Funds on FRIDAY

glacier by Sanlam

8th September 2006 COMPILED BY: GLACIER RESEARCH

This week Ian Bester and Edwin Schultz from Coronation Funds Management discuss sustainable long-term withdrawal rates for pension portfolios in light of both the long term experience plus the recent market volatility.

Coronation Fund Managers is one of the largest asset management companies in South Africa.

Coronation manage funds in excess of R90 billion, and have offices in South Africa, Botswana, Ireland and the United Kingdom. Coronation also has a presence in Namibia through their shareholding and strategic partnership with Namibia Asset Management.

How much should clients withdraw from their pension?

"If we take a late retirement and an early death, we may just squeak by"

Unfortunately, for a very large portion of the South-African retired population, the withdrawal rate debate is an academic one only, because most people have simply not saved enough to be able to meet their liabilities post retirement while keeping their capital intact. Their basic cost of living, survival essentially, will determine their withdrawal and capital consumption rates.

We are therefore painfully aware that this discussion focuses only on the fortunate few that actually are in the position to have "enough" capital available to potentially put them in a position that the returns from their investment portfolio will match the combined effect of drawing an income, inflation, tax and costs. In this rather happy outcome, the investor's capital base will remain intact at death. We use the word "potentially" deliberately.

Unfortunately not everyone with the potential to have an annuity income for life and maintain the original capital in real terms will end up achieving this. The most obvious reason is that the income withdrawal rate is too high; another is that few investors appreciate the importance of asset allocation. Investors, and their advisors, tend to overemphasize past performance when constructing investment portfolios. Unfortunately, the future may bring very different results than that set out in the table below. Over the past ten years the defining features of the economic landscape were declining inflation and interest rates. With this strong tail-wind most asset classes, especially bonds and property, offered excellent returns.

It is important to understand that the bulk of these returns were of a capital nature, as specifically bond and property prices could justifiably be higher as a result of lower interest rates.

Private Bag X5 Tyger Valley 7536
Email client.services@glaacier.co.za

Tel +27 21 917 9601
Fax +27 21 957 1710
Web www.glacier.co.za

Sanlam Personal Portfolios (Pty) Ltd, A member of the Sanlam Group
Reg No 1999/025360/07 Licensed Financial Services Provider
Directors AA Raath (Chairman & CEO), E Wessels, MT Möller

The information contained in this document has been recorded and arrived by Sanlam Personal Portfolios in good faith and from sources believed to be reliable, but no representation or warranty, expressed or implied, is made as to their accuracy, completeness or correctness. The information is provided for information purposes only and to assist the financial intermediary to submit an investment proposal to the client and should not be constructed as the rendering of investment advice to clients. Sanlam Personal Portfolios (Pty) Ltd accordingly accepts no liability whatsoever for any direct, indirect or consequential loss arising from the use of reliance, in any manner, on the information provided in this document.

An Exceptional Experience: The Past Ten Years of Annualised Returns

	2 years	3 years	5 years	10 years
All Share	46.8%	45.4%	22.5%	14.9%
Resources	46.5%	41.4%	24.1%	20.19%
Financials	49.2%	44.8%	19.5%	15.0%
Industrials	45.2%	51.2%	21.5%	10.5%
Property Unit Trusts	52.4%	43.5%	33.8%	27.4%
All Bond	15.2%	13.4%	14.6%	17.1%
Cash	7.7%	8.7%	9.9%	12.5%
CPIX	3.8%	4.0%	5.7%	6.8%

Long term asset class returns to 30 June 2006. Source: Deutsche Bank

The flipside of these capital gains is that we moved from a high yield to a low yield environment. Unfortunately, the only certainty in financial markets is that no trend continues indefinitely. Inflation has, in all likelihood, found its bottom and over the short term we expect rising inflation and therefore rising interest rates. This simply means that we can't expect a repeat of the spectacular capital gains, especially in property and bonds, for the foreseeable future.

If the asset allocation in a post retirement portfolio is entirely made up of a basket of managed flexible fixed interest funds and property funds, with no equity exposure, it could be argued that past performance played too big a role in constructing the portfolio.

When deciding on the appropriate asset allocation strategy for a portfolio, it is much more sensible to develop expectations about the future returns of different asset classes. Coronation's expected annual average returns over the next three years[1] are as follows:

Our Annulised Return Forecasts for the Next Three Years

Cash	8.0%
Bonds	7.9%
Inflation-linked Bonds	7.1%
Property	8.0%
Resources	13.2%
Industrial	22.9%
Financial	18.0%
International Equities	10.5%

If our expectations prove to be accurate, an investor in a portfolio consisting only of bond and property assets will be able to withdraw up to around 8% p.a., while preserving capital in nominal terms. The investor will however not be compensated for the erosive effect of inflation.

Equities are the only asset class that has consistently outperformed inflation by a substantial margin over the longer term. It is interesting to note that in the 60's and 70's when the world experienced rising inflation and interest rates, equities still managed to outperform inflation by a substantial margin whilst bonds underperformed inflation. But, equities introduce a higher level of volatility to the post-retirement portfolio which investors and financial advisors often prefer to avoid. Unfortunately the "ostrich"-approach will not solve the problem. Embracing and managing risk is a more appropriate response.

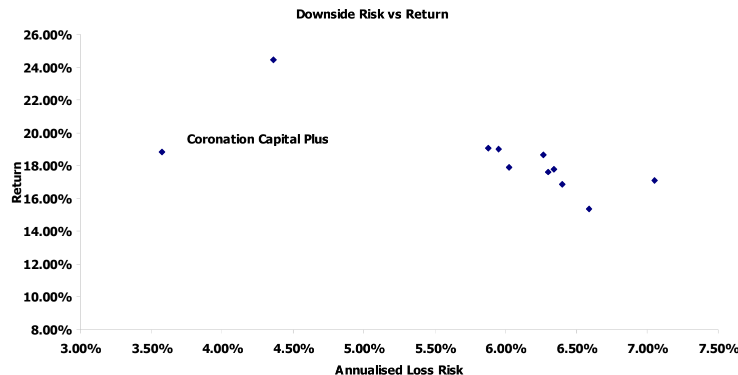
Coronation believes that a substantial portion (30 – 50%) of post retirement assets can be invested in equities without introducing excessive levels of risk to the portfolio. In August 1999 Coronation launched South-Africa's first absolute return fund aimed at pension funds.

[1] *Although it is impossible to forecast short-term market movements, it is possible to estimate average returns over the medium term with reasonable results. Actual annual experience, especially for equity, international and property assets may vary significantly, however.*

The approach adopted in this strategy differs from the typical balanced fund as follows:

1. Real return benchmarks. The fund aims to outperform inflation by at least 7%.
2. Structurally lower equity exposure. The average equity exposure for the period was 46%, compared to 60% average exposure in balanced funds. It was at times as low as 30%.
3. Capital protection over rolling 12 months.
4. Extensive use of derivatives to protect downside.
5. Clean slate share selection, i.e. no reference to index benchmarks or competitor portfolios.
   - The fund only invests in shares with a high margin of safety, i.e. share prices trading at a large discount to what we believe its fair value is.
   - Maximum exposure to a single share limited to 4% therefore greater share diversification
   - No more than 10% exposure to a single sector
6. Active tactical asset allocation. For example, the long term strategic asset allocation model might dictate that the fund should have 20% invested in property, but at the start of the second quarter 2006 Coronation held no property exposure.

And the strategy paid off, with the fund producing competitive returns at significantly lower risk of loss when compared to the typical pension fund portfolio:



Source: Coronation Calculations; Alexander Forbes Large Manager Watch

In September 2001 Coronation launched a unit trust, the Coronation Capital Plus Fund, applying similar portfolio construction principles. This fund aims to not lose capital over any 12 month period. While this fund has a minimum performance target of CPIX + 4%, the fund delivered an annual return of 17.9%, resulting in real returns of 12% p.a. since inception.

A year later Coronation launched a further unit trust, the Coronation Absolute Fund, which aims to produce a real return of at least 6% while protecting capital over a rolling 36 month period. Although the fund is managed on the same principles as the other absolute funds, the fund is not restricted in terms of its level of equity exposure. This fund is therefore not suitable for highly risk-averse investors.

The 4% and 6% minimum acceptable real returns of the funds listed above provides an indication of what Coronation believes to be reasonable withdrawal rates, if the objective is to maintain the purchasing power of the capital base indefinitely. Higher withdrawal rates may be justified, but will in all probability mean that capital will be consumed in the process.

It is critical that the investor goes through a process of thorough financial planning, facilitated by an experienced registered financial advisor, prior to constructing an appropriate investment portfolio. There is no single or correct answer to the original question, but to say that one cannot see what is ahead whilst looking in the rear view mirror.

Up to this point we have focused on the principles. It is also worthwhile to review short-term activity in our absolute return portfolios. The current environment is certainly very different from 3-4 months ago. We remember doing feedback to investors in April this year and with the exception of local equities, domestic asset classes were looking overvalued.

With equities having had a strong run as well, cash levels in the absolute portfolios were running higher than normal. Cash returns were low, earning around 7%, which made the prospect of returning inflation + 4-6% look very demanding. One silver lining, the strong Rand, presented promising prospects for the international component of the portfolios, but for domestic only portfolios the environment was challenging.

All changed at the end of May. We saw a big correction in domestic interest rate sensitive stocks, coinciding with an interest rate increase largely unexpected by the market. Bonds sold off by close to 200 basis points, and listed property was down around 24% from peak to trough. Suddenly many more opportunities with a reasonable probability of producing inflation-beating returns became available. As a result, we made significant changes to the asset allocation in our absolute funds, and feel more confident of meeting our objectives going forward. While equities still remain by far our preferred asset class, there are now many more trading opportunities in the bond market, given the increased volatility, and selected listed property stocks are again looking attractive (offering returns of 12-15% over the medium term).

We believe that there has been an over-reaction to the changed interest rate environment, which has created huge opportunities in many of the local financial and industrial stocks. There has been massive switching out of these stocks into commodity shares. At the same time, while we have increased equity exposure within the absolute funds, we have decided to retain and also re-institute new hedging strategies within the fund, in the light of a more challenging macro environment. This is in line with our mandate to protect capital within the fund.

While only time will tell, we do feel more confident of our ability to generate alpha within our funds given the indiscriminate selling in many of the local stocks. There are also now more asset classes trading closer to fair value, which should aid overall portfolio returns going forward.

Most importantly, we think the recent market volatility has highlighted the importance of having a flexible approach around asset allocation as we do in all our absolute return funds. One should think of risk not just in terms of the potential of losing capital, but more so as the potential of not matching one's liabilities. Hopefully this article has provided some insight in terms of our view on the road ahead.

Glacier would like to thank Coronation for their contribution to this series of Funds on Friday.