into a retirement vehicle.
- If you are starting late – increase your monthly contributions and start a contractual savings programme. Consolidate your debt and adjust your retirement goals if necessary.

Post-retirement tips

- Choose a suitable retirement income product. Both the Living Annuity and the Traditional (guaranteed) Annuity should be considered before making a decision.
- Plan for a higher inflationary environment.
- Keep saving a portion of your income so that you can build up a safety net for emergencies.
- Decide on a level of income high enough to fund an acceptable living standard but low enough to make this living standard sustainable. Implement a realistic retirement strategy.
- Invest in a fund that can limit the variability of returns from year to year and still be able to protect you against the eroding effects of inflation. Choose a fund that produces a reliable yield and a low risk of capital loss month to month. (The VPFP Funds which have benchmarks of 2%, 4% and 6% above inflation, can assist in developing a sustainable strategy).
- Adequate exposure to growth assets is imperative, especially in the early years of retirement i.e. don’t be ultra conservative and get stuck in a money market portfolio. (The VPFP Funds have an optimal asset allocation mandate set relative to each VPFP funds benchmark, so the retiree need not worry about asset allocation decisions or whether or not they are sufficiently exposed to growth assets).
- Your retirement income withdrawal level will NOT be sustainable if:
  - The annual income selection is above the annual fund yield.
  - Long term investment performance is unreliable.
  - Longevity is not considered in the retirement plan. (Living beyond your life expectancy)

Dear Fred & Catherine:

Over a period of a good many years I have known a great many people who at some time or another have suffered in various ways simply because they did not have ready cash. I have known people who have had to sacrifice some of their holdings in order to have money that was necessary at that time.

For a good many years your grandfather kept a certain amount of money where he could put his hands on it in very short notice.

For a number of years I have made it a point to keep a reserve should some occasion come up where I would need money quickly, with out disturbing the money that I have in my business. There have been a couple occasions when I found it very convenient to go to this fund.

Thus, I feel that everyone should have a reserve. I hope it never happens to you, but the chances are that some day you will need money, and need it badly, and with this thought in view, I started a fund by placing $200.00 in an envelope,with your name on it, when you were married. Each year I added something to it, until there is now $1000.00 in the fund.

Ten years have elapsed since you were married, and this fund is now completed.

It is my wish that you place this envelope in your safety deposit box, and keep it for the purpose that it was created for. Should the time come when you need part, I would suggest that you use as little as possible, and replace it as soon as possible.

You might feel that this should be invested and bring you an income. Forget it -- the mental satisfaction of having $1000.00 laid away where you can put your hands on it, is worth more than what interest it might bring, especially if you have the investment in something that you could not realize on quickly.

If in after years you feel this has been a good idea, you might repeat it with your own children.

For your information, I might mention that there has never been a Buffett who ever left a very large estate, but there has never been one that did not leave something. They never spent all they made, but always saved part of what they made, and it has all worked out pretty well.

This letter is being written at the expiration of ten years after you were married.

Ernest Buffett

"Dad"

Market Update – *by Tarryn Cameron of Celtis Capital*

Macro Overview

Volatility and risk aversion persisted through the second quarter on the back of the unrelenting debt crisis in Europe, while fears of a global economic slow-down re-emerged.

Following the bailout of Portugal in May (the third such recipient of financial aid), the threat of Greek Sovereign debt default re-surfaced, lifting Greek bond yields to record highs in June.

The EU and IMF hesitated in extending a further loan to Greece, as policymakers called for Greece to implement tougher austerity measures. A possible default in Greece increases the risk of default in other EU members, particularly those that have already received bailout packages (i.e. Portugal and Ireland). In addition, the potential knock-on effects on banks that have outstanding loans to these countries are far-reaching. At the end of June, Greek lawmakers voted in favour of the new austerity measures required to secure the funding needed to meet its debt obligations through August, causing some of the recent risk aversion to subside.

Despite weaker European peripheral economies, the overall economic recovery remains positive. Surging inflation above target has led the ECB to hike interest rates by 25bps already, with markets pricing in a further 25bps hike in July.

Inflation remains a material risk globally with sustained high food prices and stubborn oil prices supporting upside pressure.

Finally, the US Federal Reserve wound up its USD600 billion QE2 stimulus programme on 30 June, the policy that was launched in November 2010 to prevent the US economy from relapsing into recession. Including QE2, the central bank has injected USD2.3 trillion into the financial system. While the stimulus did lift stock markets, it also helped boost oil prices which hurt consumers and helped little towards reducing unemployment or reviving the weak housing market. According to St. Louis Federal Reserve President James Bullard, the full effect of QE2 on the US economy could take up to a year to determine.

Performance – *what added and what detracted?*

Property and Bonds were the biggest gainers over the period. The relative appeal of local bond yields has attracted further foreign investment while offshore bond performance has been driven by safe haven demand. Local property strengthened in line with bonds.

Equities were the most volatile asset class over the period given the resistance to risky assets. Again, emerging markets underperformed developed markets on risk aversion. The rand also saw some weakness in line with a stronger US dollar as investors pursued the “safety” of US treasuries, adding to rand-based offshore performance.

Position going forward

The funds remain positioned for a globally higher inflationary environment, favoring equities and inflation-linked bonds, over fixed interest instruments. We are watching equities closely for signs of stability and seek to increase as valuations improve on current weakness. We also continue to watch our inflation-linked bond position and seek to increase further as valuations become more favourable.

It is in uncertain times like these that the importance of diversification is reiterated.

VPFP Fund Performance for the Period Ending 30 June 2011

	6 Month		12 Month		24 Month		36 Month	
	Return	**Risk**	**Return**	**Risk**	**Return**	**Risk**	**Return**	**Risk**
VPFP CPI + 2	2.62%	2.111	9.68%	2.39	20.91%	3.092	28.01%	3.739
Investment Objective (CPI + 2%)	4.39%		6.66%		13.78%		24.48%	
VPFP CPI + 4	2.04%	2.382	10.52%	3.115	23.26%	4.317	24.03%	5.510
Investment Objective (CPI + 4%)	5.40%		8.74%		18.27%		32.81%	
VPFP CPI + 6	1.46%	3.150	12.57%	4.922	28.07%	6.569	19.70%	8.603
Investment Objective (CPI + 6%)	6.41%		10.82%		22.85%		40.59%	

(CPI Benchmark as at 31 May 2011)

Source: MoneyMate

If you have any questions about your investment portfolio please contact your financial advisor on the details provided on page 7.

At your service…

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Our services include…

- Pre and Post Retirement Planning
- Local and Global Investments
- Business Assurance – Keyperson and Partnership
- Personal and Group Life Assurance
- Employee Benefit Advice and Products
- Tax and Estate Planning

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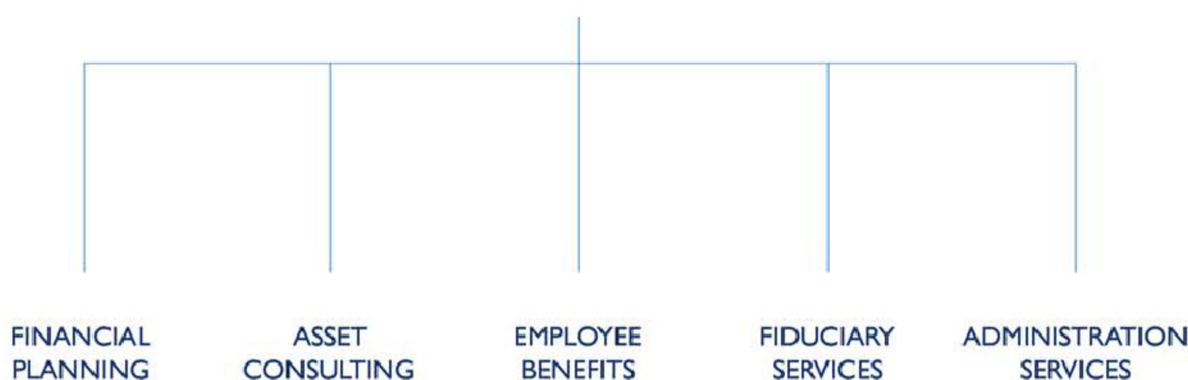

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