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Managing market risk for pensioners: protecting pension income as retirement nears



Jaco van Tonder
Advisor Services Director

The fast view

- Pre-retirement market corrections pose a significant risk to pension income stability.
- Different annuity types require tailored pre-retirement investment strategies.
- Investors choosing guaranteed annuities should during their last few working years gradually shift towards a bond-oriented portfolio that matches their chosen annuity's asset composition.
- Living annuity investors require exposure to growth assets such as equities to ensure a sustainable pension income. Therefore, de-risking their portfolio before retirement is generally not a prudent strategy.
- They should maintain their pre-retirement equity exposure into retirement, staying invested during market downturns to avoid locking in losses.

Retirement savers face numerous risks throughout their financial journey. Most of these risks are well understood: starting retirement planning too late, contributing inadequate amounts to their pension pot, making early withdrawals from retirement funds and investing pension assets too conservatively. While we've addressed these issues in previous articles, another critical risk emerges as retirement approaches – one that recent global market volatility has brought into sharp focus.

The pre-retirement vulnerability window

Adverse market movements close to retirement can significantly erode the value of a pension pot at the worst possible time. A key objective for financial advisors during these vulnerable final years is helping clients navigate this risk to ensure their retirement income objectives remain achievable.

What's crucial to understand is that the optimal approach to managing this risk depends not only on the investment strategy but also on the type of annuity the retiree intends to purchase. This article outlines tailored protection strategies aligned with different annuity types, offering a practical framework for managing risk from pre- to post-retirement.

Understanding the pre-retirement to post-retirement transition risk

We have previously explored the risks pensioners face from different pension income product options. However, the specific retirement income product chosen also exposes retirees to sequence-of-returns risk during the final accumulation years, where market shocks occurring shortly before retirement can disproportionately impact retirement incomes.

Many occupational retirement funds in South Africa attempt to address this risk through life-stage investment strategies, where asset allocations become increasingly conservative as retirement approaches. This creates a false sense of security by focusing on maintaining a stable market value of the pension benefit, when the real priority should be on the level of inflation-adjusted income the pensioner will be able to secure. That said, a life-stage portfolio may still be appropriate in certain circumstances – but it's not a universal solution for mitigating market risk close to retirement.

Case study: Mr Johnson

Let us consider Mr Johnson, who has contributed to his company pension fund throughout his working life and now has R10 million saved for retirement:

- His retirement portfolio is invested in a standard balanced portfolio (70% equities and 30% bonds).
- He plans to retire with a living annuity, maintaining 60-70% equity exposure and drawing an initial annual income of 4%.
- Shortly before his retirement date, an equity market drop of 15% reduces his fund value by 10%.

Is Mr Johnson worse off? Conventional wisdom suggests yes, as his pension portfolio has decreased by 10% to R9 million. The reality, however, depends on the nature of the market drawdown:

Scenario 1

If the equity market drawdown is short-lived due to temporary factors, Mr Johnson will be largely unaffected. As markets recover, so too will his portfolio – provided he maintains a high equity exposure.

Scenario 2

If, however, the correction stems from structural, longer-term economic headwinds leading to a 5-year bear market, Mr Johnson's portfolio will experience significant sequence-of-returns risk. His living annuity will struggle to recover unless he can temporarily reduce his income withdrawals during this period.

What can Mr Johnson do to protect his portfolio in those crucial few years before retirement? Unfortunately, there isn't a straightforward solution.

Progressively switching his pension portfolio into lower-risk investments like bonds and cash during his last few working years may seem attractive to guard against a market collapse. But it feels counterintuitive to de-risk a long-term investment portfolio to fixed income prior to retirement. By switching to fixed income, he risks locking in market losses or missing out on valuable equity market growth in those critical final years. Additionally, he would then need to phase back into equities after purchasing the living annuity, introducing further complexity.

Another case study: Ms Smith

Now consider Ms Smith, who is also about to retire from her company pension fund, with R10 million available to purchase a lifetime pension income:

- Her retirement portfolio is also invested in a standard balanced portfolio (70% equities and 30% bonds).
- She wants to retire with a fully guaranteed life annuity with a 5% fixed annual income increase – currently offering a 6.5% starting income (R650 000 p.a.).
- Shortly before her retirement date, an equity market drop of 15% reduces her fund value by 10%.

Is Ms Smith worse off? Again, conventional wisdom suggests yes, as her pension portfolio has decreased by 10% to R9 million. However, the reality depends on bond market behaviour during the equity market decline, as guaranteed annuity rates are driven by long-dated bond yields.

The outcome varies depending on the context:

Scenario 1

The correction is triggered by a temporarily overheated equity market, with no fears of an economic crisis. Bond yields and annuity rates remain stable at 6.5%. Here, Ms Smith is indeed worse off, as her starting income falls from R650 000 to R585 000 annually.

Scenario 2

The correction stems from structural economic issues – credit fears, a weakening currency and inflation concerns – causing both equity and bond markets to experience capital losses. Bond price declines increase yields, triggering a spike in life annuity rates to 8.5% (similar to the 2008 Global Financial Crisis). In this scenario, Ms Smith's starting income actually increases to R765 000 – higher than before the market correction. However, the possibility of rising inflation eroding her pension income over time is a concern.

What pre-retirement investment strategy could protect Ms Smith's pension pot? The simplest strategy would be to match the asset allocation of the guaranteed life annuity portfolio she intends to purchase for her pension income. This typically comprises 10%-15% equity exposure, with the majority of assets invested in medium- and long-dated bonds. The pension fund or financial advisor could implement a glide path to this portfolio allocation during the final 3-5 years before retirement.

Executing this strategy effectively hedges Ms Smith's income against late-market corrections negatively impacting her initial income. However, it also means that she will not fully participate if equity markets rally shortly before she retires.

Both examples illustrate that there are no free lunches when trying to protect pension pots against pre-retirement market corrections. All the options involve a trade-off between risk and return.

Solving the problem: working backwards from the annuity strategy

Both case studies highlight why advance planning for the transition into retirement is so important. Ideally, an advisor should actively engage with prospective pensioners starting 3-5 years before the planned retirement date.

Effectively managing the risks associated with a pre-retirement market correction requires a clear understanding of the intended pension annuity type. The key investment strategy involves gradually aligning the asset allocation of the pre-retirement portfolio with that of the chosen pension annuity.

Guaranteed annuities require a bond-matching strategy

For someone like Ms Smith, who is retiring with a guaranteed life annuity, income certainty is more important than other considerations. Target clients for guaranteed annuities often have limited retirement savings from the outset, reinforcing the need for secure, predictable income.

For Ms Smith, it makes sense to gradually de-risk her portfolio in the final working years. Such an approach can be implemented by investing her pension pot in a life-stage portfolio at least 3 years before retirement. This creates a glide path towards matching the bond portfolio typically backing guaranteed life annuities, largely mitigating the impact of late-market shocks on her starting pension income.

Most occupational pension funds in South Africa now offer life-stage solutions to members.

Living annuities require a growth-asset strategy

In the case of Mr Johnson, who intends to purchase a living annuity, a different approach is required. Some readers might intuitively feel that Mr Johnson should follow the same glide path towards a bond portfolio as Ms Smith. Wouldn't a bond portfolio provide a more stable fund value in the final years?

This is a common misconception, as what truly matters is the stability of pension income – not necessarily the stability of the portfolio value. Following a glide path towards a bond portfolio actually represents a tactical asset allocation strategy, where the investor shifts into fixed income before retirement, only to switch back into a balanced portfolio upon converting to a living annuity. Such dramatic changes in asset allocation exacerbate rather than solve the problem.

What truly matters is the stability of pension income – not necessarily the stability of the portfolio value.

Mr Johnson's optimal strategy is actually to maintain his pre-retirement equity exposure throughout his final working years – just as any long-term investor should remain invested during market downturns. Based on our previous research into optimal living annuity portfolios, this means maintaining around a 60% equity exposure in those critical final years before retirement.¹

If Mr Johnson wanted additional protection, he could implement other strategies to guard against market volatility around his retirement date. One strategy, if affordable, would be temporarily drawing a very low income from his living annuity for one or two years following a market crash. This would give his living annuity time to recover with the markets.

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A second strategy would be investing those final three years in a low-volatility balanced portfolio offering downside protection while still retaining meaningful exposure to equity growth assets. The **Ninety One Opportunity Fund** provides an excellent example of such an option, demonstrating a credible track record of equity market participation combined with downside protection since inception.

Figure 1: Ninety One Opportunity Fund – producing equity-matching returns at half the volatility since inception



Source: Morningstar, NAV to NAV, gross income re-invested, performance net of fees from 02.05.00 to 31.03.25. Equities represented by the FTSE/JSE All Share TR.

Conclusion: matching investment strategy to reality

A well-structured retirement transition plan isn't about blindly protecting pension asset values from adverse markets in the final pre-retirement years. Rather, it involves carefully aligning the investment strategy with each client's income goals and chosen annuity.

Different annuity types introduce distinct risks, each requiring tailored actions during those critical final years before retirement. For financial advisors, understanding these nuances is essential for designing pre-retirement portfolios that provide stability and confidence to pensioners as they approach retirement – regardless of market conditions.

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Contact information

36 Hans Strijdom Avenue
Foreshore, Cape Town
8001

Telephone: +27 (0)21901 1000
Client service support: 0860 500 100
Email: clientservice@ninetyone.com

Please contact our Advisor Service Centre on telephone: 0860 444 487.

Alternatively, please contact your Ninety One investment consultant.

www.ninetyone.com