GRAYISSUE
LONG TERM COMMENTARY

11 July 2005
Issue no. 46

# Back to basics with retirement annuities

The 'Rusconi Report' issued late last year caused much consternation in the savings industry by publicising the high cost of saving for retirement - particularly in conventional retirement annuities (RAs). The report was critical of the conventional ones offered historically (and still offered by life companies), and highlighted concerns relating to these products such as:

- Costs: both the total amount of the costs (which impacts on the overall performance of the investment - in many cases wiping out all growth) and the lack of transparency of the make-up of these costs.
- Termination fees and penalties applicable if investors cannot or do not wish to continue paying into an RA - this 'penalty' often relates to the recoupment of an upfront commission paid by the life house and is not adequately disclosed to the investor resulting in the true value of the investment being substantially less than that reflected on his or her statement.
- Inflexible rules restricting or penalising transfers to a different investment company - 'portability' of investments (as it is called) is accepted and indeed required in most jurisdictions.
- Commission structures: the size, the 'up-front' payment and the disclosure of commissions paid to brokers/salesmen also came in for much criticism.

This report raised awareness amongst legislators, regulators and the man in the street and a number of high profile rulings by the Pension Fund Adjudicator subsequently indicate that improved consumer protection is on the way. One must however distinguish valid criticism of some of the market practices from rejection of RAs in general, which would be unfair. The reality is that there is an increasing need for investors to make provision for their own retirement and sensibly structured RAs offer many benefits. Allan Gray was one of the first companies to offer retail retirement products with no upfront charges, negotiated adviser fees and annual management fees linked to investment performance. Our clients have enjoyed the rewards of this and increasingly the general public is demanding the same of their own RA investments.

If we go back to basics with RAs, they can be very flexible and tax-efficient savings vehicles.

**Tax benefits**

1. If you are not contributing to a pension fund, you can contribute up to 15% of taxable income to an RA tax-free.
2. If you receive taxable income that is not taken into account when calculating your pension contribution (such as overtime, bonuses, etc.), up to 15% of this income can also be contributed to an RA tax-free.
3. By lowering your taxable income, a contribution to an RA may result in your taxable income falling into a lower tax bracket.

**Benefits at retirement**

1. You can retire at any time from age 55 to age 70 or at an earlier age if disabled.
2. At retirement, a maximum of one third of your capital in the RA can be taken in cash.
3. A portion of the RA (currently the greater of R120 000 or R4 500 times the years of contributory membership of an RA) can be withdrawn tax-free.
4. What's left is taxed at the higher of the average rate paid by you in the tax year of your retirement or the preceding tax year.
5. At least two thirds of the capital must be invested in a pension-providing vehicle such as a living annuity or a guaranteed life annuity. No tax is payable on the transfer of money into a pension product but the annual pension received after retirement is taxed at your marginal tax rate (likely to be lower than that prior to retirement).
6. RA capital cannot be withdrawn prior to retirement, which makes sense, given its purpose.

**RA flexibility**

1. As is the case with Allan Gray's RA, contributions can be discontinued for a period and resumed later, or they can be discontinued permanently at any time prior to your retirement without penalty.
2. Investors may make once-off or regular contributions.
3. RAs such as that offered by Allan Gray are fully 'portable' and you may transfer your investment to another RA without penalty, subject only to certain procedural formalities.

Given these benefits, one should avoid letting the recent controversy about RAs put you off saving for your retirement; delaying saving could have a significant price of its own.

*Commentary by Greg Fury, Chief Operating Officer, Allan Gray Limited*