



The pursuit of the seven-day weekend

Part Two (of Two)

For most South Africans, retirement savings are their primary, and in many instances only form of investment funds. This two-part article seeks to explore some of the challenges facing investors when saving for this goal and focuses on the many benefits that retirement funds provide in helping them to achieve their objectives efficiently. In [part one](#), we explored the features and benefits of retirement funds that allow for efficiency of succession and the avoidance of undesirable consequences on death. These characteristics ensure that the maximum value can be received by a loved one on death when compared with an equivalent discretionary savings pool.



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Masterclass Insights

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Part two focuses on features that help to maximize the size of the pot available at retirement. This is the primary concern for most people as it is critical in determining the quality of life they can enjoy after they leave the world of work. We have therefore focused on the tax benefits and the impact they have on the outcome that can be achieved relative to a discretionary savings vehicle.

Figure 1: Retirement fund versus discretionary investment

	Retirement Fund	Discretionary
Deductability of contributions	✓	✗
Capital gains tax on growth	✗	✓
Income tax on growth	✗	✓
Divident withholding tax	✗	✓

It is not all about returns

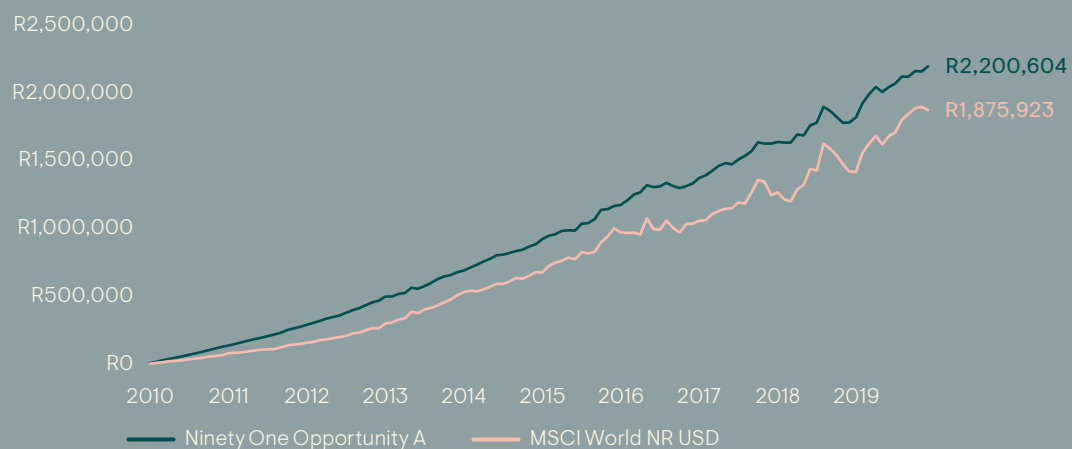
In recent years the discussion around retirement funds has been dominated by Regulation 28 and the impact it has had on inhibiting investment returns. This is not surprising in an environment where local asset classes have disappointed and returns from offshore investments have rocketed; however, to focus on relative returns in isolation can be dangerous. Higher returns do not necessarily translate into higher portfolio values as the deductibility of pension fund contributions means that the retirement fund starts the race with a considerable head start.

To illustrate this point, we can look at the performance of global equities versus the Ninety One Opportunity Fund over the 10 years to the end of 2019.

- During this period the MSCI World Index outperformed the Opportunity Fund by an average of nearly 7.5% p.a. which is significant. However, framing this within an investment perspective puts a completely different spin on things.
- Essentially, for a taxpayer whose marginal rate is 45%, a discretionary investment only receives R5 500 for every R10 000 that can be invested in a retirement fund because the discretionary investment can only be made with after-tax monies. Figure 2 shows the impact of this on the value over the 10-year period.

Figure 2: Decisions are often made based on relative performance

But don't ignore the power of deductibility of contributions



Source: Morningstar and Ninety One, to end December 2019. For effect of contribution illustrations – R10k per month invested into RA example versus R5.5k for MSCI World illustrations with contribution value escalating by 5% p.a. Investment performance is for illustrative purposes only. The investment performance is calculated by taking all ongoing fees into account for the amount shown and income is reinvested on the reinvestment date. Initial fees are not applicable to this fund.

Despite the enormous outperformance of the MSCI World Index, the value that could have been achieved by making pre-tax contributions to the Opportunity Fund via a retirement fund, results in a higher value than could have been achieved by investing post-tax monies in global equities on a discretionary basis.

It can also be dangerous to assume that recent trends will persist into the future or at the same magnitude. Whilst local assets disappointed over the past 10 years, the same was true for global equities in the previous decade. If we look at the performance over the entire 20-year period, the Opportunity Fund outperformed global equities by a significant margin which is magnified when the deductibility of contributions is factored into the equation.

However, the tax efficiency of a retirement fund during the saving phase is offset by greater tax consequences when a person starts to draw an income. Any withdrawals from a living annuity will be taxed as per the PAYE tables, meaning as much as 45% of the gross income could be absorbed by tax. On the other hand, disposals from a discretionary vehicle are treated as capital disposals and subsequently the amount of tax deducted on withdrawal is typically lower. It is therefore possible theoretically for the discretionary savings vehicle to reduce the size of the gap during the decumulation phase. It should be noted, however, that negating the tax benefits of a retirement fund completely is easier said than done. It requires significant and persistent outperformance which needs to be attainable for multiple decades rather than years.

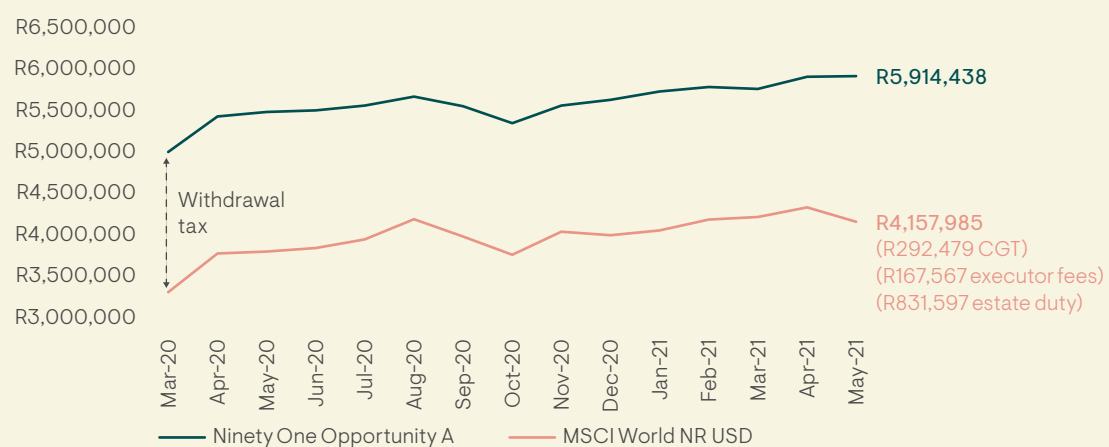
The ‘fear of the heart versus debate of the mind’

We are also sensitive to the fact that many clients are fearful due to the political landscape and in these cases the discussion goes way beyond the debate around relative investment returns. For these individuals it isn't just a fear of missing out but rather a fear of joining in. The concern is that being a member of a retirement fund, may lead to a complete erosion of their retirement savings. Whilst we understand the juxtaposition of the ‘heart versus mind’ debate at play, we need to ensure that clients are aware of all of the compromises involved when opting against a retirement fund so that they can make a fully informed decision. Some individuals decided to redirect their retirement fund contributions to discretionary vehicles, while others have gone a step further and cashed in existing preservation fund savings and redeployed those savings offshore. The latter course of action requires the most careful consideration because it involves making an irreversible decision, with very negative consequences.

When withdrawing capital from a retirement fund, the impact of the withdrawal tax tables can significantly reduce the net amount available for the offshore investment. Many investors hope to counter these consequences by reinvesting their proceeds in offshore equities in the hope that they will recover their losses and achieve an improved outcome over the long term. While offshore equities have rallied strongly, past outperformance cannot be guaranteed at the same magnitude in the future.

Figure 3 shows the impact on a pre-retirement withdrawal of a R5m pension fund benefit. This would result in nearly R1.7m of its value being lost to tax which is equivalent to starting the offshore investment with a 34% drawdown on day one.

Figure 3: Beware of unintended consequences
Clients need to be mindful of future fees and taxes



Source: Ninety One, Morningstar and SARS, performance net of fees to end May 2021. Withdrawal tax deducted based on 2020/2021 withdrawal table. Performance shown in ZAR. Gain for offshore investment calculated in USD and converted to ZAR, CGT of 18% applied. Executor fees calculated at 4.03% and estate duty at 20%. Investment performance is for illustrative purposes only. The investment performance is calculated by taking all ongoing fees into account for the amount shown and income is reinvested on the reinvestment date. Initial fees are not applicable to this fund.

- The graph shows that taking money out of the preservation fund and re-investing the net amount in global equities, would not only have significantly reduced the value relative to remaining invested in the Opportunity Fund but would also have introduced a significant future tax liability.
- In little more than a year, an unrealised capital gains tax (CGT) liability of nearly R300 000 would have been created, even though the value as at end May 2021 was approximately 17% lower than the preservation fund's value prior to cashing in the benefit.
- On death, executor fees and estate duty would be applicable, which, based on the value at the end of the illustration, would be close to R1m in aggregate.

Retirement funds remain fit for purpose

The aim of this series of articles was to provide a deep dive into the process of saving for retirement and to assess the prospects of different strategies in delivering on investor goals. Retirement funds were designed specifically to provide for this outcome and have proven to be incredibly effective in doing so. They have many tax and structural benefits that help maximise value during the accumulation phase, provide a regular income in the decumulation phase, and help maximise the value that can be preserved on death.

They are utilised by people from all walks of life from the poor to the ultra-wealthy, all of whom have the opportunity to enjoy these benefits. A discretionary savings vehicle, on the other hand, is in most instances the preserve of wealthier individuals and subsequently receive little relief from fees and wealth taxes on disposal and death.

When predicting outcomes via different investment vehicles, it is not as simple as looking at different asset class returns and assuming that higher returns equate to better outcomes. One needs to consider all the financial planning implications. Retirement funds have shown that taking all of these factors into account, they are incredibly hard to beat when saving for one's golden years.

As always, we recommend that investors seek guidance from financial advisors to ensure they give themselves the best chance of achieving the retirement they deserve.

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