GRAYISSUE
LONG TERM COMMENTARY

1 October 2003
Issue no. 26

How to structure your investment strategy close to retirement

In the many discussions that I have had with people close to retirement, I am told that they were advised to reduce their share exposure to 0% over the last years before retirement. Given the volatility experienced in share markets over the last years and the good returns provided by low risk investments, this strategy made sense. Over the longer term though, under more normal market conditions, I believe this strategy is too simplistic.

For investors who will either invest in a product that provides a guaranteed income for the remainder of their lives or those who will need to consume a relatively high proportion of all their assets from the first year after retirement, this strategy does make sense.

For other investors, especially investors that only need to draw a low proportion of total assets as income after retirement, a better strategy would be to determine what share exposure is needed after retirement. In the years prior to retirement, the investor will then gradually reduce his exposure to shares to this level before retirement. For these investors, the exposure to shares immediately before retirement and after retirement will remain the same.

Let me explain. At retirement, investors can basically follow one of two investment strategies. The first is to invest in a product that provides a guaranteed income for the remainder of the person's life. The second is to invest in a well-diversified portfolio of the major asset classes (shares, property, bonds and cash) to provide an optimum level of growth without too much exposure to risk.

In the first scenario, the investor implements a major change of investment strategy at retirement. Prior to retirement the investor has exposure to shares to provide long-term growth. After retirement the investor has a guaranteed income with no exposure to shares. In this scenario, a high exposure to shares in the last years before retirement can prove disastrous. If shares perform poorly during the last years, the investor will suffer a permanent loss of value as he will no longer be exposed to the share market and will therefore not participate in the likely recovery thereof. To prevent this, these investors will want to reduce their exposure to shares to 0% in the years prior to retirement.

In the second scenario, the investor that needs to consume for example 5% of his/her total assets annually after retirement, can decide to protect 7 years of income from volatility by investing 35% (7x5) of assets in money market instruments. The remainder of the assets (65%) can then be invested in shares.

The strategy followed by this investor after retirement is to fund 65% of his/her annual pension by selling shares and 35% by selling money market instruments. If the share market experienced negative growth, the investor will fund his/her annual pension by only selling the money market portion of the assets. This can continue for a maximum period of 7 years, during which the share market could have ample chance to recover.

Once the share market has recovered to normal levels, the person will rebalance his/her portfolio to 7 years of income in money market instruments and the rest in shares, and the process will start all over again. If this investment strategy is followed after retirement, it will not make sense for the investor to reduce the exposure to shares to below 65% before retirement.

Commentary by Barend Ritter, Head of Individual Retirement Products