

PLANNING FOR RETIREMENT – BY FAIRBAIRN CAPITAL INVESTMENT INTELLIGENCE

We invest for various reasons but the one common investment objective we share is investing for retirement. This is an important issue as we spend a considerable portion of our lives in retirement.

The investment landscape for retirement can be divided into two broad phases:



Whilst there are few ways to guarantee the capital accumulated at retirement, there are several ways to optimise this amount:

During the Accumulation Phase

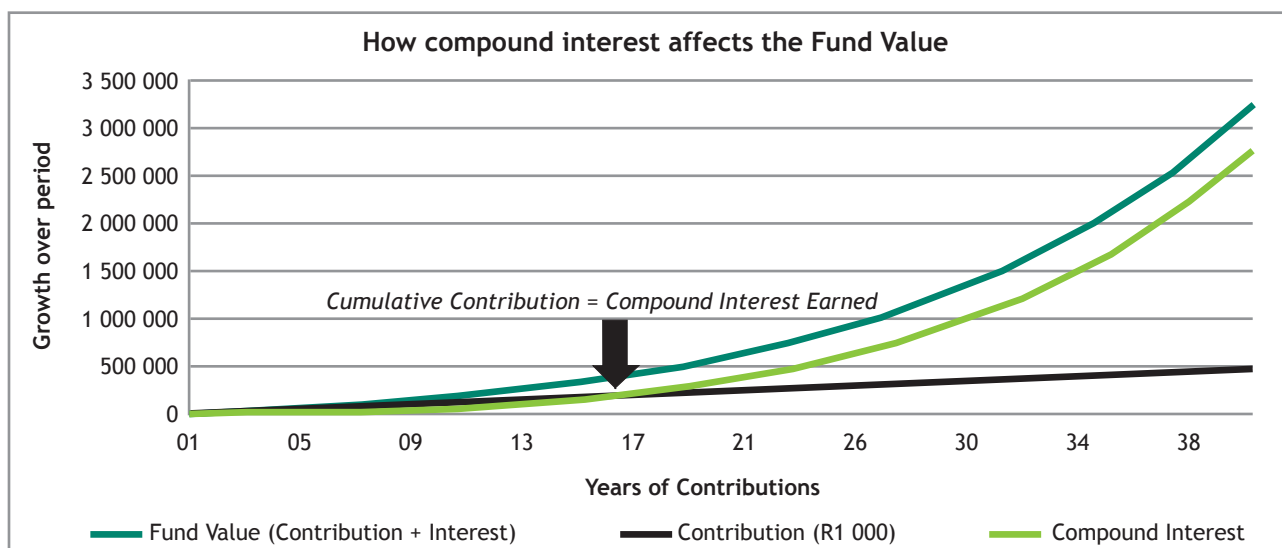
Start early

The Old Mutual Retirement Fund Survey 2010 revealed startling discrepancies between investors' expectations at retirement and reality. The findings were that 43% of respondents believed they had enough money to retire, when in reality only 26% actually had enough, with most people retiring on a pension equal to 28% of their final pay cheque. The average person has

at least 40 years to invest in a retirement fund (assuming you start investing when you begin working at age 25). However, the sad reality is that according to the Old Mutual survey the average period for which pensioners contributed to a pension or provident fund was only 27.5 years. The problem is that many pensioners are missing out on the power of compound interest.

Using a rather basic example: if you invested R1 000 a month for 40 years at a nominal rate of 8% per annum, at retirement you would have accumulated 50% more capital than someone who started investing 5 years later, and approximately 130% more than someone who started investing 10 years later. However, this example assumes that your contributions do not increase over the 40-year period; had they increased the effects would have been considerably larger. You may wonder why the investor with the 40-year period has such a large advantage at retirement, given that the head start was merely 5 or 10 years.

The chart below illustrates the contributions to the retirement fund (from the R1 000 per month) and the compound interest (interest earned on interest).





The fund value consists of the monthly contributions plus the compound interest over the 40-year period. From the 16th year onwards, the compound interest earned exceeds the contributions paid by the investor. By the end of the 40 years, the monthly contributions only constitute 15% of the fund value and the remainder is the compound interest earned. In fact, if you stopped contributing to the fund after the 16th year (when contributions are equal to compound interest) the value of the fund would still exceed that of an investor who started 5 years later and continued contributing for the next 35 years. Therefore, delaying the start of your retirement savings, by even a few years, could have a significant effect on the final value of your retirement savings.

Maintain some exposure to growth assets

A crucial part of saving for retirement is to ensure that the accumulated money grows in excess of inflation. The cost of living increases every year – sometimes significantly so – and investors need to ensure that their savings can keep up with and exceed this pace of increase. Put simply, a R100 today will not buy the same quantity and quality of goods and services as it could, say, five years ago.

One way to beat inflation is to invest in asset classes such as equities and property, which tend to beat inflation over the long term. These asset classes tend to be more volatile in the short term, as we've seen recently. However, investing only in conservative assets such as cash and bonds is unlikely to provide sufficient inflation-beating returns required for a comfortable retirement.

The average after-inflation returns for South African asset classes over the last 10 years, ending June 2010, were: equities 10.5% a year, bonds 6.3% a year, and cash 4.0% a year. Therefore, risky asset classes like equities, although volatile in the short term, tend to outperform other asset classes in the long term and saving for retirement is typically a long-term objective.

Reduce the risk in your portfolio by diversifying

Diversification will offer some protection against volatility in the market, without compromising financial freedom at retirement. Ensuring that "all your eggs are not in one basket" will ensure that if the market declines, the adverse effects will be minimised. If, for example, the market crashes shortly before your retirement date, an equity portfolio will decline accordingly but a diversified portfolio will decrease to a lesser extent. In summary, it is essential to hold all the asset classes (cash,

bonds, equity and property) to ensure that the best returns are obtained at the acceptable level of risk.

There are numerous balanced funds available to investors and Fairbairn Capital offers some of the better funds available in the industry within the stable growth and balanced growth categories of its Elite range of funds. These funds typically have a performance target of CPI + between 3% and 7%. As these funds target a real return, your spending power should comfortably keep up with inflation if they deliver on their objectives.

Consider using less aggressive funds closer to retirement

As retirement age draws closer, the main concern will be to protect the large capital base that you have built up over the years. Whilst adhering to the principle of diversification, it is possible to make use of less aggressive balanced funds. These are funds that typically still make use of the major asset classes – cash, bonds, equity and property – but have a low allocation to riskier growth assets. This reduces the risk within your portfolio, without compromising future inflation-beating returns. It is important to consider your investment needs as well as your risk preference when considering which fund to invest in.

During the Decumulation Phase (only applicable to Living Annuities)

Retirement

At retirement the greatest risk will be that of capital preservation. If you draw an income amount that exceeds the return on your invested capital then you start to erode your accumulated capital base. It is important to remember that your retirement savings are subject to three elements:

1. Your (and your employer's) contributions
2. Investment returns before retirement
3. Investment returns after retirement

Too much emphasis is often placed on the investment returns before retirement. However, equally important is the return on investment after retirement, as a considerable portion of our lives is spent in retirement. Pensioners should consider investing in funds with explicit capital protection objectives, which at the same time aim to optimise the income yield of the fund. Because of the risk of outliving your capital, it is prudent to maintain a certain level of exposure to growth assets such as equity and property. There are several funds within the Fairbairn Capital Elite range of funds suited to this objective.

ECONOMIC OVERVIEW By Felix Ubogu, Head of Investment Intelligence

The ongoing recovery remains intact but the slowdown in economic activity in the second quarter indicates that the recovery remains fragile. Some market commentators believe there is an increased probability of a double-dip recession. However, the probability remains relatively low, making a double-dip recession unlikely. There are two reasons for this – one is that it is hard to imagine a Lehman-sized crisis that can wreak havoc with confidence, and the second, central banks and governments remain committed to sustaining the recovery.

With interest rates in the developed world being at historical lows (near 0% in the US, 1% in Europe and 0.5% in the UK), this conventional policy tool of central banks is now unavailable. However, unconventional measures such as quantitative easing (increasing the supply of money) and reducing the interest rate paid on bank deposits held with the central banks are still available to central bankers.

The growth rate of most countries slowed in the second quarter. In the US the growth rate slowed to 1.6% and in China it slowed to 10.3% quarter on quarter. Japan's dismal growth saw it overtaken by China, now ranked the second largest economy and of increasing importance to resource-rich countries like South Africa.

Growth also slowed in the Euro-area but Germany's better than expected growth rate of 2.2% in the second quarter prompted its central bank to revise upward its 2010 forecast to 3%. The South African economy grew by 3.2% in the second quarter, compared with the 4.6% growth in the first quarter.

Concerns persist around the likely impact of austerity (belt-tightening) measures aimed at reducing sovereign debt in the developed world to more acceptable levels. Several European countries have announced spending cuts and tax increases in order to reduce their deficits. Austerity measures are one of the primary concerns fuelling fears of a possible double dip.

Uncertainty persists

Equity returns since the start of the year have been a tale of two halves. From the start of the year until the end of April, returns were reasonable. However, concerns about government actions to address their national debt levels have fanned fears of another recession. These fears have more than offset the gains in the first part of the year. Hence, eight months into 2010 and equity returns are still under water. Asian markets have been particularly hard-hit with Japan's Nikkei Index and China's Shanghai Composite Index experiencing much greater losses.

Major Equity Markets (year-to-date returns)





The return prospects in countries trying to trim national debt through austerity measures are not promising. As a result, emerging markets have benefited from significant foreign portfolio flows. This has been a contributing factor to the strength of the rand, which ended August at R7.37 to the dollar. Although a strong rand hurts exports, it has helped to keep inflation well within the 3% - 6% target, with inflation in July moderating further to 3.7%.

Interestingly, although equity markets have been in the red since the start of the year, several domestic balanced funds with exposure to equities have delivered positive returns. Balanced funds are typically allowed to allocate up to 75% of the portfolio to growth assets such as equities. The ability to generate a positive return in a volatile market is one of the advantages of delegating the important decision of asset allocation to professional active fund managers. At Fairbairn Capital, we pride ourselves on our ability to identify skilled active managers and offer our clients the opportunity to invest in their funds.

The market is riddled with uncertainties – for example, should the authorities continue to stimulate their economies or should they be more concerned about trimming their deficits? Hence, the last four months of the year may well be bumpy. One way to reduce your stress levels is to review your investment portfolio with your financial adviser or your broker to ensure that it remains relevant to your objectives, and subsequently view the balance as infrequently as possible to prevent panic switching.

We continue to remind risk-averse investors who choose to remain in cash that although cash provides peace of mind, over the long term, its returns are only marginally above inflation. Historically, the returns on growth assets such as equity and property have been significantly above inflation over the long term. Moreover, a weak global economy and low inflation may prompt the South African Reserve Bank to lower the interest rate at the next Monetary Policy Committee meeting, further reducing the returns on money market investments.

ENHANCEMENTS TO THE GALAXY CASH MANAGEMENT ACCOUNT (CMA)

As a result of your valuable feedback, we have made two new enhancements to the Galaxy Cash Management Account:

- You will now be able to choose to have your unit trust distributions reinvested either into your fund or into the CMA, depending on your financial objectives.
- Previously when there were insufficient funds in the CMA to cover 12 months' worth of fees and/or income, an automatic top-up was done. You can now choose whether you want this top-up to happen for one month or 12 months.

If you require further information or assistance regarding your investment choices, please contact your Old Mutual financial adviser or your broker.

Please note that while care has been taken to ensure that the information provided in this newsletter is correct, it represents an overview of the topics under discussion and as such does not constitute advice. We suggest that you contact your professional adviser before taking any decisions based on the information herein. Fairbairn Capital is an elite service offering brought to you by Old Mutual Investment Services (Pty) Limited and Old Mutual Life Assurance Company (South Africa) Limited, Licensed Financial Services Providers.

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