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Investing for a world of change

Taking Stock

Spring 2024

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Taking

Perception versus reality: lessons from life and investing

This year has been transformative for me, as I welcomed my daughter into the world. Parenthood, like many life experiences, comes with a blend of expectations and reality checks. While I always wanted to have a child, nothing quite prepared me for the short-term challenges – like those sleepless nights or teething troubles. But in the long term, those temporary difficulties fade into the background. I'm sure that 20 years from now, I won't be reminiscing about that exhaustion; instead, I'll cherish the milestones and memories we've created together.

This experience highlighted an important parallel between parenthood and investing: the gap between perception and reality, and the importance of having a long-term mindset. We often have preconceived notions of how things will unfold, yet the reality can be quite different. In parenting, the short-term challenges of sleep deprivation don't diminish the long-term rewards. Similarly, in investing, short-term market fluctuations shouldn't derail a well-thought-out long-term strategy.

Instinctively, it feels as if the rate of change has sped up and market volatility has increased since Covid, and that dramatic events are unfolding in ever-quicker succession – from Russia's invasion of Ukraine to the escalating conflict in the Middle East to a seemingly never-ending cycle of elections across the globe. But again, this perception belies the reality. The VIX (a measure of market volatility) has remained relatively stable when viewed relative to the long term. This should remind us not to lose sight of the bigger picture amidst day-to-day uncertainty and a seemingly never-ending barrage of negative news headlines.

Siobhan Simpson
Head of SA Unit Trusts

Stock

Unfortunately, countless investors have done just that. Despite the strong market recovery, many have sought refuge in the perceived safety of cash. This trend is reflected in the unit trust industry flows. Over the year ending June 2024, the industry recorded its worst flow numbers ever, with nearly R37 billion in outflows (excluding money market funds). The flipside of this is that household bank deposits have soared to a record R1.85 trillion, according to the South African Reserve Bank's Quarterly Bulletin, and money market fund assets are at all-time highs.

Despite the strong market recovery, many have sought refuge in the perceived safety of cash.

Since Covid, the only sector to capture meaningful inflows was income funds, which attracted R133 billion, while multi-asset funds saw outflows to the tune of R74 billion. Despite the outflows, both the multi-asset and equity sectors grew their assets under management, reflecting the strong market rebound. By contrast, two-thirds of the growth in income fund assets was due to the inflows, not market performance.

Despite the perception that investors were not being rewarded for risk, the reality paints a different picture. Over the year to 30 September 2024, SA equities returned 23.9%, bonds delivered 26% and listed property a remarkable 51%. Those sitting in cash earned a modest 8.6% return. Even over the longer term, where in some years there was a convergence of asset-class returns, investors would still have been better off had they had a balance of exposures.

Financial advisors play a crucial role in helping clients understand their true investment horizon and how to think about risk. Just as the challenges of early parenthood fade in importance over time, so too should the short-term volatility in investment portfolios when viewed against long-term goals. Be sure to read Paul Hutchinson's article in which he explores why patience is possibly the most important virtue when investing for long-term growth.

Financial advisors play a crucial role in helping clients understand their true investment horizon and how to think about risk.

In the same vein, both parenting and investing require a long-term commitment and discipline, and the sooner you start instilling the discipline, the better the long-term outcome. Consider these three scenarios over a 20-year period:

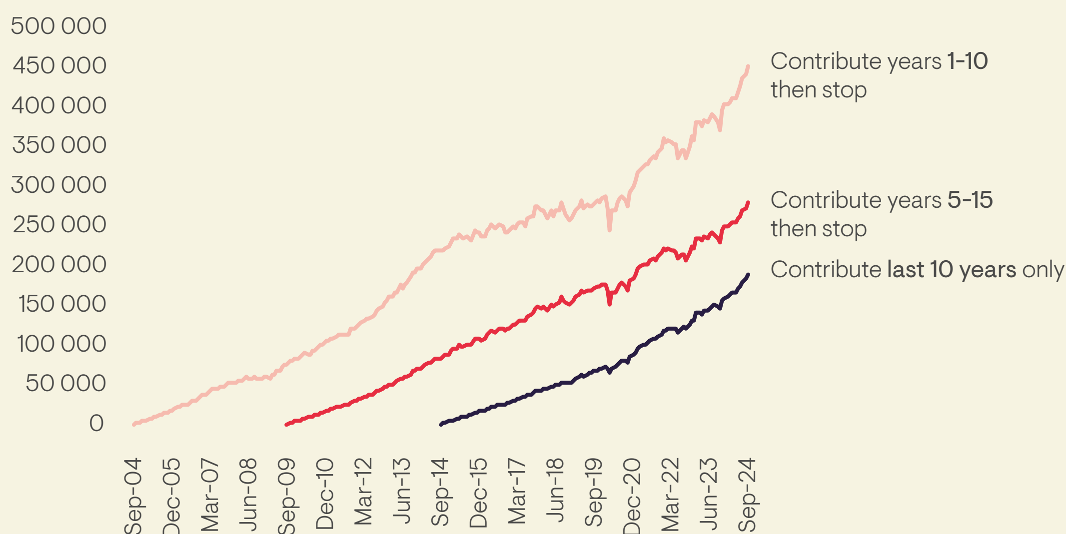
1. Invest R1 000 every month for 10 years in a high equity multi-asset fund, then stop contributing and hold the investment for a further 10 years.

2. Wait 5 years, then invest R1 000 a month for a 10-year period in the same fund, then stop investing for the last 5 years.

3. Wait 10 years, then invest R1 000 every month in the same fund for the next 10 years.

While the total contribution in all three scenarios is the same, the results vary dramatically. Figure 1 tracks the performance of the average high equity multi-asset fund. It powerfully illustrates that if you had invested for the first 10 years only and then stopped contributing, your money would be worth almost 2.4 times more than had you waited 10 years to get started, and roughly 60% more than it would have been had you chosen scenario 2.

Figure 1: Start investing early to reap the rewards



Past performance is not a reliable indicator of future results; losses may be made.

Source: Ninety One and Morningstar, dates to 30.09.24. Performance figures are calculated NAV to NAV, net of fees, with income reinvested (ZAR). For illustrative purposes only. The performance numbers shown for each scenario represents the cumulative lump sum performance over the full investment term.

From early investment discipline to enjoying the fruits of it later in life, Jaco van Tonder shares key findings from his updated research on living annuities. He considers, amongst others, the appropriate offshore allocation, guaranteed annuities and the inflation rate, manager alpha and its outsized impact on living annuities. Be sure not to miss it.

In conclusion, remember that investing – like parenthood – requires a long-term commitment. By maintaining this perspective, advisors will help clients navigate the gap between perception and reality, ultimately leading to better long-term investment outcomes.

Thank you for your continued support.

Siobhan Simpson
Head of SA Unit Trusts

“Thanks to the GNU, we find ourselves in a virtuous cycle.”

Jeremy Gardiner

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Jeremy Gardiner
Director

A dark storm or new dawn - time alone will tell

As the dust finally settles on a year in which more than half of the world's population went to the polls, it is clear that in most cases, the incumbents struggled, as voters blamed them for high inflation, interest rates and the rising cost of living.

Fortunately, from an economic perspective, fears of record high interest-rate induced growth problems in the US (which buys around 8% of our exports), have largely evaporated. Exactly what the Trump presidency will bring remains uncertain and a topic of much emotional debate. What is pretty certain though is that the US's strong economy plus a combination of Trump's tax cuts, tighter immigration and tariffs, will prove inflationary and reduce the potential for rate cuts. It will be really disappointing if the Trump victory denies us the 'low interest rate, soft dollar, risk-on' world we in SA have so long been waiting for.

Despite Trump's negative comments about Africa being a sh**hole, we can significantly limit the collateral damage by adopting a more considered and commercial approach to our international relations. Hopefully, our new and respected International Relations Minister, Ronald Lamola, adopts a slightly more low-key approach to our positioning on world affairs, because Trump will be a lot less lenient than the Biden/Harris administration, and as the old adage goes, "Choose your battles wisely."

view

We lost an enormous amount of jobs thanks to Covid, and then load-shedding. We cannot afford to lose our export-related jobs as well by offending and being punished by our major trading partners. Every job is precious. There's no need to choose between our BRICS 'friends' and the West; we can be friends with either/or, but from a trade perspective, we need to cultivate strong ties with both the West and the rest.

Much has been written about our government of national unity (GNU) being an 'arranged marriage', convened primarily between two parties who aren't wild about each other. The problem they face is that they're better off together than on their own. The ANC was not governing SA well on its own and the DA was facing an uncertain future. As official opposition party, the DA only managed to garner an additional one percent in support in the election following a year in which the country was effectively brought to its knees by mismanagement and corruption.

Fortunately, research by the Social Research Foundation shows that both the ANC and the DA's support levels have risen since the elections, whilst those of MK and the EFF have dropped.

The GNU members will fight, as we've seen, over issues such as basic education, NHI and cadre deployment, but it's not unhealthy. At least now there's debate and all players are heard. Previously, Luthuli House dreamed up policy, and then rammed it through, because they could. Now they have to get consensus amongst the various GNU partners. So fighting is fine, but we cannot have them threatening divorce every time. The GNU is precious and must be protected at all costs. Do not underestimate the negative impact on SA assets and our country were it to collapse.

Thanks to the GNU, we find ourselves in a virtuous cycle, which could well have been vicious.

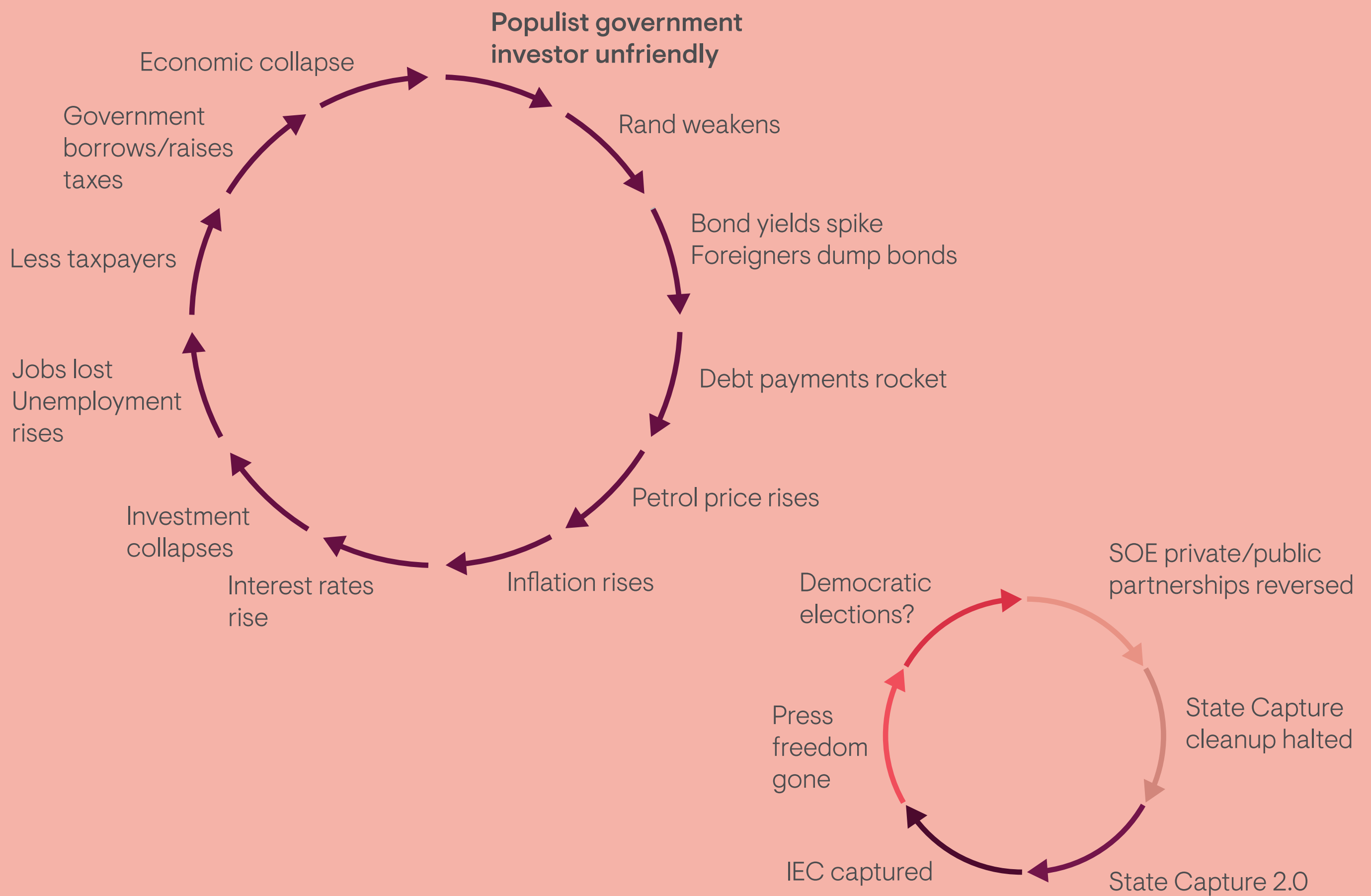
> The GNU is precious and must be protected at all costs.

Who knows what a second Trump presidency will bring? All one can predict is that it will be volatile. But if I had to choose between a volatile election result in the US or in SA, I'd take the US any day.

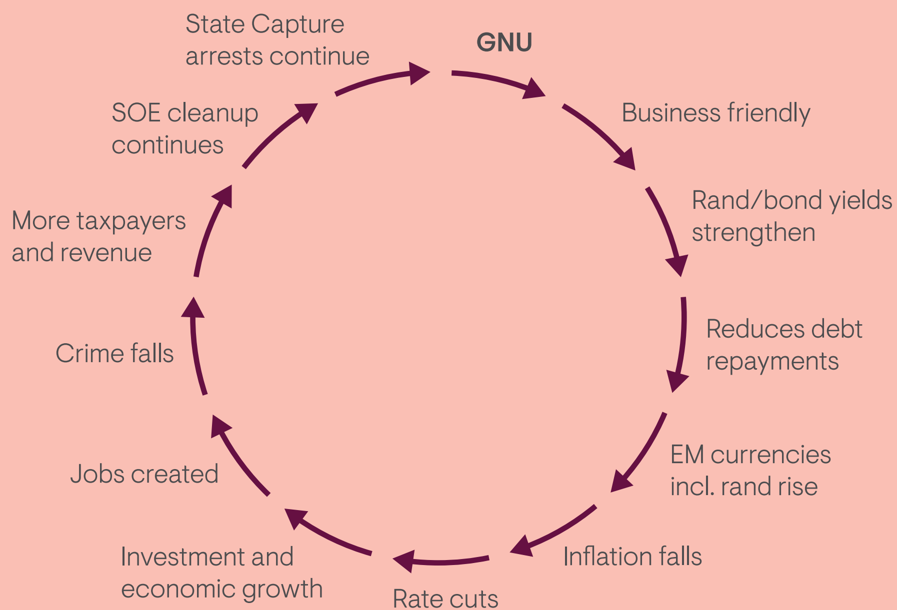
Miraculously, for once, we got the stable option. We can be very thankful, but we mustn't be naïve. The GNU is fragile, and if it collapses, all bets are off the table. Who knows where the rand would go then?

The road ahead will be bumpy, but at least there is a road.

Where we could have been



Where we are now



“A better growth rate will go a long way to help South Africa out of the debt hole.”

Malcolm Charles and Sisamkele Kobus

Malcolm Charles
Portfolio Manager, Emerging Market Fixed Income

Sisamkele Kobus
Economics Analyst

South Africa back on track?

The fast view

- The rand should be more stable now that load-shedding is no longer constraining the economy.
- Inflation remains well behaved, providing room for the South African Reserve Bank to continue easing interest rates.
- We anticipate economic growth of 1.7% next year, thanks to lower inflation, support from two-pot withdrawals, rate cuts and investments in infrastructure, including renewable energy.
- The favourable outlook for the rand, inflation, interest rates and growth supports our bond market.

South Africans are generally optimistic, but the long, dark years of state capture and load-shedding have weighed heavily on the national psyche.

With an energy availability factor hovering in the mid-fifty percent range in 2023, South Africans braced themselves for stage 7 or higher load-shedding as winter approached. The electricity crisis acted as a permanent handbrake on our economy, leaving consumers and businesses idling in the parking lot of SA Inc.

There's nothing like a crisis to force change

Most of the required reforms to alleviate load-shedding were already enacted at the peak of the electricity crisis. The President's establishment of a "war room", in the form of NECOM,[1] allowed government, business, and consumers to all play a pivotal role in finding ways out of the energy crisis. Since late March, we've had no load-shedding, and the energy availability factor is above 70%. Businesses and households have invested substantially in renewable energy, resulting in reduced demand on Eskom generation. It has also allowed the national power utility to perform crucial maintenance at its power stations.

> Since late March, we've had no load-shedding, and the energy availability factor is above 70%.

Renewable energy has become a much larger component of the energy mix, effectively doubling from c. 10% of installed capacity to 20% over the last 2 years. The huge acceleration of private-public partnerships means that NERSA-registered projects are sitting at 9.7GW,[2] with their capacity close to Eskom's Medupi and Kusile power stations. Additionally, rooftop solar energy has almost trebled over the last 2 years to 6GW.[3] While rapid growth in energy generation is helping to get South Africa back on track, we are also seeing much-needed transmission reform.

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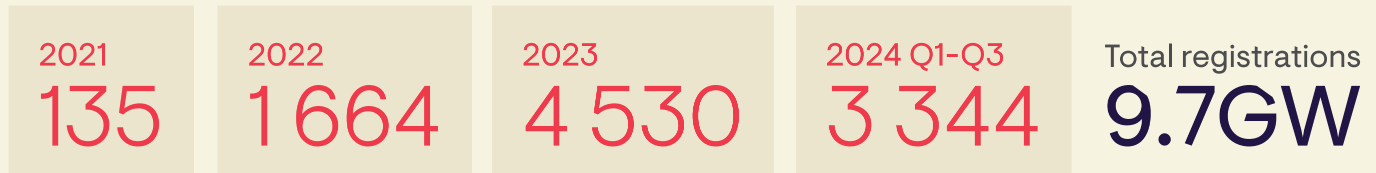
1. The National Energy Crisis Committee.
2. Ninety One and NERSA, September 2024.
3. NERSA and Eskom, July 2022 to June 2024.

NERSA renewable project registration (MW)



Over the past 2 years

Installed capacity of renewable energy has doubled from

c.10% to 20%

Rooftop solar energy has almost trebled

6GW

Cumulative estimated Rooftop PV

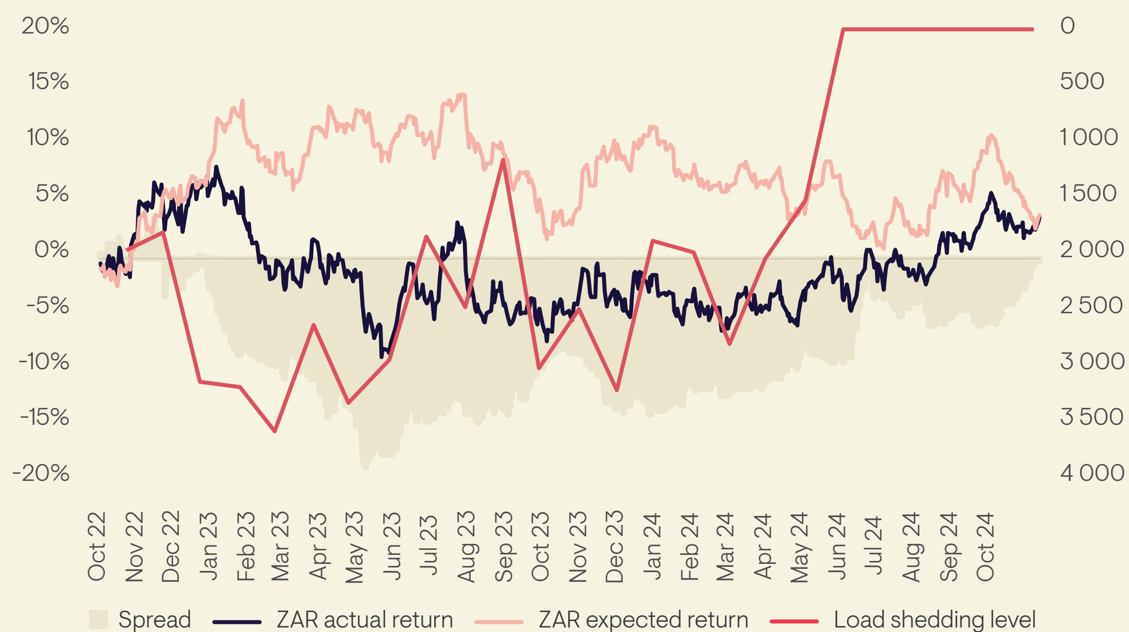
	Estimated Rooftop PV
Jul-22	2 264MW
Dec-22	2 586MW
Jul-23	4 740MW
Dec-23	5 203MW
Mar-24	5 809MW
Jun-24	6 050MW

Source: Ninety One, NERSA, Eskom, September 2024.

Rand bouncing back

Substantial improvements on the electricity front have helped the rand to recover. A staggering 75% of the rand's underperformance over the last 2 years can be attributed to load-shedding. Figure 1 shows how the gap between the currency's expected return and actual return widened dramatically as SA reached record-breaking levels of load-shedding in 2023. The peak of the rand's underperformance was in May last year, but since then, the discount in the rand has steadily closed.

Figure 1: Load-shedding was the key driver of rand weakness



Source: Ninety One, Bloomberg and Deutsche Bank, 5 November 2024.

With the SA election out of the way and no load-shedding since late March, the rand looks fairly valued. We expect the currency to be more stable than in the past. Improving terms of trade, softer oil prices and stronger commodity prices also support the rand.

> The discount in the rand has steadily closed.

Infrastructure spend to provide much-needed 'juice' to SA economy

The government of national unity (GNU) delivered a pragmatic medium-term budget, vowing to get the debt-to-GDP ratio under control. This was in line with the fiscal consolidation path that National Treasury committed to ahead of the 2023 medium-term budget policy statement (MTBPS). In last year's MTBPS significant spending cuts were pencilled in to address revenue slippages. Ahead of the election, there was scepticism about whether politicians would give National Treasury the necessary space to maintain fiscal prudence. The GNU medium-term budget has stayed the course, with debt consolidation an essential strategy for putting government finances on a healthier footing. While the government will have to do some tap dancing to keep investors, rating agencies, and public sector unions happy, a better growth rate will go a long way to help South Africa out of the debt hole.

The GNU medium-term budget has stayed the course, with debt consolidation an essential strategy for putting government finances on a healthier footing.

Finance Minister Enoch Godongwana outlined additional reforms to support public and private investments in growth-boosting infrastructure, with the MTBPS dedicating a chapter to this important issue. The GNU's strong commitment to infrastructure investment was evident in the MTBPS. The second phase of Operation Vulindlela[4] will build on this foundation, targeting critical infrastructure bottlenecks that stem from municipal capacity constraints. Areas of focus will still be along the broad categories of energy, transport, digital infrastructure and water. These initiatives will not only be a 'life saver' for communities and businesses but will serve as an important engine of growth.

While public infrastructure spending has been largely absent over the last few years, the South Africa National Road Agency (SANRAL) has been carrying the infrastructure torch. The parastatal has reached for its wallet, allocating R26 billion to essential road upgrades from its R42 billion cash pile. Further tenders are in the pipeline. SANRAL's infrastructure projects are already having a powerful multiplier effect across the broader economy, supporting job creation, local businesses, and community upliftment.

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4. Operation Vulindlela is a joint initiative of the Presidency and National Treasury to accelerate the implementation of structural reforms and support economic recovery. Operation Vulindlela aims to modernise and transform network industries, including electricity, water, transport and digital communications.

Can the GNU deliver growth?

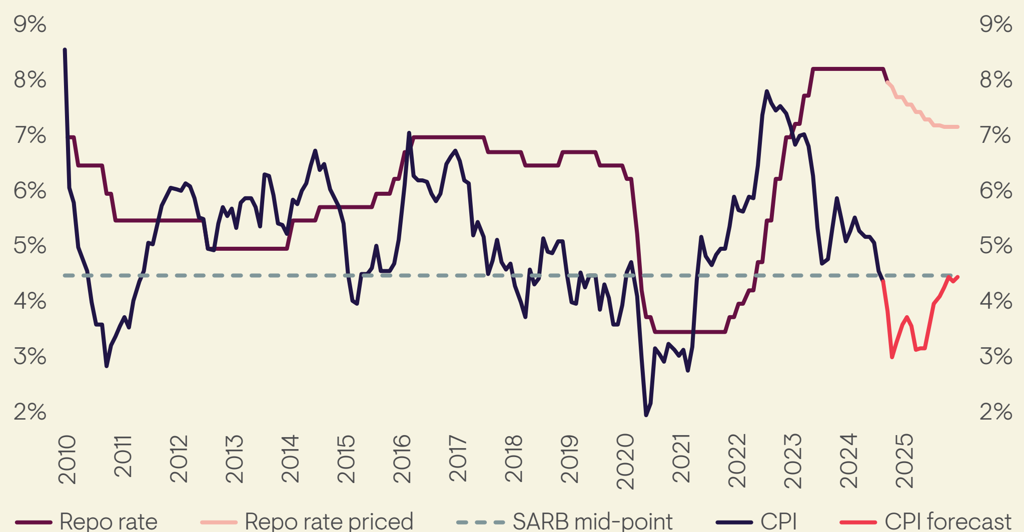
It's too early to tell whether the GNU has moved the growth dial. While there are some policy disagreements among the GNU parties, they are united in getting growth going. Our new system of governance has sparked competition and cooperation among ministers, which should ultimately benefit SA Inc. Some ministries now have a DA minister paired with an ANC deputy minister and vice versa. They have to cooperate to get results. But the GNU ministers are also in competition mode, as they need to sell their party's service delivery success to voters in the next local and national election. This situation has created some healthy competition, and like fund managers, ministers now have to worry about relative performance – how are they faring relative to their peers? Some ministers are already hogging the limelight. For example, Home Affairs Minister Leon Shriver is spearheading visa reforms to boost growth while Trade and Industry Minister Parks Tau is forging a closer relationship with business, focusing on policy reforms that will help to attract investments into the economy.

Benign inflation outlook and rate-cutting cycle bolstering the economy

Growth has been limping along this year, but decelerating inflation and a lower interest rate environment are helping to lift business and consumer confidence. Two-pot withdrawals are also providing a short-term boost to households. CPI inflation has remained comfortably within the target band, and we expect it to move lower, averaging less than 4% over 2025. This should give the South African Reserve Bank room to continue cutting interest rates. SA is now aligned with the global economic cycle for the first time in many years, which bodes well for local assets. Against this backdrop, we anticipate economic growth of 1.7% next year.

Figure 2: More rate cuts are on the table

SA inflation and interest rate expectations



Forecasts are inherently limited and are not a reliable indicator of future results.
Source: Ninety One, October 2024.

A supportive environment for SA bond market

The favourable outlook for the rand, inflation, interest rates and growth supports our bond market. We believe the high yields on SA bonds sufficiently protect against the risks and represent good value over the medium to longer term. Income will remain an important driver of returns, with high yields offering investors the opportunity to earn returns well ahead of inflation.

> Income will remain an important driver of returns.

In conclusion, South Africa is in a much better place than a year ago, but the GNU needs to ensure it delivers on its promises. Now that the electricity handbrake is being lifted, there's every chance that South Africa will get back on track.

"… Take it slow, and it'll work itself out fine. All we need is just a little patience."

Guns N' Roses

fast

Paul Hutchinson
Sales Manager

Lessons in patience

The fast view

- Investors often lose out on returns by being impatient and not staying the course with their investments.
- Market volatility is more pronounced over the short term, while the range of return outcomes narrows substantially as the investment time horizon lengthens.
- A correctly structured investment portfolio requires surprisingly little attention during periods of excessive market volatility.
- We encourage investors to seek professional investment advice, tailored to their individual circumstances.

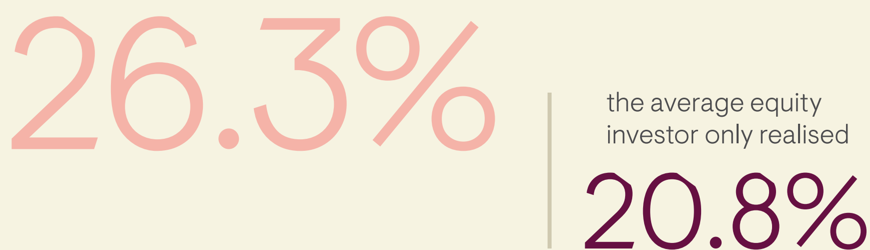
view

Patience is possibly the most important virtue when investing for long-term growth. In fact, one of the world's most successful investors,[1] Mohnish Pabrai goes further, emphasising that "the number one skill in investing is patience – extreme patience."

However, there is continued evidence that investors act impatiently against their own best interests. Earlier this year, DALBAR, a financial services market research firm, released the results of their 30th annual Quantitative Analysis of Investor Behaviour (QAIB) study to the end of 2023. This study measures the effect of investor decisions to buy, sell and switch into and out of mutual funds (unit trusts) over short- and long-term periods.

Unfortunately, the results of the QAIB study do not change. Due to impatience, investors earn less – in many cases, much less – than mutual fund performance reports would suggest. For the calendar year 2023, the US equity market was up 26.3%, whereas the average equity investor realised only 20.8%. Over longer time periods, the average investor gap – the difference between what the portfolio returns and what the investor experiences – while still significant, is lower: approximately 3.6% per annum over both 5 and 10 years. Compounding this difference over the long term will make a meaningful contribution to an investor's ability to retire comfortably.

Over 2023, the US equity market was up



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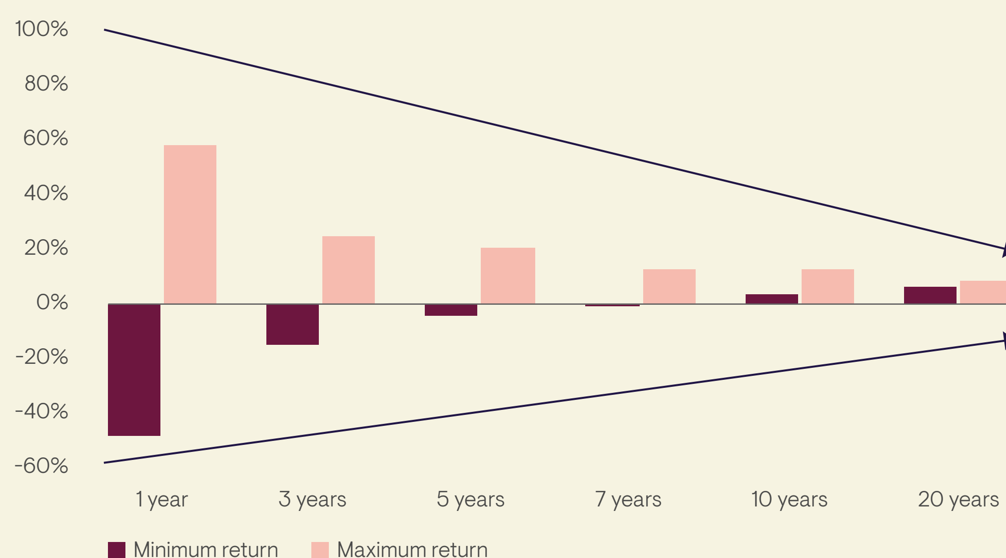
1. From 2000 to 2018, his flagship hedge fund returned 1 204% versus the S&P 500's 159%.

Interestingly, this impatient behaviour is not unique to end investors. William Green[2] makes the compelling point that in 1951, the average holding period of the underlying stocks in US mutual funds was about 6 years. This had reduced to only 1 year by 2000. Vanguard founder, Jack Bogle, warned that "the folly of short-term speculation has replaced the wisdom of long-term investing". By way of comparison, the average holding period of all the stocks ever owned in the Ninety One Global Franchise Fund is almost 4.6 years, and the average holding period of the current portfolio positions is 8.1 years.

We have previously illustrated the benefits of being patient and staying invested in volatile periods using a 'Funnel of uncertainty' chart, which illustrates how the range of return outcomes narrows materially as the investment time horizon extends.

Figure 1: MSCI All Country World Index (ACWI) range of returns

Rolling returns of the ACWI



Source: Morningstar, 1 July 1995 to 30 September 2024. MSCI ACWI NR USD.

You will note that the lowest 1-year return was -48% for the 1 year to 28 February 2009, at the depth of the Global Financial Crisis, whereas the highest return was 58% for the 1 year to 28 February 2010, a range of 1-year return outcomes of an astonishing 106%. However, when considering the lowest and highest 10-year annualised returns, the range has narrowed materially – from a low of 3% per annum to a high of 13% per annum – an all-positive range of return outcomes of only 10%. Over rolling 20-year periods the range of return outcomes reduces further to only 3%. This reinforces the notion that with time/patience comes a greater degree of certainty.

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2. William Green, *Richer, Wiser, Happier*, 2022.

Recently though, I came across a more data-rich way of illustrating investment returns over different time horizons, which we have reproduced for global equities going back to 2001.

Figure 2: MSCI ACWI calendar year annualised forward returns

No. of years forward	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
1	-16%	-19%	34%	15%	11%	21%	12%	-42%	35%	13%	-7%	16%	23%	4%	-2%	8%	24%	-9%	27%	16%	19%	-18%	22%
2	-18%	4%	24%	13%	16%	16%	-20%	-12%	23%	2%	4%	19%	13%	1%	3%	16%	6%	7%	21%	17%	-2%	0%	
3	-3%	8%	20%	16%	14%	-8%	-5%	-4%	12%	7%	10%	14%	8%	3%	9%	7%	12%	10%	20%	4%	6%		
4	1%	8%	20%	15%	-4%	1%	-1%	-5%	13%	10%	8%	10%	8%	8%	4%	11%	13%	12%	9%	8%			
5	3%	11%	18%	0%	3%	3%	-2%	-1%	15%	9%	6%	9%	11%	4%	8%	12%	14%	5%	12%				
6	6%	11%	5%	5%	5%	2%	1%	2%	13%	7%	6%	12%	7%	8%	10%	13%	8%	8%					
7	7%	1%	9%	6%	3%	4%	4%	3%	11%	7%	9%	8%	10%	9%	11%	8%	10%						
8	-1%	5%	9%	4%	4%	6%	4%	2%	10%	9%	6%	11%	11%	10%	7%	10%							
9	2%	6%	7%	6%	6%	6%	3%	3%	12%	7%	8%	11%	11%	6%	8%								
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20	6%	8%	8%	8%																			
21	7%	7%	9%																				
22	5%	7%																					
23	6%																						

The way to read the chart is to pick a starting year, i.e. any year from 2001 to 2023, and then go down the ‘number of years forward’ column. The corresponding square provides the annualised return from that starting year. For example, the 10-year annualised return, starting in 2014, was 8%.

Source: Morningstar, 1 January 2001 to 31 August 2024, MSCI ACWI NR USD.

The chart provides additional useful insights:

Firstly, there are many more positive returns than negative returns! However, there have been a handful of deeply negative returns, centred around the 2008 Global Financial Crisis. In fact, the worst calendar year return was -42% in 2008. This significant drawdown then resulted in the worst 2-year annualised return of -20% per annum (2007/2008).

Interestingly, over this period (2001 – 2023), apart from the -1% annualised return for the 8 years from 2001, the global equity market has not had a negative 6-year annualised return. Investors have been rewarded for demonstrating "*just a little patience.*"

The long term rewards of investing in equities – positive real returns and more certain investment outcomes - are further reinforced when considering how tightly clustered the annualised returns are in the bottom left section of the chart.

Reading the rows in the chart from left to right also provides insight into the range of 1, 2, 3, ... annualised returns – see the bolded numbers, which represent both the highest and lowest annualised return in each row. So, for example, the calendar 1-year return ranges from -42% in calendar year 2008 to +35% in 2009.

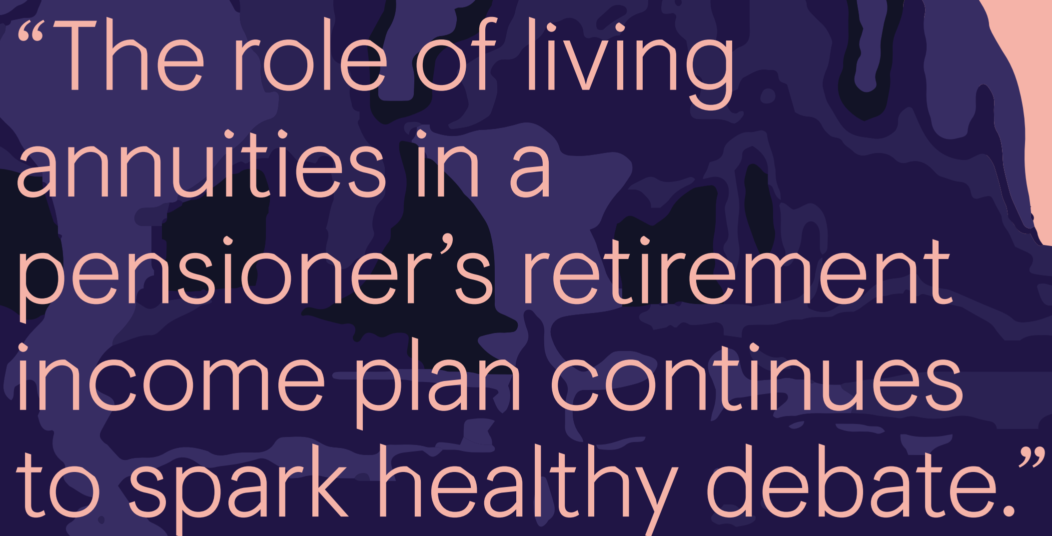
Investors who panicked and disinvested after such a negative return in 2008 missed the material 35% recovery in 2009. This reinforces the key lesson of staying invested.

As with the funnel of uncertainty chart, the range of return outcomes narrows materially as the investment time horizon lengthens.

Conclusion

During times of market instability, investors must not panic. Rather, they should remain patient and recommit to their long-term investment goals and bear in mind that they are most likely to achieve these by time in the market and not timing the market.

A good financial advisor can help investors to understand their future cash-flow requirements and ensure that investment portfolios are set up correctly to cater for these needs. A correctly structured investment portfolio requires surprisingly little attention during periods of excessive market volatility. However, a further critical role played by good financial advisors is to counsel patience during these not-infrequent periods of uncertainty. We therefore encourage investors to seek professional investment advice, tailored to their individual circumstances.



"The role of living annuities in a pensioner's retirement income plan continues to spark healthy debate."

Jaco van Tonder

Jaco van Tonder
Advisor Services Director

Avoid these blind spots when structuring retirement income

The fast view

- Investing pensioners' retirement assets primarily in offshore assets has become a popular investment strategy. However, a very high offshore exposure may not be appropriate for annuitants.
- While the erosion of purchasing power is the number one risk to pensioners, the long-term cyclicality of inflation is often overlooked in retirement planning.
- The unpredictability of financial needs over a retirement period that could span 30 years or more demands a flexible approach when structuring retirement income.
- A well-constructed living annuity invested with proven investment managers, remains a core tool for advisors to solve the long-term retirement income puzzle for pensioners.

As we approach the end of 2024, it is important to reflect on the year's key themes shaping retirement income advice in South Africa.

Before we dive into the themes, some historical context is needed. Between 2000 and 2015, SA bond, property and equity markets delivered attractive real returns, allowing living annuities to become the preferred retirement income product. It is estimated that around 2015, over 90% of pension fund assets were allocated to living annuities upon retirement.

However, this trend shifted after 2015 as the SA economy faced a series of crises, including load-shedding, the Covid pandemic and infrastructure failures. Difficult market conditions sparked an industry-wide debate about the most appropriate application of living annuities in retirement plans. Key issues include safe versus dangerous living annuities, addressing the challenge of poorly structured living annuities and the role of guaranteed annuities. At Ninety One, we have published widely on these topics since 2017, and our articles and videos are available on our website.[1]

In this article, we focus on the more recent retirement income themes that defined 2024 and discuss some potential blind spots when structuring solutions for pensioners.

1 Can offshore be too much of a good thing?

In our initial work on sustainable living annuities in 2017, we identified offshore equity exposure as one of the key pillars of a successful living annuity. Our research showed that a healthy living annuity needed at least 25% exposure to offshore equities to maximise a pensioner's success rates.

In light of the challenging market conditions during and after the Covid pandemic, we revisited our models to address a new question: Could excessive offshore exposure negatively impact the success rates of a living annuity?

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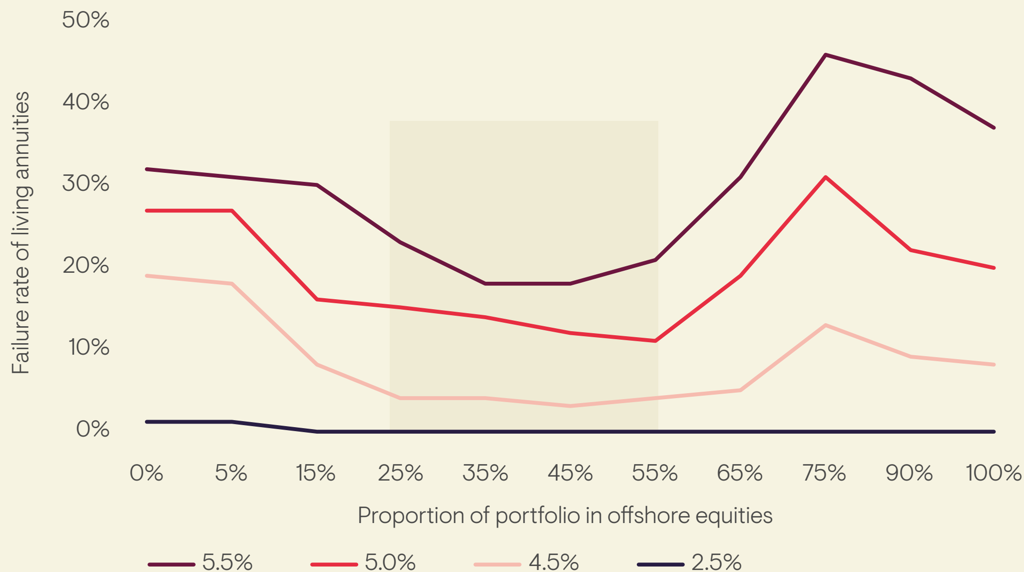
1. Managing retirement income I Ninety One I South Africa.

Figure 1: Impact of offshore exposure on different income-drawing living annuities



Source: Ninety One.

Figure 1 illustrates the failure rates associated with various levels of offshore equity exposure across four different living annuities with varying starting income draws. What is important is the shaded area where the failure rates of the annuities are at their lowest. That occurs when the offshore equity exposure in the annuity is anywhere between 25% and 55%.

A second key takeaway from the graph is that very high offshore equity exposure (over 60%) dramatically increases the failure rates of living annuities in all cases, except for very low income-drawing annuities (i.e. 2.5%).

This conclusion contributes to an ongoing debate and serves as an important warning to advisors who primarily invest pensioners' living annuities in offshore assets. Such a strategy may only be suitable for investors planning to emigrate and who will have future living expenses in hard currency. For those intending to retire in South Africa, a very high offshore exposure in their living annuity may not be appropriate.

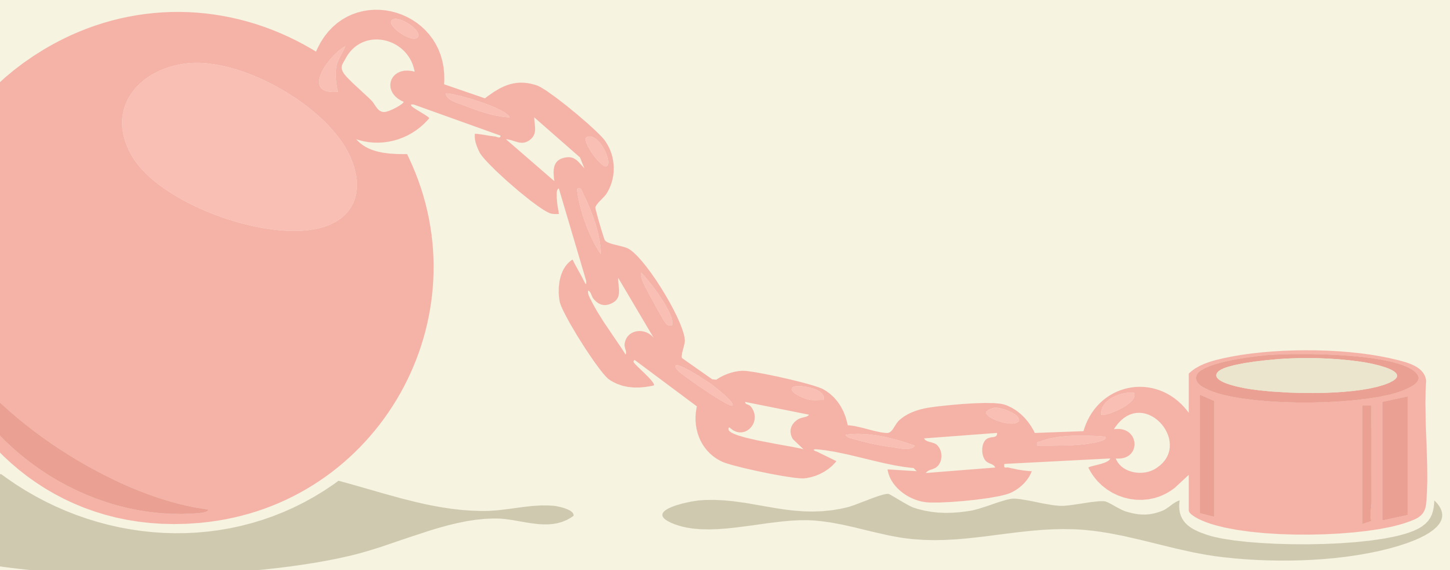
2 Guaranteed annuities and the inflation/ interest rate cycle

A second debate has centered around the growing popularity of guaranteed life annuities, particularly as bond yields (and therefore annuity rates) spiked.

Since the period of higher interest rates and inflation also coincided with pedestrian equity market returns, many advisors faced a dilemma: continue along the path of a living annuity struggling to beat inflation in the short term, or take the 'easier' option (from a client relationship perspective) and place clients in a guaranteed life annuity at attractive rates?

> Guaranteed or hybrid annuities have their place for the right client. But these products are not silver bullet solutions.

Make no mistake, guaranteed or hybrid annuities have their place for the right client. But these products are not silver bullet solutions: They introduce other risks that advisors need to quantify for pensioners. Other than the obvious risks such as liquidity constraints and long-term exposure to a life company's balance sheet, we will examine guaranteed annuities and focus on the most important risk facing any pensioner: **inflation**.

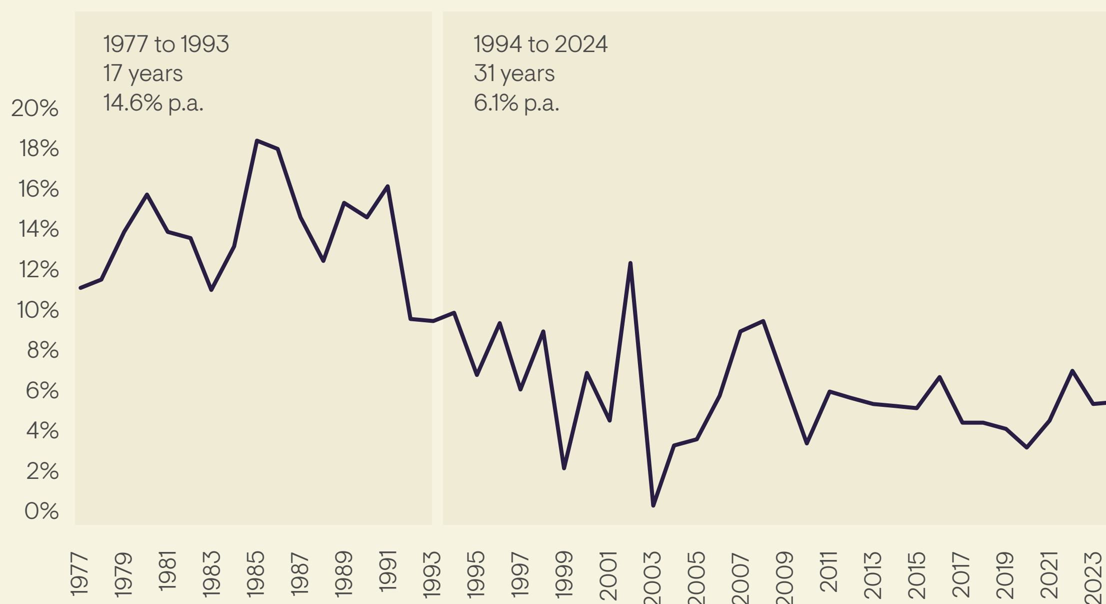


Inflation – the number one risk to all pensioners

Inflation is a widely recognised economic concept, familiar to many, including clients. Given this awareness, it is surprising that the significant long-term risk posed by inflation is often overlooked in retirement income planning.

To unpack this point, let us look at one of the frequently underestimated characteristics of inflation: its long-term cyclicality. Figure 2 illustrates South Africa's consumer price index (CPI) since 1977.

Figure 2: Historical South African consumer price index



Source: Morningstar, dates to 30 September 2024.

The graph highlights an important principle for pensioners: Inflation moves in long-term cycles, and over the course of the average 30-year pensioner income plan there is a meaningful chance of encountering one of these higher-than-expected inflation decades.

This poses a problem, particularly for guaranteed annuities that offer fixed percentage income increases every year. Having recently lived through 20 years of low global inflation, it is easy to forget the high inflation decade of the 1970s. Especially, since spikes in annuity rates reflect sharp increases in bond market yields which, in turn, indicate market concerns about higher future inflation.

And you do not need a significant mistake in your inflation estimate for the error to have serious repercussions when compounded over a decade or more. Table 1 shows the cumulative loss in buying power of an income over different terms and for different levels of inflation errors.

Table 1: Cumulative deterioration in the buying power of income from underestimating inflation over extended periods

	Loss of buying power of income over different terms	
Inflation error	**10-year term**	**15-year term**
1% p.a.	10%	16%
2% p.a.	22%	35%
3% p.a.	34%	56%

Source: Ninety One.

Even moderate inflation (say, 8% p.a. inflation for a decade) will reduce the real buying power of an annuity with 6% p.a. income increases by almost 22% over the course of 10 years. And if you picked a 5% p.a. fixed increase, in these conditions your buying power would be eroded by close to 35% within a decade – and more than 50% over a 15-year period.

So why not just purchase a CPI-indexed life annuity and pass the inflation risk on to the life company, I hear many readers ask? The problem in South Africa is that our bond market does not offer a decent range of inflation-linked bonds for life companies to hedge themselves against the inflation risk. Therefore, few local life companies offer a CPI-linked increase option for their life annuities. Those that do, provide poor rates – typically just over 5% initial income on a dual-life annuity for a pensioner in their early 60s. These rates are similar to the 5% maximum initial income draws you can safely get from a sustainable living annuity.

3 The value of optionality in retirement planning

Our third discussion theme for 2024 highlights the importance of optionality in retirement planning, particularly for pensioners facing financial uncertainty. Unlike 30 years ago, when retirees typically lived 15 years after retirement, modern mortality tables in South Africa indicate that retirement plans should cater for around 30 years of income.

Many financial advisors have observed that retirement is no longer a one-time event in your 60s, requiring minimal ongoing advice. Today's retirees live longer and may pursue second careers, complicating cash-flow predictions even a decade after retirement. Factors like health issues or family changes often necessitate significant adjustments to retirement plans, making continuous advice crucial.

This extended retirement period and the unpredictability of financial needs are causing many pensioners to postpone purchasing guaranteed life annuities. Many advisors and retirees are increasingly adopting a "wait-and-see" approach on guaranteed annuities, even if an early purchase would likely offer better value for money.

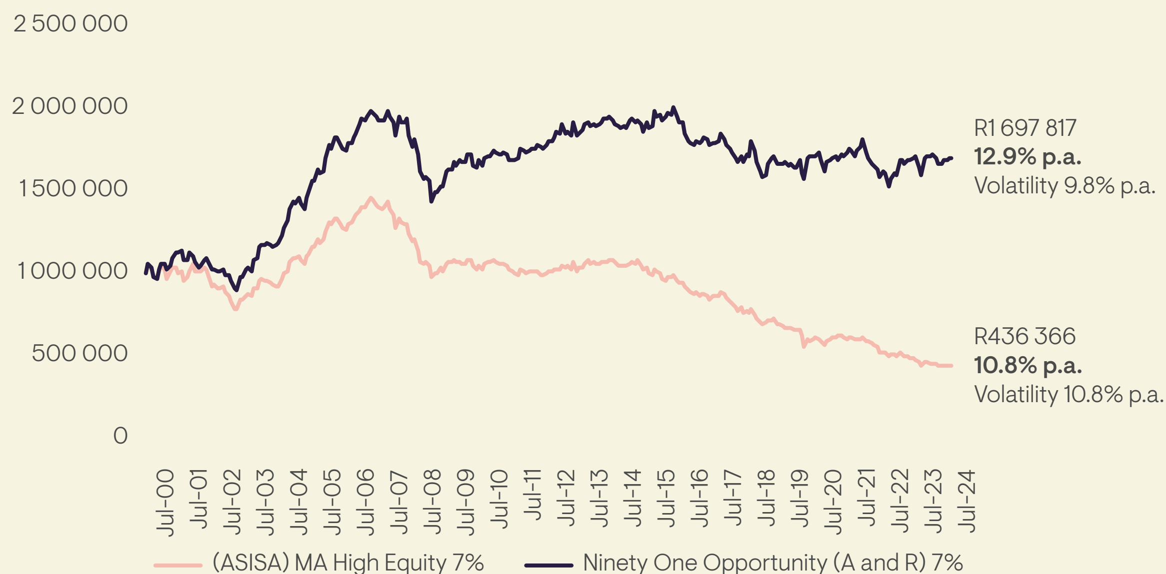
Conversely, living annuities provide valuable flexibility, allowing adjustments to income or transitions to different annuity types over time. Therefore, advisors should consider allocating a pensioner's retirement assets across multiple living annuities at retirement to maximise the pensioner's future flexibility.

4 Manager alpha and its outsized impact on living annuities

The final discussion focuses on the crucial role that both the portfolio and the investment manager play in the financial success of a living annuity. This important aspect is often overlooked.

Figure 3 depicts the inflation-adjusted assets of two living annuities from 1 January 2000 to 30 September 2024. Both started with a capital sum of R1 million, a 7% income draw (so higher than our rule-of-thumb maximum rate of 5%) and CPI income increases every year. One of the annuities is invested in the ASISA Multi-Asset High Equity sector (often referred to as the Balanced fund sector) and the other in the Ninety One Opportunity Fund.

Figure 3: Importance of manager alpha – two 7% p.a. income living annuities



Past performance is not an indicator of future results; losses may be made. For illustrative purposes only.

Source: Ninety One and Morningstar, dates to 30.09.24. Performance figures are calculated NAV to NAV, with income reinvested, net of fees in ZAR. The performance of Ninety One Opportunity is based on the A class for periods that fall within the A Inc ZAR class unit inception date (02.04.00). An individual investor's performance may vary depending on actual investment dates. Highest and lowest annualised returns for Ninety One Opportunity (rolling 12-month figures): Jul-05: 43.8% and Feb-09: -15.7%. Please also refer to the Ninety One Opportunity Fund page on our website.

The performance numbers shown for each living annuity represents the cumulative lump sum performance over the full investment term.

The graph highlights how small absolute levels of manager outperformance compound quickly over time, especially in a living annuity. The difference in volatility and performance for each of the annuities is only in the region of 1-2% per year. However, after almost 25 years, the inflation-adjusted portfolio value for the annuity with the Ninety One Opportunity Fund is more than double that of the sector average.

The manager outperformance over the period also means that the Ninety One Opportunity Fund was able to sustain a 7% income draw living annuity – an income level that is much higher than our safe maximum level of 5% mentioned earlier.

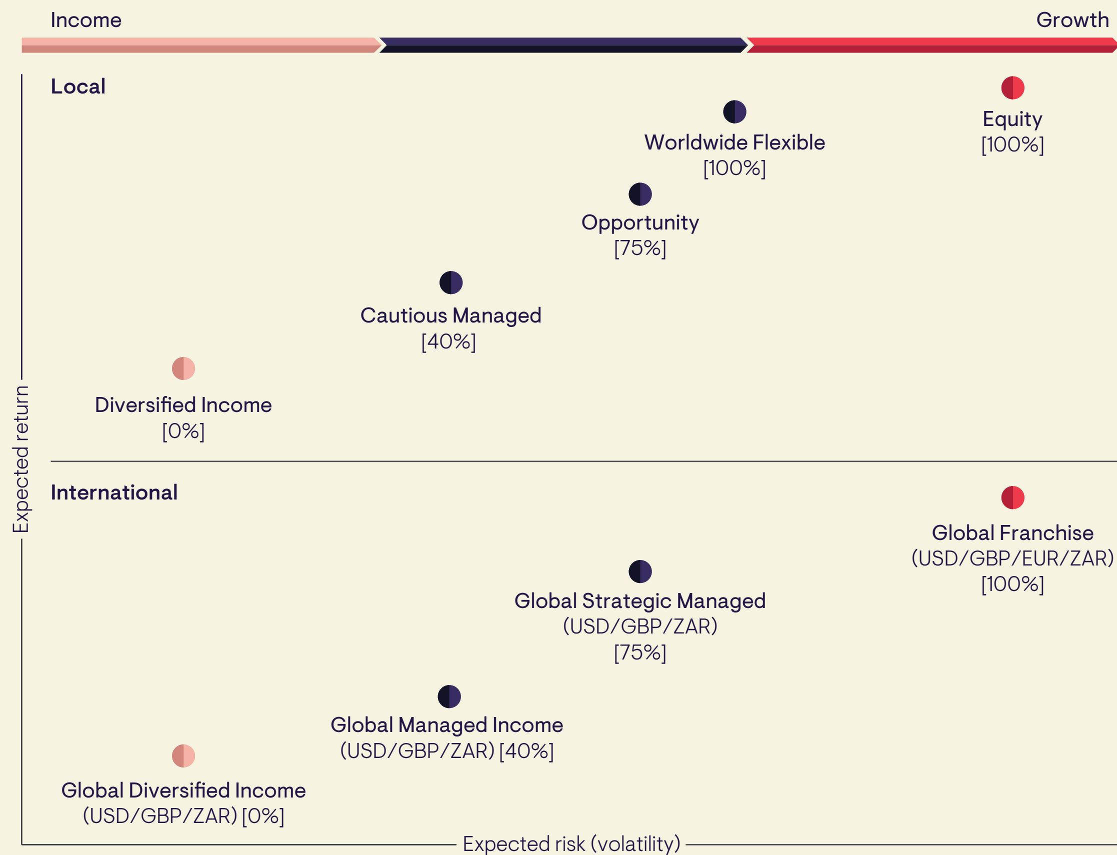
Conclusion

The role of living annuities in a pensioner's retirement income plan continues to spark healthy debate and market analysis.

After many years where the discussion focused rather one-dimensionally on "living annuities versus guaranteed annuities", the debate has become more nuanced. It now centers on optimising the result from a living annuity, and when to blend different types of annuities over the retirement lifetime of a pensioner couple.

A well-constructed living annuity invested with proven investment managers, remains a core tool for advisors to solve the long-term retirement income puzzle for pensioners.

Ninety One core fund range



Note: [ ] indicates maximum in equities. Our offshore funds are available as feeder funds. The expected risk and volatility may not be achieved, and the value of your investment may go down as well as up. Please refer to our Core fund range page on our website.

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CS_717 11/2024