GRAYISSUE

July is savings month – a good time to start saving effectively

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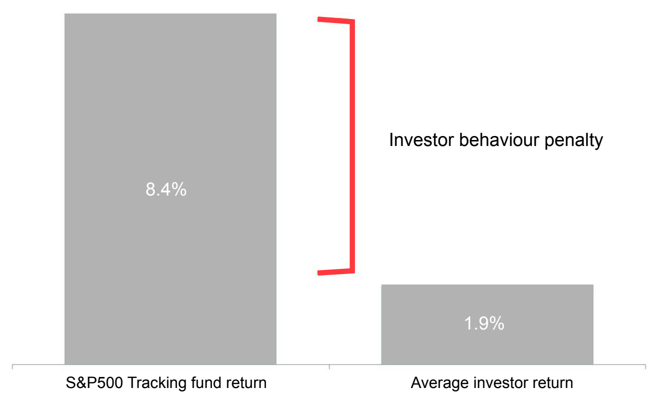
If you are 30 years old and wish to retire in 35 years time, you will need to save approximately 12% of your salary to retire comfortably. If you delay saving by 10 years, leaving only 25 years to your retirement, the percentage rises to 21%[1]. While the need to save is important, South Africans on average are not getting this right. Here are a few suggestions to contribute to saving effectively:

Make savings count

Investment performance in excess of inflation contributes to effective long-term savings. In the example above, you have to save 12% of your income to retire comfortably in 35 years time. A 1% increase in investment performance will increase your post-retirement income by 31%. If you are retiring in 25 years, this same 1% increase in investment performance will result in a 23% increase in your post-retirement income.

However, investor behaviour tends to detract from this performance. The performance an average investor in a fund sees lags the performance of the fund (see **Graph 1**). You should avoid inappropriate short-term decisions based on emotions (e.g. switching to chase past performance, switching due to panic, being overly conservative). Try not to undermine a long-term saving approach with short-term, emotional investment decisions.

GRAPH 1 Fund return versus average investor return

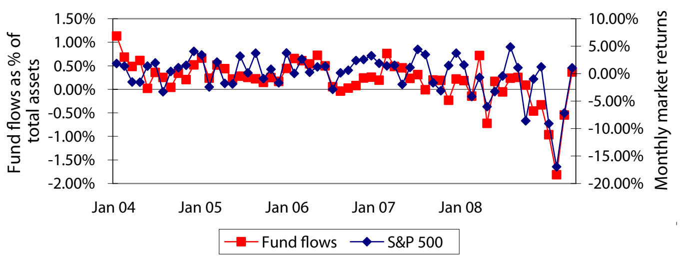


Source: DALBAR Inc. www.dalbar.com

Resist the pressure to spend in favour of saving

When it comes to financial products, people are prone to 'herd mentality', where a large number of investors follow a direction even if it is not particularly logical. This is well illustrated by a study which shows fund flows as a percentage of assets against fund performance (see **Graph 2**). Investors tend to sell when the market is low and buy when it is high or rising. In other words, the appetite to buy increases as the price of the product goes up.

GRAPH 2 Investor fund flows and market performance for the five years ended 31 December 2008



Source: DALBAR, Inc www.dalbar.com

Saving is driven by the same 'herd' movements associated with financial products. In South Africa, the very low or negative levels of household saving indicate that currently most people are spending as opposed to saving. For a portion of our population there is no option of saving; for the rest, saving is an option, yet they still often elect to follow the crowd and spend, even though the consequences at retirement are devastating.

Be disciplined

According to research, when offered the choice of a certain gain, or a gamble for a bit more but with the risk of loss, most people will take the certain gain. For example, if offered R3 000, or an 80% chance of gaining R4 000 but a 20% chance of losing the R3 000, most people (80%) will take the certain gain. However, when offered a certain loss against a gamble of losing more, with a small potential of breaking even, most people will take the gamble. For example, if offered the option of losing R3 000 versus an 80% chance of losing R4 000, but with a 20% chance of breakeven, most people (92%) will take the gamble[2].

When confronted with a losing position people are more inclined to gamble. By putting off saving in favour of spending now, a person is gambling that he/she will be able to save in future for retirement. As the time passes the relative position falls further behind and the person is likely to continue to gamble.

Saving is not a get rich quick scheme, it is not about chance and it will not suddenly happen. It is about starting early, planning and being disciplined. Take a long-term, approach.

[1] *Assumes: initial salary of R10 000 per month; inflation 6%; salary inflation 7%; 70% replacement value post retirement; 6% benefit increase post retirement; retirement at 65 and post retirement saving will last until 85; investment return 11%*
[2] *Source: gametheory.net based off research from Tversky and Kahneman*

Commentary by Rob Formby, director of retail operations, Allan Gray