Seed Weekly

The Retirement Savings Conundrum

seed investments

Saving for retirement remains the primary goal of most of Seed's Private Clients, and our team of Advisors put hours of work into finding the most suitable vehicles and products to suit each the unique circumstances of each client.

An interesting and ongoing challenge is examining the key differences between compulsory savings vehicles, such as Retirement Annuities (RA) and Pension Funds, and discretionary investments that are not constrained by the Regulation 28 asset class limits.

What is Regulation 28?

Regulation 28 forms part of the Pension Fund Act and specifies exposure limits for specific asset classes. The aim of Regulation 28 is to ensure clients' retirement portfolios are well diversified and not overly exposed to the more volatile asset classes. The main limits are:

Equities (Local & Global)	**Max 75%**
Property (Local & Global)	**Max 25%**
Global Exposure	**Max 30%**

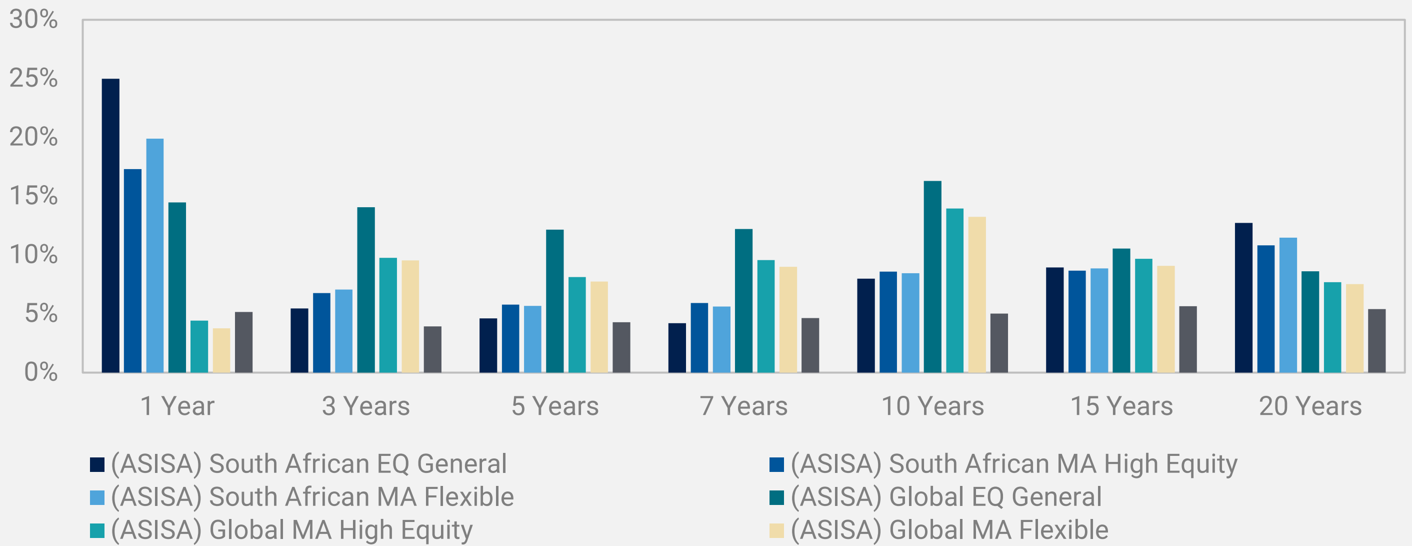
Some clients view Regulation 28 as very restrictive, especially those with a higher risk appetite looking for more growth asset exposure and, especially, a higher global allocation.

The undeniable benefit of compulsory savings vehicles is the tax treatment – investors qualify for a tax deduction on their contributions of up to 27.5% of taxable income (up to a maximum of R 350,000) per annum. However, when an investor retires from their RA (only allowed after age 55) and makes the compulsory switch into a Living Annuity (LA), the regular income received is taxable according to the standard income tax tables.

Clients and Advisors are now faced with a trade-off – utilise the tax benefits afforded by the RA and lose out on potentially higher returns, or enjoy the flexibility of a discretionary investment, but with no tax deduction on contributions.

Let us have a look first at the view that returns are higher outside of the Regulation 28 sphere. The chart below compares the annualised returns for six ASISA categories over various time periods in ZAR terms. The South African categories must invest at least 60% of assets in South Africa, with further maximums of 30% globally and 10% in the rest of Africa.

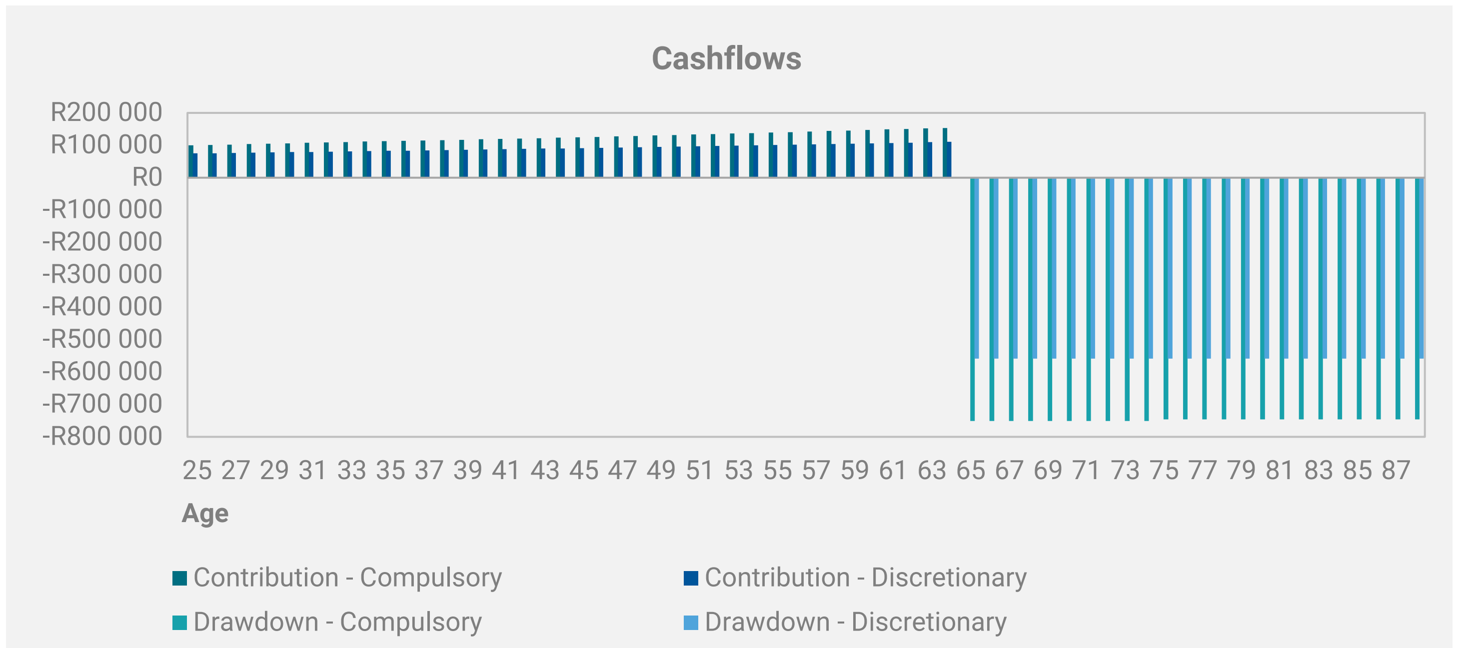
The Global categories must invest at least 80% of assets outside of South Africa, and many are effectively 100% global portfolios. The Equity sub-category invests a minimum of 80% into equities (most funds are close to 100%), the Multi Asset High Equity sub-category is limited to 75% total equity and 25% total property, and the Flexible sub-category is effectively unconstrained.



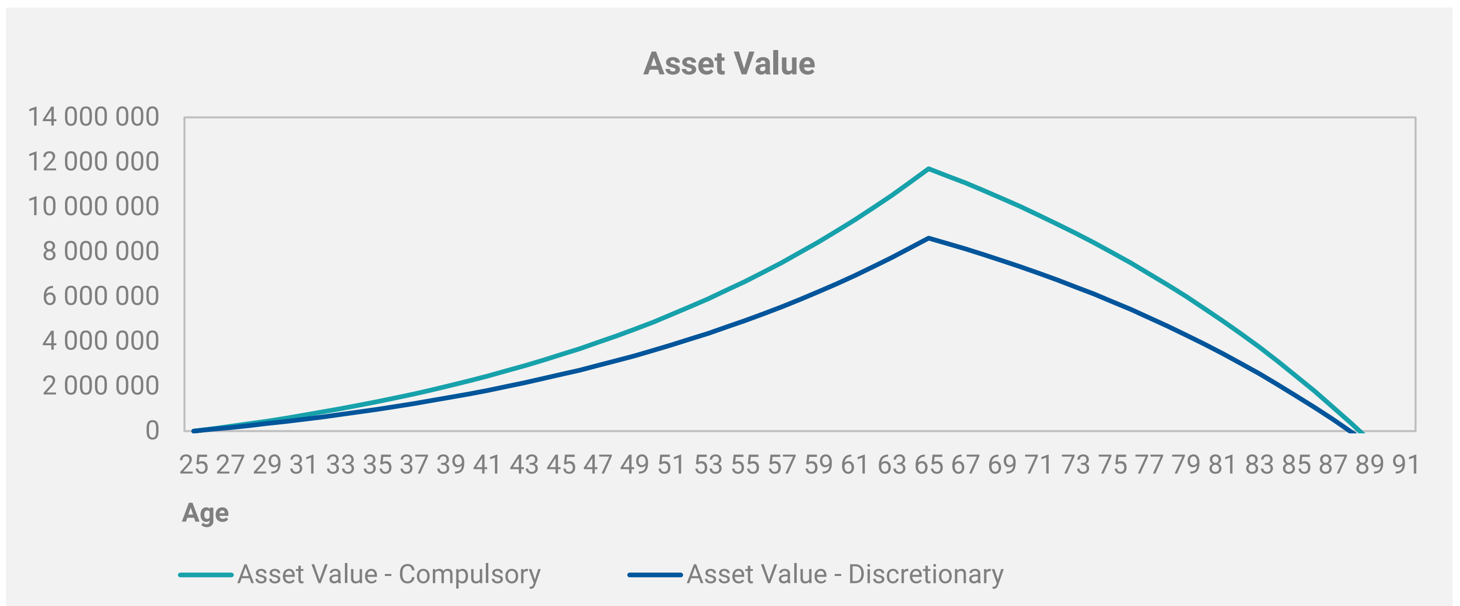
The chart illustrates that, although the local categories have outperformed their global counterparts over the very long term, global has been the winner over all other periods - except for the last year during the strong Rand recovery.

Using the relative historical performance above as a guide, we can now simulate the entire investment life cycle for clients – from the contribution stage all the way through to drawdowns during retirement – for both the compulsory and discretionary options.

As a first example, we will look at a 25-year old investor who has just started saving for retirement, earns R 500,000 per year increasing at CPI + 1% and contributes 15% of their salary towards retirement. After age 65, the net income requirement is 75% of salary. Initially, we will assume a real return of 4% for both the compulsory and discretionary options.



The chart above displays the annual cashflows for each of the options. By reinvesting the annual tax rebate, the compulsory contributions exceed those on the discretionary side, but during retirement the compulsory drawdowns are also higher to allow for the tax impact.



For this specific client, the simulation produces very similar results for the two options – assets are depleted at age 89 for the compulsory scenario and at age 88 for the discretionary choice. If the return assumption is increased to CPI + 4.5%, these ages are stretched to 97 and 96 respectively, which will be sufficient for most clients.

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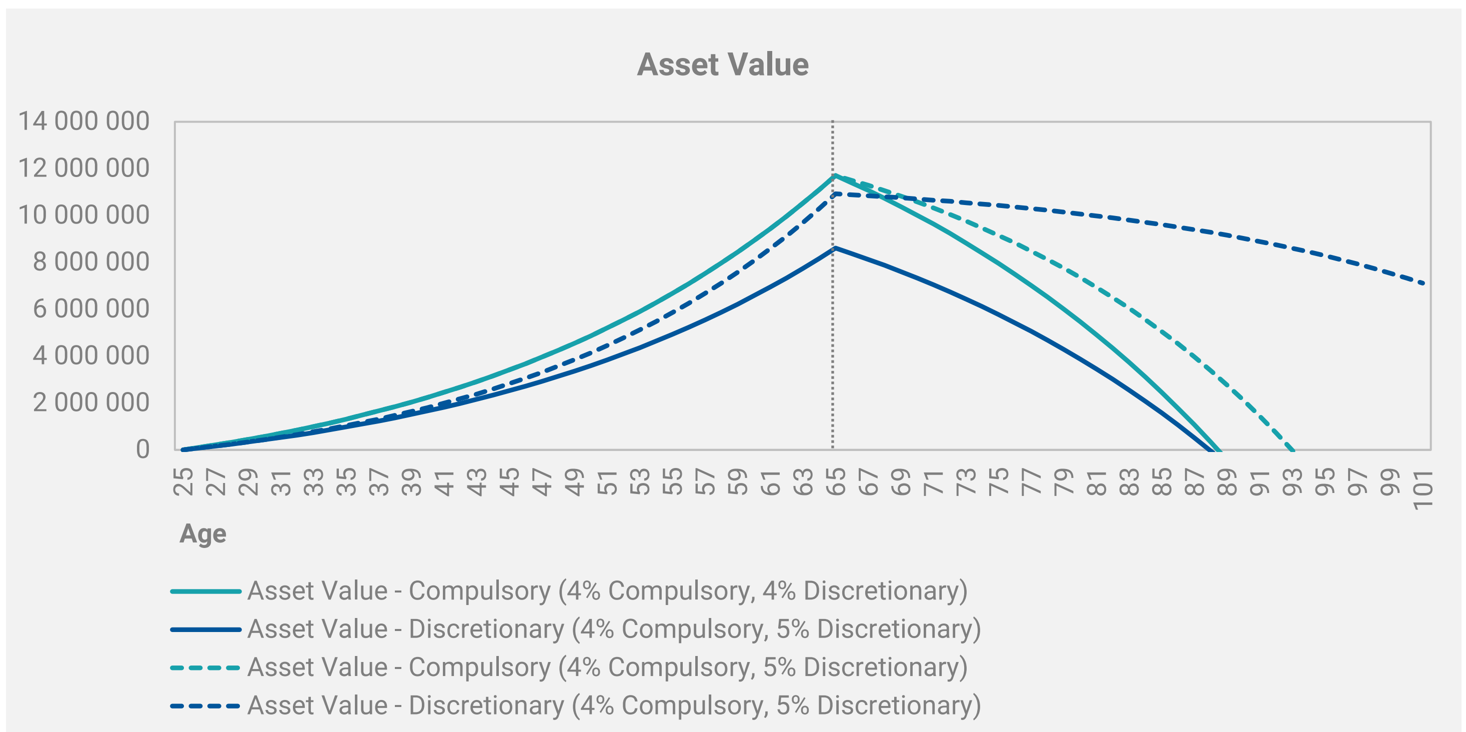
What will the impact be if the view holds true that global will outperform local consistently going forward? For the next part of our analysis, we have increased the return on discretionary assets to CPI + 5% pa, which might not sound significant but can make a huge difference over an investment horizon of 60+ years.

The chart below compares the new results to the original scenario, and it is clear that the discretionary option now produces a much better result. During the build-up phase, the discretionary option's higher return assumption compensates for the lower annual contributions, and the portfolios are very similarly valued at retirement age. During the drawdown phase from age 65 onwards, the discretionary option's lower initial drawdown rate of 5.1% compared to 6.4% on the compulsory side makes a big difference to the final outcome.



The above analysis is intended as a simplified investigation into the trade-off between the compulsory and discretionary routes and focuses specifically on the differences in tax treatment. The comparison is by no means exhaustive, and other factors that need to be considered include liquidity constraints, estate duty, nomination of beneficiaries and creditor protection.

The Seed Wealth Management Team is well equipped to help you make sense of this complex investment landscape. Please contact our offices on +27 21 914 4966 or send an email to wealthadmin@seedinvestments.co.za to speak to an Advisor who can help you start the process of crafting a personalised investment plan based on your individual needs and circumstances. We are on the journey with you, and we always love hearing from you!

Kind regards,

Cor van Deventer *CFA, FASSA*
Portfolio Manager

Chart Data Source(s) : Morningstar, Seed Investments (updated at 30 June 2021)

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