THE REAL RISK **OF GOOD HEALTH**

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ABOUT **THE AUTHOR**

Zain is portfolio manager of the Old Mutual Real Income Fund. With a keen interest in the bond market, his responsibilities further include enhancing the global capabilities' processes and contributing to the boutique's overall investment strategy.

We are living in extraordinary times. As we look around the world today, the rate of change and disruption in all spheres of life is unparalleled in human history. This is nowhere more evident than the rapid advances made in medicine and medical technology.

It is remarkable to think that the first antibiotic, penicillin, was discovered less than a century ago in 1928. For centuries before that discovery, minor injuries or infections would often have been life threatening. Consider, too, that childbirth was more risky – for both mother and child – than going to war.

The rate of progress over the past 50 years has been phenomenal. Medicine is now moving to the next frontier – away from the diagnostic towards preventative – with developments in DNA sequencing, bionics and regenerative medicine that promise to extend our lifespans even longer.

KEY TAKEOUTS

- RAPID MEDICAL ADVANCES MEAN WE ARE LIVING LONGER
- INFLATION IS AN OVERLOOKED RISK OF LIVING LONGER
- GROWTH ASSETS ARE KEY TO SUSTAINING RETIREMENT INCOME

[1] Source: Organisation for Economic Co-operation and Development (OECD)

Excluding the "blue sky" potential of these technologies, the United Nations 2017 World Population Prospects report conservatively projects that the average global life expectancy will rise from 71 years in 2015 to 77 by 2045-50.

While six years may seem unremarkable, in the context of retirement ages having consistently declined over the past 50 years[1], this is roughly a doubling of your post-retirement life expectancy, a challenge for both individuals and the savings and investment industry. How do we stretch our already inadequate retirement savings an extra 10 years?

This dilemma is exacerbated in South Africa, where most of us are already not saving enough to maintain a decent standard of living after retirement.

THE PROBLEM WITH EARLY RETIREMENT

As we move towards retirement and exit the workforce, our investment objectives shift from saving and growing our capital to drawing down on those savings to replace salaries that we no longer receive. As our savings become our primary source of income, we are more vulnerable to even temporary drawdowns in our capital. Conventional wisdom suggests a shift away from "risky" growth assets, like equities and listed property, towards more stable income-generating assets, like cash and bonds. However, longer post-retirement life expectancy means not only do we have to build our retirement solutions to generate income and protect capital drawdowns, we also have to beat inflation over an extended period of time.

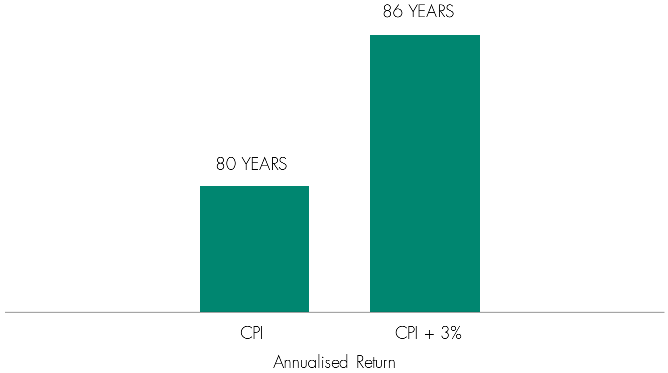
Exacerbating this is the fact that, as we age, our spending patterns shift. Healthcare costs become a rising share of our expenses, often carrying much higher rates of inflation. Cruelly, our costs of living can escalate at a faster pace than when we were younger. The graphic below is an extract from our yearbook Long-Term Perspectives showing how the costs of kidney dialysis in South Africa have increased by an average of 10.1% a year since 1990, markedly higher than the average headline inflation rate over the period of 7.2%.

WHEN YIELD IS NOT ENOUGH

With inflation being an often overlooked risk of living longer, a key lesson from Long-Term Perspectives, we can also find current examples of how quickly capital is eroded when we are constrained to investing only in "safe" assets in the wrong environment. Neither developed market bonds nor cash has provided meaningfully positive real (after-inflation) yields for the better part of the last decade. For instance, global bonds have yielded an average of only 0.5% (real)[2] since the start of 2008, compared with an average of 2.8% for the 30 years prior. While the yield difference may not appear to be much, over time it can have a material impact on your retirement goals.

Our simulation alongside shows the effect of low returns on the longevity of your retirement savings. The illustration assumes that you retire with a lump sum and draw an income of 5% a year increasing with inflation annually. The difference of only an additional 3% a year return in the post-retirement phase would be the difference between running out of savings at age 80 versus age 86. Assuming a retirement age of 65, this is a 40% increase in the longevity of your post-retirement savings.

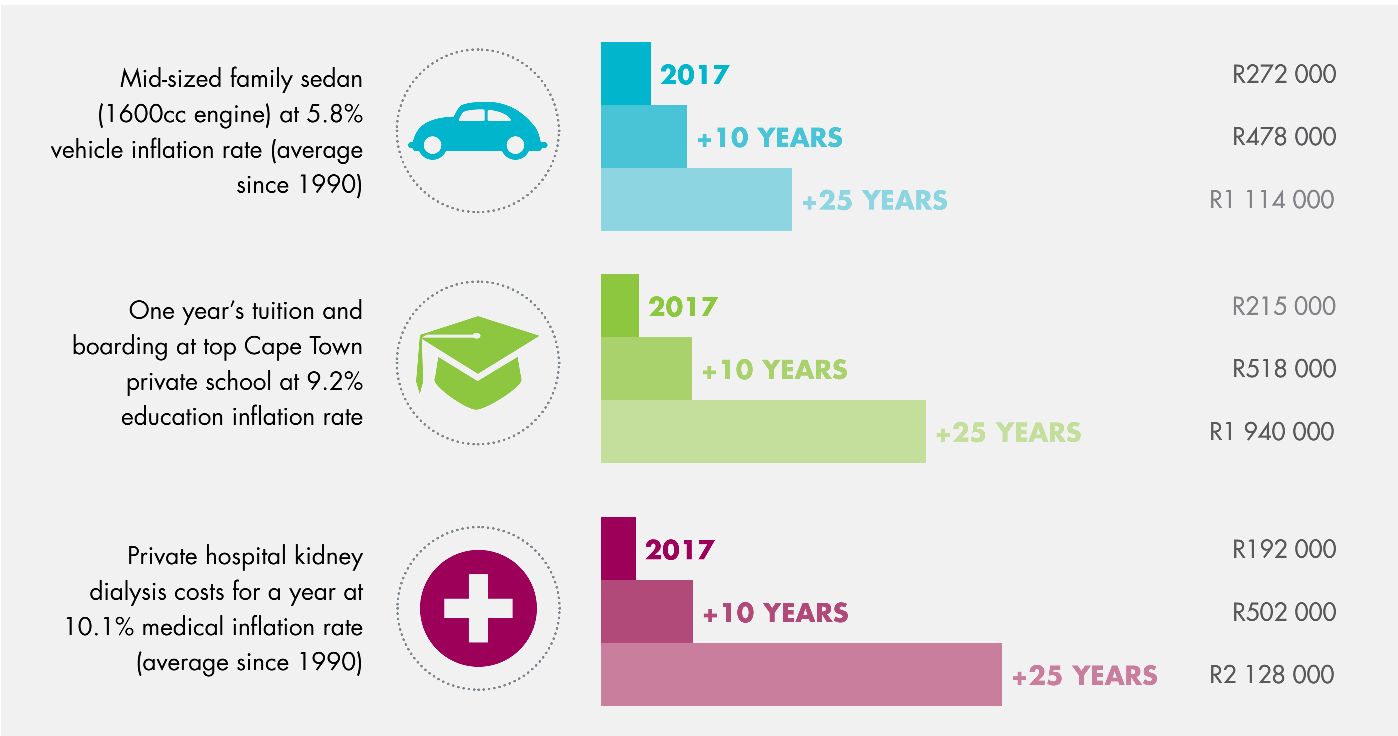
LONGEVITY OF CAPITAL GIVEN DIFFERENT RETURN EXPECTATIONS



Source: Old Mutual Investment Group

While we think it is unlikely that global bond yields will remain around 0% for the next 40 years, it is a powerful illustration of how important the delivery of real returns is post retirement.

THE IMPACT OF INFLATION ON OUR EVERYDAY LIVES



Sources: Stats SA, Old Mutual Investment Group

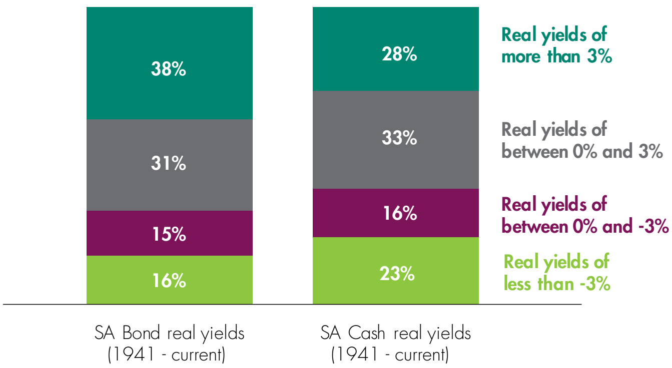
[2] Assuming an average inflation rate of 1.5% a year. Sources: FactSet, IMF

ACCESSING THE FULL TOOLKIT

South Africa has, by comparison, benefited from positive real cash and bond yields for the better part of the last 30 years. However, this has not always been the case, with domestic cash rates eking out only moderately positive real returns of 0.7% over the past 88 years[3]. Domestic bonds, by comparison, have fared better, delivering an average of 1.6% in real terms since 1941. However, what this average does not show are the extended periods when real yields and returns have been negative, and often deeply so.

The chart shows the distribution of real cash and bond yields since 1941. Cash and bonds have only been able to deliver real yields in excess of 3% (gross of fees) 28% and 38% of the time, respectively. As we discussed earlier, were you to be caught in an extended period of negative real yields (occurring, on average, once every three years in bonds and two out of every five years in cash), the destruction in real capital while you continued to draw down on income, would be difficult to reverse.

PERCENTAGE OF TIME SA FIXED INCOME REAL YIELDS WERE POSITIVE (DATE SINCE 1941)



Sources: FactSet, Old Mutual Investment Group

For the reasons already outlined, we consider growth assets as a key ingredient across our funds, including those geared towards retirement provision. Within the Old Mutual Real Income Fund, which aims to deliver an income that grows over time while protecting capital, we do so by looking for selective, high conviction ideas that meet the criteria of having a combination of yield with some growth, inflation protection and capital growth.

The inflation-beating nature of these assets, be it listed property shares or domestic equities, enables the fund to meets its objectives of both preserving and growing our investors' real level of capital irrespective of the cycle or policy regime we are in.

In addition, we also look for what we call "between the gap" assets, which have some features of growth and income assets. A good example of this is the listed property A-shares that we hold in the fund. A-shares contractually promise to deliver dividend growth of the lower of either 5% or inflation, while having a priority of payment over the equity class. In difficult years, this means that all of the promised dividends and contractual growth must be paid to the A-shareholders before a cent is paid in equity dividends. This provides a much more stable income-generation and return profile, as well as ticking the box of near-inflation growth – making it ideal for the fund.

While I am not suggesting that we are on the cusp of a secular rise in inflation that would eat away at the yield of traditional income assets, our studies into data over the past 100 years or so have taught us that it is important to have both the skills and the access to the full toolkit of assets through different market cycles.

RISK MEANS NOT MEETING YOUR OBJECTIVES

Although growth assets generally carry higher capital and drawdown risks than bonds or cash, the fact that their returns are weakly (and often inversely) related to fixed income assets at different stages in the economic cycle means that, when combined, the risk in the portfolio is less than the sum of its parts. While a highly inflationary environment results in lower bond prices, it is generally favourable for growth asset prices, as companies are able to grow their earnings with and ahead of inflation. Conversely, low growth and deflation are bad for equities, as companies' profits are eroded by a loss of pricing power, while bonds generally perform well as yields fall with inflation.

At MacroSolutions, we define risk not as "volatility" or "destruction of capital", but rather the possibility of us not delivering to your investment objectives over time. We believe the reduced risk of running out of capital too soon (by adding growth assets to your income portfolio) far outweighs the marginal increase in capital preservation risk over the very short term.

The right tactical asset allocation can further enhance our clients' outcomes. In the Old Mutual Real Income Fund this means that the fund is not compelled to be invested in growth assets at all times. We will continue to look for the right assets, opportunities and environments to enhance the fixed income core – by making use of the other tools in our toolkit. This, while always remaining cognisant of the risk and return promises we have made to our clients. ■

[3] MacroSolutions Long-Term Perspectives 2018