

# Your ten retirement tips for 2010

November 2009

We have reached the end of another challenging year in the investment and retirement fund industry. 2009 started with global financial markets in freefall and the entire financial system in crisis. In an attempt to stem the flow and avert a second 'great depression', the world's leading central banks responded with now well-documented stimulatory measures. By March 2009 markets reached the point of maximum pessimism - and then everything changed as markets bounced back sharply.

For those planning for retirement or already in retirement, the changed environment presents a number of challenges. Below is a list of 10 retirement issues to consider during your year-end break.

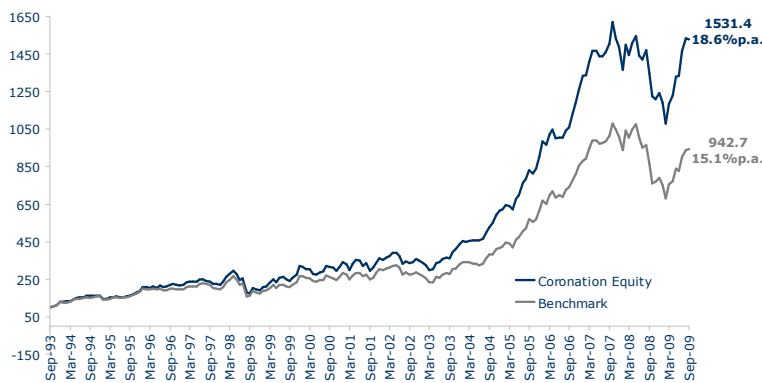
## 1. Don't assess a manager's performance over the short term (1-year)

If you assess your manager's performance over 1 year, expect to chase your tail. Short-term returns are incontrovertibly random. It is statistically unlikely that an asset manager will not have a good year in a 5-year period - all managers have good and bad years. However, when you assess performance over meaningful periods (5 or 10 years) you'll find only a handful of managers who consistently deliver.

Example:

Had you invested R100 in the JSE All Share Index in September 1993, your capital would have grown 9 times. This is a fantastic outcome that, as an aside, is unlikely to be repeated over the next 10 years. Had you invested the same amount with Coronation on the day the company started doing business in September 1993, your capital would have grown 15 times - illustrating the power of compounding. Outperformance of on average 3% per annum over a period of 16 years means that your capital is up 70% more than the market - a result that can be life changing to a retired investor.

FIG 1 CREATING LONG-TERM WEALTH

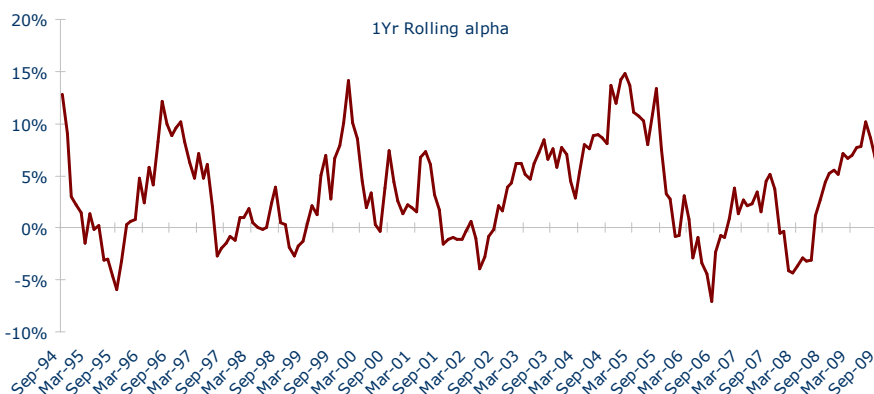


	Coronation Equity	Benchmark	Alpha
Since inception*	18.6%	15.1%	3.5%
10 years	20.4%	16.3%	4.1%
5 years	23.6%	19.8%	3.9%
3 years	13.1%	8.4%	4.7%
1 year	13.7%	9.1%	4.6%

\*Returns since inception in June 1993 to end September 2009

But what do these returns look like over 1 year? As illustrated in Figure 2, one should expect the short-term alpha of a long-term manager such as Coronation to be lumpy - meaning that there will be a couple of periods of market underperformance.

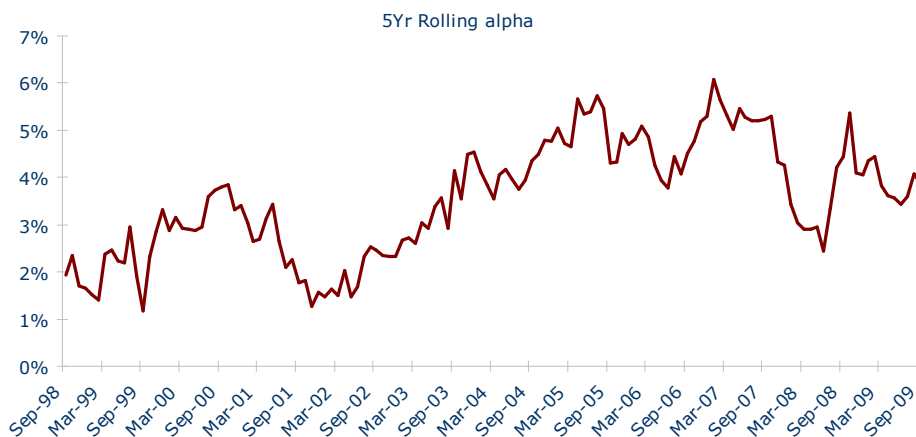
FIG 2 SHORT-TERM ALPHA IS LUMPY





But we don't believe that we were wrong during these periods. The paradox of investing is that when the market misprices an asset, the long-term manager has to be prepared to do something different to the market - buy the assets that are falling and sell those that are rising. If you have conviction in your investment calls, you will do very well over the long term. A key principle for us as a long-term manager is that in the periods of underperformance one is in fact tilling the ground for the harvest to come. A good manager will undoubtedly have many such periods. That said, over rolling 5-year periods Coronation was never below the market.

FIG 3 IT'S OVER THE LONG TERM THAT WE MEASURE RESULTS



## 2. Headline inflation is not necessarily applicable to all South Africans

A looming crisis in the retirement industry is how we view inflation. Headline inflation, as is quoted in the media, is based on an 'average' South African's 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 it's higher than we think. One therefore needs to be mindful of this when we do any retirement planning.

## 3. Expect to live longer

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 up to his/her mid 80s. Life expectancy is way ahead of where it was 20 to 30 years ago and needs to be considered when planning for retirement.

FIG 4 SOUTH AFRICAN LIFE EXPECTANCY

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

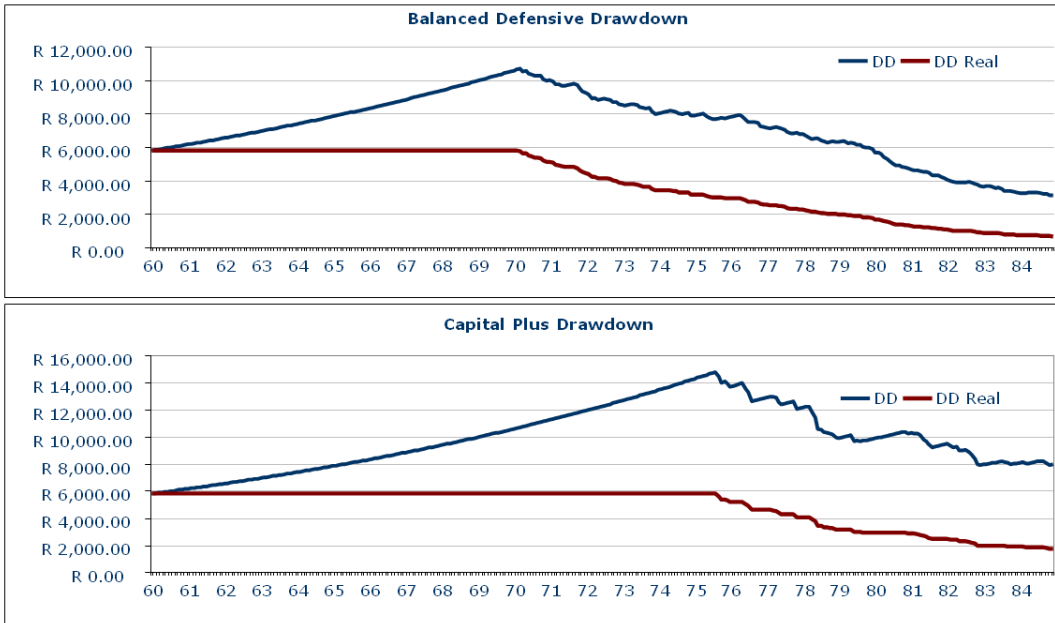
## 4. The need for exposure to growth assets is high

When you retire at age 60, the first ten years of retirement is bound to be financially comfortable. This sense of comfort could however be short-lived. As you move into the next ten to fifteen years you may realise that you've been left vulnerable, either from excessive draw-downs on your capital or insufficient exposure to growth assets in the early years of retirement. The two graphs in Figure 5 below illustrate a fairly extreme situation, clearly showing the impact of insufficient exposure to growth assets and a high drawdown rate over the long term.

The first graph illustrates a 60-year old who invests his retirement capital as a lump sum in the Coronation Balanced Defensive Fund (a typical type of fund for a living annuity) and draws an annual income of 7%. The first 10 years of retirement would be comfortable as the annual income level available grows with inflation. However, when the investor reaches age 70 his drawdown rate will reach the maximum living annuity limit of 17.5% and the real value of income will reduce aggressively, leaving the investor in a very dismal financial position from his early 80s.

The second graph illustrates a much better outcome for the same investor. In this scenario, the investor's capital is invested in the Coronation Capital Plus Fund. The fund's bigger risk budget (and resulting higher exposure to growth assets) will preserve the real value of the investor's capital for at least the first 15 years of retirement. However, at an initial drawdown of 7%, even in this fund the investor's real income would start to come down at age 76, albeit less aggressively than for an investor in a fund with a smaller risk budget.

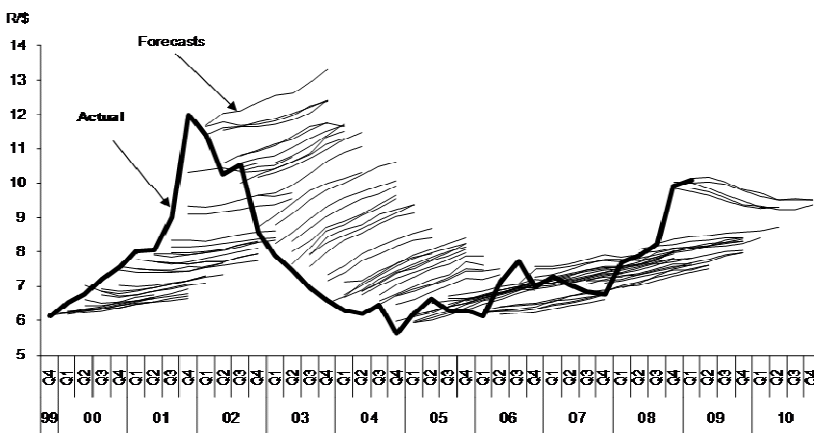
FIG 5 INSUFFICIENT EXPOSURE TO GROWTH ASSETS WILL COST YOU IN THE LONG RUN



**5. Avoid anchoring off the recent past**

Investors tend to base their decisions on recent experiences - this is called anchoring. A good example of how we anchor is the rand. Figure 6 illustrates the expectations for the rand of all economists in South Africa. Without exception, they have predicted the rand to weaken by 3% per annum. It almost doesn't matter if the rand had halved; economists simply adjust to a new level and set their expectations from there.

FIG 6 FORECASTING THE RAND - BE CAREFUL OF ANCHORING OFF SPOT



Source: Franco Buseti, Macquarie

The housing market is another good example where anchoring takes place. Over the past eight years house prices in South Africa have practically tripled. It may be difficult to believe, but a house that is in the market for R2 million today, would have probably fetched around R600 000 in 2001. How many of us were keen to buy a house eight years ago? Or who wanted to get into the buy-to-let market?

The reality is that not many of us did because we adjust to the price levels of the day almost regardless of whether or not the levels are high or low. In the world of investments one has to understand where prices have gone and therefore whether that asset presents value or not.

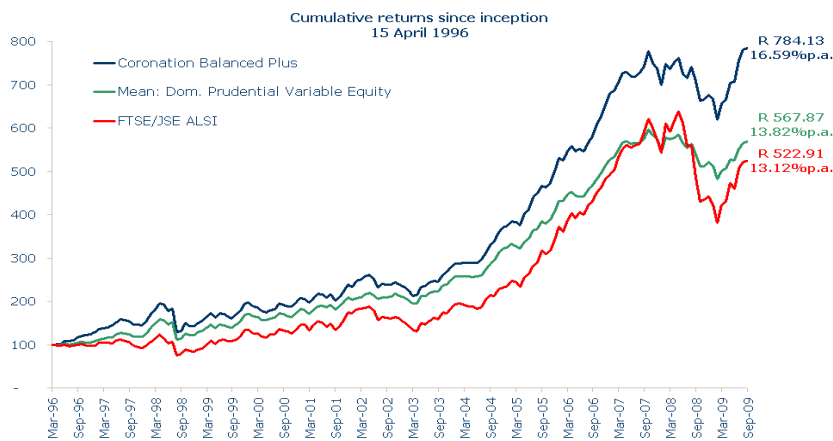
Today we are again anchoring off the last 10 years which has been a spectacular period for property returns. At Coronation we believe these returns are going to be much lower over the next 10 years. Similarly, the rand's been exceptionally strong for the past 6/7 years, but people just don't want to go offshore even when presented with a compelling argument for doing so. Because local equities have outperformed global equities over the past 10 years, doesn't mean that they will do so again in the next ten. Markets work in cycles and if you extrapolate the past into the future, we think that you are likely on the fast track to the poor house.

## 6. Don't underestimate the importance of asset allocation

One of the big trends we see in the unit trust industry is that people are moving out of building block funds into asset allocation funds, where the asset manager is empowered to make the asset allocation decision on their behalf. To illustrate how the asset allocation decision can dwarf the security selection decision in one's portfolio, consider the following example: Had your money been invested in the Coronation Top 20 Fund at inception in October 2000, you would've made a fantastic investment as this fund has outperformed at 8% p.a. since inception. However, had only 20% of your capital been invested in this fund, you would have fared far worse than an investor with 50% of his capital in equities over a period in which the All Share Index was up 3.5 times, even if they were invested in the worst performing equity fund.

As an active manager, with more assets in the asset allocation funds than in the building block funds, we have the skills to make these decisions on behalf of clients. Our asset allocation skill is best illustrated in the performance of the Coronation Balanced Plus Fund (Fig 7) which has outperformed equities - the highest return asset class - since inception in April 1996, and with a mandated maximum equity allocation of 75%.

FIG 7 THE POWER OF ASSET ALLOCATION



Source: Morningstar as at 30 September 2009

## 7. Are you thinking enough about tax?

While it may have been inconceivable three years ago, most developed countries are now running budget deficits in excess of 10%. What this means is that the central banks' exit strategies are likely to comprise of an ugly cocktail - higher taxes, lower government spending and higher interest rates. High-earning residents in the UK are already exposed to higher tax rates, keeping only 36 cents per pound earned after income and NHS taxes. In South Africa we should prepare ourselves for the possibility of higher taxes. We believe that an increase in the capital gains tax rate is one potential response to pressure on Government revenue.

The following example illustrates the damage higher tax rates could do to South African savers:

Consider two investors who invest in the same unit trust fund over a period of 20 years. Investor one leaves his capital in the same fund and only disinvests at the end of the 20-year period. Investor two, however, crystallises his gains each year and as a result is subject to capital gains tax. Over the investment period, investor two leaks 15% of his capital, or 27% should Government decide to double his tax rate from 10% to 20%. To avoid this leakage, we believe investors will increasingly be forced to find a manager that they can back over the long term and stay invested in the funds they are in from the start.

## 8. Markets are efficient discounting mechanisms

Shares were spectacularly cheap at the start of the year as they were pricing in financial Armageddon. As a result, risk assets represented the third best buy in 150 years during the first quarter of 2009. However, many investors (quite sadly) missed the rally as

they were sitting in cash. Investors should remember that markets are efficient discounting mechanisms. When the newsflow is poor, this will already be reflected in the share price: it is in fact the time to be buying assets. Similarly, when the SA economy has performed very well and newsflow is good, markets will reflect the environment in the share prices, and this will often be the time to be selling assets.

FIG 8 RISK ASSETS IN Q1 WERE THE THIRD BEST BUY IN 150 YEARS

	Peak date	Decline from peak to trough	Recovery from trough	3 year CARG
USA S&P	9/10/07	-56.8%	57.6%	-6.1%
UK FTSE 100	31/10/07	-65.0%	73.7%	-6.1%
Nikkei	08/05/06	-53.2%	51.1%	-7.3%
German Dax	28/12/07	-60.9%	78.8%	1.3%
Russia	19/05/08	-80.0%	176.4%	-4.5%
China	30/10/07	-73.9%	126.7%	17.7%
India	8/01/08	-70.4%	116.1%	7.3%
South Africa (ALSI)	31/10/07	-65.3%	107.0%	6.7%
MSCI World	31/10/07	-60.3%	68.7%	-5.0%
MSCI EM	29/10/07	-66.1%	102.8%	6.4%
USA S&P	9/10/07	-56.8%	57.6%	-6.1%
UK FTSE 100	31/10/07	-65.0%	73.7%	-6.1%

### 9. Use the strong rand to balance your portfolio

In the last quarter of 2001 the rand weakened by 32% (it closed the year at 11.90/\$). Panic ensued and money poured into offshore unit trusts until virtually every fund in the country had reached its capacity. From that point on the rand strengthened steadily, all the way to 5.60/\$ in December of 2004. We can think of no better example of how 'the man in the street' inevitably buys high (in this case when the rand had already weakened) and sells low (when the rand is strong). Since that crazy summer of 2001, offshore funds have experienced steady outflows as investors brought back the capital that they so hastily externalised.

While the rand may remain strong in the short term, we believe that the risks are heavily skewed to the downside. Industrial South Africa is not competitive at these levels. This is unlikely to change with electricity prices set to increase substantially over the next few years and wage settlements to be in the high single digits. Investors were desperate to go offshore when the rand was weak (prices were high). Today the rand is strong (prices are low) and appetite appears to be non-existent. We think this is a big mistake.

Studies on optimal portfolios recommend a 20%-30% offshore allocation through the cycle. With the rand strong and better value offshore we think investors should be at the high end of that range. Don't wait for the rand to weaken before you move.

### 10. Buy global equities

It seems that South Africans have been so scarred by their recent experiences (anchoring) that they are determined to avoid offshore investments, regardless of the merits of investing offshore. Offshore investments diversify a balanced portfolio and offer an opportunity to increase return and reduce risk. South Africa represents 1% of global GDP. It is a commodity-heavy country on the southern tip of Africa. The opportunity set offshore is greater with industries that don't exist locally, such as IT, electronics and pharmaceuticals. The world is changing - emerging markets are driving the global economy as they industrialise and urbanise. This will create wealth for investors prepared to take a long-term view and invest in those regions. We believe global equities currently present more value than any other asset class.

FIG 9 SOUTH AFRICANS FORGET THAT LOCAL EQUITIES DON'T ALWAYS WIN

