GRAYISSUE

Consider your lifestyle inflation when saving for retirement

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While most investors seem to understand the need to contribute consistently to their retirement funds, and to start saving as early as possible, many investors fail to understand the impact of their 'lifestyle inflation' on their ability to save enough to maintain their standard of living during retirement.

What do we mean by lifestyle inflation?

Price inflation is a general increase in prices and a corresponding fall in the purchasing power of your money. Salary increases that keep pace with price inflation allow you to maintain a fixed standard of living over time. However, salary increases that exceed price inflation may increase your standard of living and therefore also your cost of living. You can think of this as lifestyle inflation, which is the increase in your standard of living over time. When investing for retirement, it is important to plan for future increases in prices (i.e. price inflation) and future increases in your standard of living (i.e. lifestyle inflation).

Larger salary, easier retirement?

Promotions and salary increases late in your working life are probably the reward for hard work and commitment. It doesn't take long to get used to the better lifestyle that comes with these pay increases and when you retire, it is your new lifestyle that you will be trying to match. If this new lifestyle was not allowed for when calculating how much to save in previous years, your increase may have a dramatic impact on how long your existing retirement savings are expected to last and what you need to save moving forward.

To illustrate this, consider someone who started working at 25, is now 45, and is looking to retire at 65. They receive salary increases linked to price inflation throughout their working life, and contribute 10% of their salary to their retirement savings. If we assume inflation of 6%, a return of 11% and a salary replacement ratio at retirement of 70%, they would maintain their pre-retirement standard of living to age 94.

But many people progress through their careers. To illustrate the effect of this, assume that the person above works hard and gets a big promotion and a once-off increase of 60% at age 45. Changing nothing else, they could now be expected to maintain their pre-retirement standard of living to only age 79.

The 'lifestyle inflation' introduced by the 60% increase reduces the impact of their savings to that point compared to their (new) standard of living. To maintain their pre-retirement standard of living to age 94 following the increase, they would need to increase their retirement savings by more than 8% or defer their retirement by four years, since they are now saving to reach a more demanding goal and they have less time to reach it.

A more consistent and gradual increase in standard of living may seem more realistic than a large once-off increase. However, whether gradual or once-off, the results are similar. For example, if the person in our example were to receive increases of price inflation + 1% throughout their working life, instead of price inflation increases, changing nothing else, they could be expected to maintain their pre-retirement standard of living to age 81 instead of age 94.

Allowing for lifestyle inflation

The message is simple: if your income is rising ahead of inflation you need to increase your retirement savings even faster to keep up. Each rand that you spend on a better lifestyle is a rand you will get used to spending, and thus need to fund from your retirement income when you stop working.

By prudently allowing for future increases in your standard of living, looking in the rearview mirror at each increase and matching your return requirements and risk appetite with an appropriate asset allocation, you are more likely to achieve your retirement goals. If you already contribute the maximum allowed to enjoy tax incentives, don't let this be a deterrent. The government provides further tax incentives at retirement (see text box).

New tax break for retirement fund investors

The government encourages us to save for retirement by offering various tax incentives if we invest in a registered retirement fund, such as a retirement annuity fund (RA). RAs are structured to encourage saving. Fifteen percent of non-retirement funding income can be contributed to an RA to reduce your taxable income and any investment income (including interest and dividends), as well as capital growth, is tax free. In addition, at retirement the tax exemptions and subsequent tax rates are favourable.

As of 1 March 2014 a new incentive is being introduced. The Income Tax Act will allow all non-deductible contributions, irrespective of the retirement fund to which the contributions were made, to be pooled, and be exempt from income tax, on a first-come-first-served basis against any lump sum taken or annuity income received at retirement.

Example: Mr X belongs to a retirement annuity fund. He has R200 000 in non-deductible contributions accumulated when he retires from the fund. He decides not to take a lump sum and acquires a living annuity with the R1 000 000 retirement interest at retirement.

The first R200 000 received in annuity payments from the living annuity will be exempt from income tax.

If you are planning to start investing in a retirement annuity, or make use of the tax concession for this tax year, please ensure that you invest prior to the end of the tax year on 28 February.

Commentary by Shaun Duddy, business analyst, Allan Gray