ISSUE 03
03

COROLAB

Your guide to investment ideas

THE INCOME AND GROWTH CHALLENGE

Featuring our Balance Defensive and Capital Plus Funds

THE INCOME AND GROWTH CHALLENGE

Investors who are near or already in retirement face the most challenging of investor needs: investing for both immediate income and long-term growth. The key challenge, is to ensure a sustainable living standard by balancing the needs of today with those of the future. The past 10 years have been very good to investors in local assets, and many retirees that expect a repeat of this experience may not be well positioned to cope with the tougher investment environment that is presently unfolding.

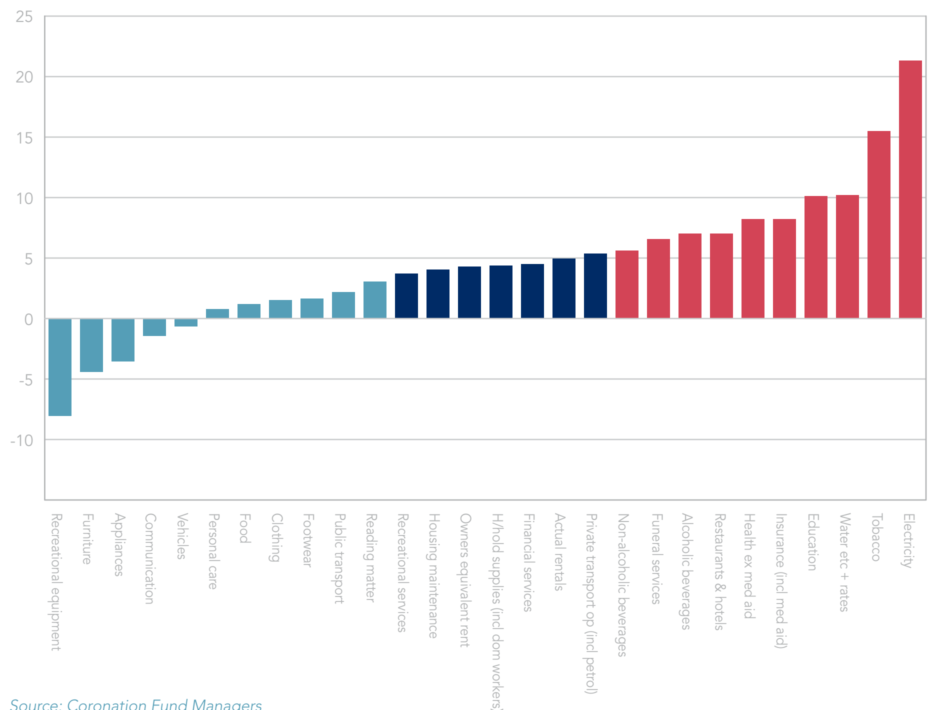
Given our lower return expectations for all the domestic asset classes, we believe investors with insufficient growth assets in their retirement portfolios may find themselves desperately vulnerable later in retirement. As such, we believe that most income and growth investors do not have enough exposure to growth assets, partly as a result of this exceptional period of superior performance.

In this issue, we discuss the most important considerations that investors with income and growth needs should take into account to ensure that their retirement planning is appropriately prudent.

1 Plan for higher inflation

Headline inflation, as quoted in the media, is based on the 'average' South African's basket of goods. However, older individuals in the higher income categories often have disproportionate exposure to healthcare, municipal rates, water and electricity in their basket of goods and services. All of these will continue to increase faster than quoted headline inflation (see Figure 1 for an example of how different spending categories influence the current inflation rate). Therefore, the prudent planner will likely conclude that it is sensible to make provision for a higher personal inflation rate than that recorded in the headline number.

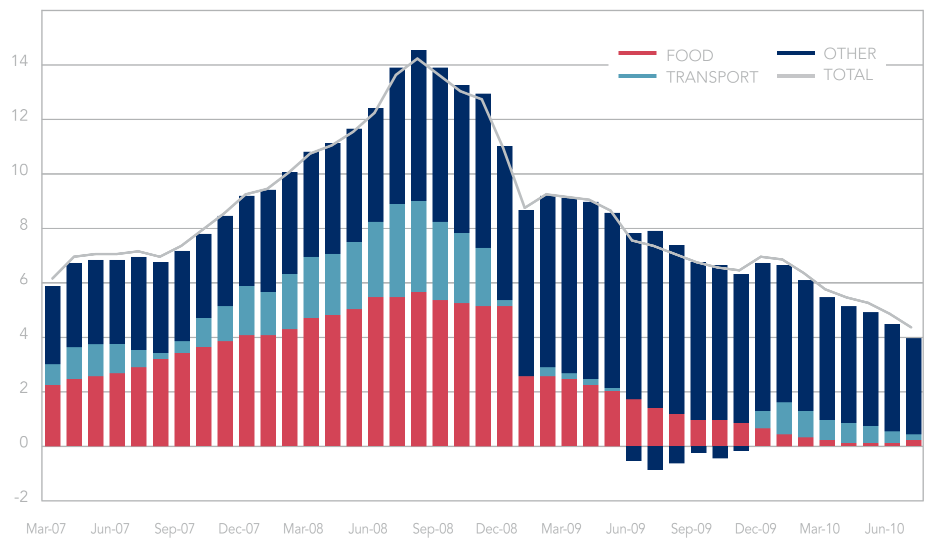
FIGURE 1 WHAT IS YOUR PERSONAL INFLATION NUMBER?
The CPI basket as at 31 July 2010



Source: Coronation Fund Managers

If one looks at the historical sources of inflation (Figure 2), it is notable that food and transport contributed significantly to the spike in inflation towards the middle of 2008. At that time, the price of oil reached $140 per barrel and the rand was trading at around R7.81. Today these two components are contributing almost nothing to overall inflation – but this will change eventually. Food and transport are big drivers of inflation and are unlikely to remain at current levels. The prudent planner will make provision for a significantly higher inflation rate than the current rate of 3.7%.

FIGURE 2 INFLATION CONTRIBUTION AS AT 31 JULY 2010



Source: Statistics South Africa

2 Plan for lower returns

EXPECT INTEREST RATES TO REMAIN LOWER FOR LONGER

The growth momentum of the global economy has started to slow. In the US, the rate of employment has fallen and weaker house sales are being recorded. Even the Chinese economy has lost momentum after a very strong run. In Europe the problems are even greater, with countries such as Greece, Spain, Portugal and the UK being forced to adopt tighter fiscal policies, cutting government spending and raising taxes in a bid to repair their poor financial balances.

We believe that central banks will keep interest rates at exceptionally low levels for as long as necessary. While many fear deflation, we believe the risk of keeping interest rates at close to zero for an extended period of time and printing money will ultimately result in inflation coming through in future.

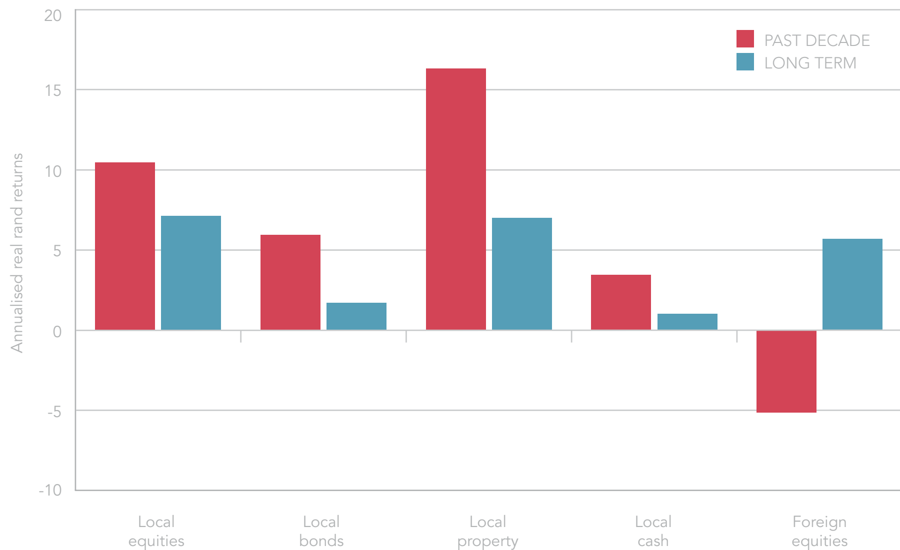
Against this background, we believe income and growth investors are at risk if they do not have enough growth assets in their portfolios. Growth assets are the most reliable means of protecting one's capital against the eroding effects of inflation.

2 Plan for lower returns

THE LAST DECADE IS NOT A GOOD BASIS FOR EXPECTED RETURN FORECASTS

Investors in local assets have been handsomely rewarded over the past 10 years. Equities and listed property in particular have delivered very strong real returns, while cash and bonds also did well. However, in Figure 3, we show that these returns are in fact far ahead of their long-term averages, and foreign equities are too far behind (as illustrated by the MSCI World Index). Using the past decade's performance as a guide for future returns therefore offers a poor basis for prudent retirement planning in our view.

FIGURE 3 ANNUALISED LONG-TERM TOTAL RETURNS PER ASSET CLASS
Past decade (to June 2010) versus last 110* years



** Shorter history for foreign equities (40yrs) and local property (30yrs)*

Source: Deutsche Bank, I-Net Bridge, Triumph of the Optimists – Dimson, Marsh and Staunton

In order to explain why we believe local assets are likely to revert to their long-term averages, one needs to consider the source of the past 10 years' returns.

The return on any asset class consists of two parts: income and capital appreciation/depreciation. In turn, the capital appreciation/depreciation leg consists of growth in earnings (in the case of equities) or rentals (in the case of listed property) as well as the positive or negative effect of a rerating of the asset class (in other words, how much more (or less) investors are willing to pay for an asset class).

Figure 4 shows that local shareholders benefited from company earnings that grew significantly faster than South Africa's overall GDP (6% after inflation for the All Share Index versus 3.6% for the economy) as a result of a decline in tax rates, muted real wage growth and expansion abroad. While equities have enjoyed a positive rerating of 1% p.a. over the past 10 years, the impact of earnings growth on the asset class's total return has been far greater.

2 Plan for lower returns

We believe that for company earnings to grow at a faster pace than the economy in which they operate is unsustainable, and we therefore expect lower returns from this asset class over the next 10 years.

Investors in income-generating investments such as bonds, and particularly listed property, benefited from a structural rerating made possible by a large decline in inflation and interest rates over the 10-year period. For this effect to be repeated, inflation in SA would need to fall to the 2%–3% range over the next 10 years, which we believe is unlikely. Given that distributions (in the case of listed property) and coupons (in the case of bonds) have already come down from the levels of 10 years ago. We believe that, for prudent retirement planning, investors need to assume a derating of these asset classes, rather than a rerating.

In Figure 5 we provide a 10-year forecast of what we believe the different asset classes are likely to deliver, solidifying why we believe it is prudent for income-and-growth investors to have enough exposure to growth assets in their portfolios.

FIGURE 4 ASSET CLASS RETURN ATTRIBUTION FOR THE PAST 10 YEARS
To June 2010

	ALL SHARE INDEX	LISTED PROPERTY	ALL BOND INDEX
TOTAL RETURN	16.4%	23.3%	12.2%
EARNINGS (DIVIDENDS, DISTRIBUTIONS OR COUPONS)	3.4%	12.1%	10.8%
CAPITAL GROWTH	13.0%	11.2%	1.4%
– EARNINGS/DISTRIBUTION GROWTH	11.9%	5.0%	–
– RATING	1.0%	5.9%	1.4%
INFLATION	6%	6%	6%

Source: I-Net Bridge and Deutsche Bank

FIGURE 5 10-YEAR FORECAST FOR LOCAL AND OFFSHORE ASSET CLASSES

	PAST 10 YEARS	10-YEAR FORECAST*
GROWTH ASSETS		
LOCAL EQUITY	17.0%	10–12%
GLOBAL EQUITY	2.3%	13–15%
PROPERTY	23.2%	9–10%
INCOME ASSETS		
BONDS	13.2%	8–9%
CASH	10.3%	7.5–8.5%
INFLATION	6.8%	6%(+?)

*Source: I-Net Bridge, Deutsche Bank, *Coronation Fund Managers*

3 Plan to live longer

While it is rather unsettling to think of one's own mortality, most of us under-estimate the investment horizon that needs to be planned for in retirement. Advances in healthcare technology and improvements in nutrition mean that people are living longer, and therefore life expectancy is increasing. For example, if you are a South African female retiring at 65, you can expect to live a further 20 years (see Figure 6 below). But your effective time horizon may be longer as you may live beyond the average retiree. The prudent approach would therefore be to plan your affairs to have a sustainable income for at least 25–30 years. At a 6% inflation rate, this means that you will require nearly 6 times (allowing for inflation) the level of income at the end of your planning horizon than at the start, just to be able to buy the same amount of goods and services.

FIGURE 6 SOUTH AFRICAN LIFE EXPECTANCY AT RETIREMENT AGE

RETIREMENT AGE	MALE	FEMALE
60	81	84
65	82	85
70	84	86
75	85	87

Source: Actuarial Society of South Africa

4 What are the implications for retirement planning?

We have illustrated so far that the typical retiree needs to plan for a horizon of 25–30 years, can expect a relatively high inflation rate and, for at least the next decade, should expect returns to be more subdued than over the last 10 years. The prudent planner's response to this backdrop will include moderating income drawdown rates and ensuring that their portfolios are adequately exposed to growth assets.

To illustrate why we argue for the inclusion of growth assets in a post-retirement income portfolio, consider the 'actual impact of inflation analysis' in Figure 7. This table compares the actual results that would have been achieved by investors drawing different levels of income from two portfolios with differing risk profiles. The first option is a very conservative income assets only portfolio, and the second a moderate risk income and growth portfolio, with a roughly even split between income and growth assets over time. We have used the average money market fund for the former and the Coronation Capital Plus Fund as an example of the latter. The analysis is performed for the period July 2001, when Capital Plus was launched, to June 2010. Over this period, the average money market fund returned 9% p.a., with a very low standard deviation of 1%, while Capital Plus returned 15% p.a. at a standard deviation of 8%.

The first point to note is how quickly inflation erodes purchasing power. The table indicates that, if you drew an annual income of R70 000 in 2001, you need R122 221 to buy the same basket of goods and services today. The second point is that Capital Plus (the portfolio with roughly 50% invested in growth assets) was a lot more effective in generating income over the period regardless of the initial income rate selected. For example, if your initial income rate was set at 9% in 2001, you need to draw 11% from Capital Plus today, while your income requirement from an average money market fund would have already breached 17.5% – the maximum drawdown rate for a living annuity.

4 What are the implications for retirement planning?

Drawing too high an income at the start of your retirement and/or expecting too high a rate of return is as dangerous as investing too conservatively. Consider the 'income rate and return analysis' in Figure 8. This table shows a variety of possible initial income rates, from 2.5% to 17.5%. This range represents the current legal drawdown limits applicable to living annuities. It also shows a variety of potential annualised net investment returns that may be earned, from 2.5% to 15%, in the columns. Each cell in the resulting table represents the number of years before income, (adjusted for inflation of 6%), will start declining. Another way to think about this is how many years you have before your standard of living will start to decline in the different scenarios. At a rate of return of 15% p.a. (historically achieved by Capital Plus), any initial income rate up to 7.5% represents a sustainable income, as income will continue to grow in line with inflation for at least 50 years. However, note what happens when the expected return drops by 2.5% and 5%: the period of sustainability drops dramatically to 22 and 13 years respectively at a drawdown rate of 7.5%.

Given our expectation for lower returns, we do not believe that initial income rates above 6%–7% will be sustainable for most retirees (and then only from a portfolio with adequate exposure to growth assets.)

FIGURE 7 ACTUAL IMPACT OF INFLATION ANALYSIS

INCOME RATE IN 2001	3%	5%	7%	9%
Capital invested in 2001	1,000,000	1,000,000	1,000,000	1,000,000
Annual income in 2001	30,000	50,000	70,000	90,000
Annual income in 2010 (effect of actual CPI)	52,381	67,301	122,221	157,142
Capital in 2010, if invested in MMF (9% p.a. @ 1% SD)	1,445,000	1,134,100	889,161	696,729
Capital in 2010, if invested in Capital Plus (15% p.a. @ 8% SD)	2,263,122	1,775,337	1,391,906	1,090,671
INCOME RATE IN 2001				
Coronation Capital Plus	2%	5%	9%	11%
Average money market fund	4%	8%	14%	MAX

Source: Coronation Research

FIGURE 8 INCOME RATE AND RETURN ANALYSIS

SELECTED INCOME RATE P.A.	NOMINAL NET INVESTMENT RETURN P.A.					
	2.5%	5.0%	7.5%	10.0%	12.5%	15.0%
2.5%	21	30	50+	50+	50+	50+
5.0%	11	14	19	33	50+	50+
7.5%	6	8	10	**13**	**22**	**50+**
10.0%	4	5	6	**7**	**9**	**20**
12.5%	2	3	3	4	5	7
15.0%	1	1	2	2	2	3
17.5%	1	1	1	1	1	1

Source: Asisa Standard of Living Annuities with additional calculations by Coronation Research

! Many retirees are drawing 7.5%–10% and expecting returns of 12.5%–15%. Note how sensitive their income security is to a 2.5% decline in expected return.

5 Coronation's income and growth solutions

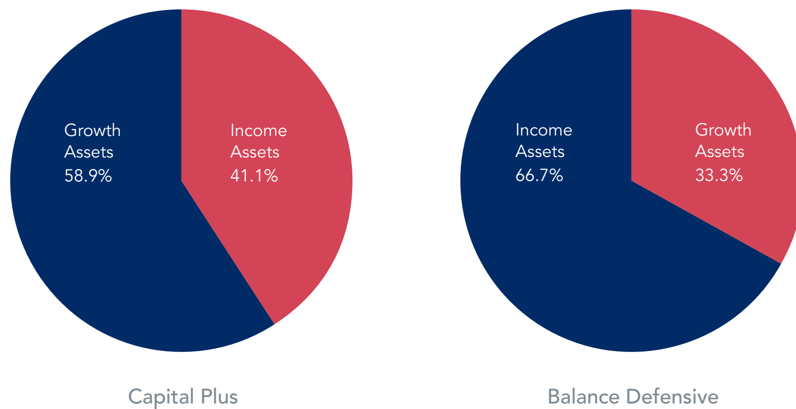
We have now argued the need for growth assets in an income and growth portfolio. But returns will not be optimised by investing only in shares and property as the returns on growth assets can vary from year to year. For example, the local equity market had a standard deviation of 20% over the past decade, while studies show that the real returns from an income and growth portfolio is optimised with a standard deviation of 10% or less.

Coronation offers two funds that meet the needs of income and growth investors – **Balanced Defensive** and **Capital Plus**. These funds' risk budgets are designed to provide optimal outcomes by balancing the quest for attractive levels of real return over the long term with minimising the risk of capital loss over the short term.

The Balanced Defensive portfolio can invest a maximum of 40% in growth assets and is managed to deliver positive returns over any 12-month period with a high degree of probability. It is currently the top-performing fund over 3 years in the Asset Allocation – Prudential Low Equity Category. Since inception in February 2007, Balanced Defensive has produced a return of 9% p.a. at a standard deviation of 4.5%.

The Capital Plus portfolio has a unique risk budget and is optimised for income and growth investors with longer time horizons. Up to 60% of the portfolio can be invested in growth assets and despite its larger risk budget, the portfolio also aims to preserve capital over any 12 months. It has produced a nominal return of 15% p.a. (or 8.5% p.a. in real terms) since its inception in 2001 at a standard deviation of 8%.

FIGURE 9 ASSET ALLOCATION AS AT 31 JULY 2010



Both Capital Plus (LHS) and Balanced Defensive (RHS) have appropriate risk budgets for income-and-growth investors.

Coronation client charter

- We strive to always put clients first
- We have an unwavering commitment to the long term
- We focus on producing top performance over all meaningful periods
- We are uncompromising about ethics

* Disclaimer
"All information and opinions provided are of a general nature and are not intended to address the circumstances of any particular individual or entity. As a result thereof, there may be limitations as to the appropriateness of any information given. It is therefore recommended that the client first obtain the appropriate legal, tax, investment or other professional advice and formulate an appropriate investment strategy that would suit the risk profile of the client prior to acting upon information. Coronation is not acting and does not purport to act in any way as an advisor. Coronation endeavours to provide accurate and timely information but we make no representation or warranty, express or implied, with respect to the correctness, accuracy or completeness of the information and opinions. Coronation does not undertake to update, modify or amend the information on a frequent basis or to advise any person if such information subsequently becomes inaccurate. Any representation or opinion is provided for information purposes only. In the event that specific collective investment schemes in securities (unit trusts) and/or their performance is mentioned please refer to the relevant fact sheet in order to obtain all the necessary information in regard to that unit trust. Collective Investment Schemes in Securities (Unit trusts) are generally medium to long term investments. The value of participatory interests (units) may go down as well as up and past performance is not necessarily a guide to the future. Unit trusts are traded at ruling prices and can engage in borrowing and scrip lending. A schedule of fees and charges and maximum commissions is available on request from the company/scheme. Commission and incentives may be paid and if so, would be included in the overall costs. Fluctuations or movements in exchange rates may cause the value of underlying international investments to go up or down. Coronation Fund Managers will not be held liable or responsible for any direct or consequential loss or damage suffered by any party as a result of that party acting on or failing to act on the basis of the information provided in this document. Coronation Asset Management (Pty) Ltd is an authorised Financial Services Provider. All performance information is for the period ending 31 August 2010 and is based on data provided by Morningstar."

Telephone: +27 (0)21 680 2000 Fax: +27 (0)21 680 2100 Website: www.coronation.com Client service: 0800 220 11 77