GRAY ISSUE

Think twice before cashing in retirement savings before you retire

2 March 2011
Issue no. 115

In a policy document released alongside the National Budget, Treasury wrote that the introduction of mandatory preservation of pension funds is 'critical'. The figures in **Graph 1** (2009 Benchmark Survey by Sanlam Employee Benefits) illustrate why Treasury is worried, indicating that 74% of job leavers opt for a cash payout from their retirement funds.

Investors commonly decide to cash in their retirement savings, if their fund rules allow, when they have been retrenched or are changing jobs, going with the short-sighted premise that they still have time to make up for the 'lost' years.

Keep your hands out of the cookie jar

But taking a cash payout is the worst course of action. Firstly, it may hamper your ability to accumulate enough savings to retire with a degree of financial security later on because you miss out on the power of compound interest. Secondly, it attracts the most tax, reduces the tax-free amount available to you when you retire, and causes the benefit that you take at retirement to be taxed at a higher rate. In addition, you lose the benefit of earning returns on money you pay as tax.

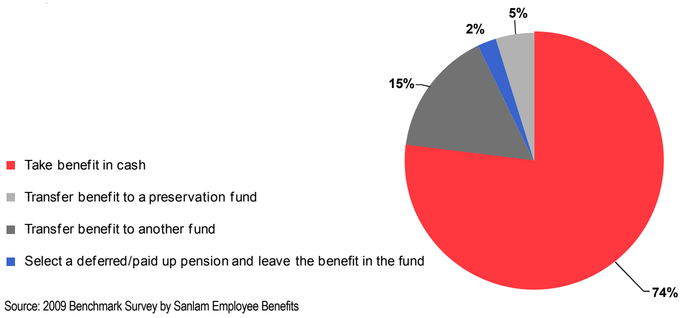
Not preserving your retirement savings can cost you more years than you anticipate. **Graph 2** shows the impact of drawing up to 100% of your retirement savings at the age of 35, on both the rand value you will have at retirement (on the vertical axis) and the years your savings would last (on the horizontal axis). As shown in the graph, if you take a 100% payout at 35 when you have been saving for 10 years, you will end up having 40% less to live on when you retire. Put differently, if you assume you will need a monthly pension income of 70% of your final salary (increasing with inflation), your retirement savings will run out 12 years earlier than if you never took the payout. A scary number if you consider that people are living longer.

While you may not have the luxury of choice if you have lost your job, if you do not need to use your retirement savings for survival, you should think twice before dipping into the cookie jar.

What are your options?

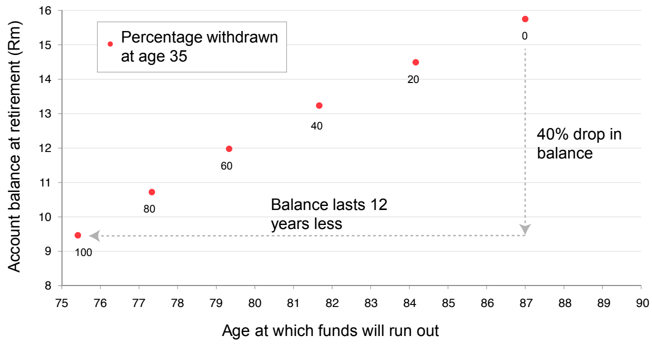
If you don't take a cash payout, when you leave your employer you can transfer your retirement benefits to a fund at your new employer, transfer them to a retirement annuity (RA) or transfer to a preservation fund. Other options include deferring your pension, which means staying a member of your current fund until you retire, or possibly retiring early. Your decision will be influenced by your fund rules, and also by your requirements – both before and at retirement – as different products have different restrictions (see **Table 1**).

Graph 1 | Retirement savings options taken by job leavers



Source: 2009 Benchmark Survey by Sanlam Employee Benefits

Graph 2 | Not preserving costs you time and money*



Source: Allan Gray research

* Assumes: Starting age 25; initial salary of R10 000 per month; inflation 6%; salary inflation 7%; contribution rate 10%; investment return 11%; 70% replacement value post retirement; 6% benefit increase post retirement; retirement at age 65.

If you want the flexibility of being allowed to make a single withdrawal from your benefits before you retire, consider transferring your retirement savings into a preservation fund. Graph 2 shows that if you make a withdrawal and preserve the rest, your shortfall will be less pronounced, but still considerable.

RAs don't allow for any withdrawals prior to retirement, but unlike preservation funds, RAs allow you to make further contributions to your pension benefits. RAs allow you to contribute on a regular basis, to interrupt contributions for a period and to stop contributions at any stage (although there may be cost implications depending on your product provider).

Table 1 | Retirement funds: rules and restrictions

	Retirement annuity	Pension preservation fund**	Provident preservation fund**
Withdrawals	No withdrawals allowed before retirement.	Once you are a member, you may make one withdrawal before retirement. This option is subject to the requirements of the transferring fund and/or legislation/the regulatory authorities.	Once you are a member, you may make one withdrawal before retirement. This option is subject to the requirements of the transferring fund and/or legislation/the regulatory authorities.
Contributions	You can contribute on a regular basis, interrupt contributions for a period and stop contributing at any stage.	No additional contributions allowed.	No additional contributions allowed.
Rules at retirement	The maximum cash withdrawal allowed is one-third of your capital; the rest must be used to purchase a pension-providing product such as a living annuity.	The maximum cash withdrawal allowed is one-third of your capital; the rest must be used to purchase a pension-providing product such as a living annuity.	You have the option of withdrawing all your capital as cash.

**Pension preservation funds are for transfers from a pension fund and provident preservation funds are for transfers from a provident fund.

Commentary by Jeanette Marais, director of distribution and client services, Allan Gray