

PERSONAL FINANCE

Choosing the 'chocolates' you want

At a recent meeting of the **acsis**/Personal Finance Financial Planning Club, Personal Finance editor Bruce Cameron spoke about the choices available to you in formulating a financial plan.

By Bruce Cameron

Financial planning involves balancing various choices, Bruce Cameron says. However, the choices you make are often buffeted by unexpected events.

The nature of financial planning was summed up by the character Forrest Gump (in the movie of the same name), who, while sitting on a park bench, said: "My momma always said life is like a box of chocolates; you never know what you're gonna get."

But, Cameron says, "momma" did not tell Forrest something else: that many people don't get any chocolates at all.

In the context of financial planning, he says, many people do not receive any chocolates because they make the wrong choices or they simply fail to make any choices.

Your investment choices

Underlying most of your retirement plans are the investment choices you make, Cameron says. These include the type of product, the product itself and the underlying investment choices. Your investment choices are almost limitless.

At issue is not just that you can make bad investment choices, such as pyramid schemes, but that some choices are inappropriate for your circumstances.

The important point is that you make a considered decision that is realistic for the lifestyle you wish to enjoy, Cameron says. This means taking account of your financial goals, your financial needs, product costs, tax, contractual commitments, guarantees, investment risk and the returns you realistically require.

He says it also means not succumbing to the two biggest enemies of investment: fear and greed. Fear not only results in your selling when markets are down, but also in your not investing at all.

If you put your money into an interest-earning bank account, after tax and after inflation you are more likely to lose money than would be the case if you invested it on the stock market, Cameron says.

In fact, you will be far better off by being invested in stock markets, because over the medium and long term, the returns from shares have historically out-performed every other asset class, he says.

A conservative cash investment can result in you losing money, Cameron says. For example, if you invested R1 000 a month for 40 years, you will have invested R480 000. If you receive an average return of eight percent, you will have accumulated R3.2 million. But if the average inflation rate has been 10 percent a year, the actual buying power of your R3.2 million will be reduced to R340 000 - less than what you have invested.

Cameron says you also have to make choices about things such as medical scheme membership, estate planning and spending patterns to ensure that you and your dependants will have financial stability. And the sooner you make the

choices, the sooner you will achieve that stability.

Your life assurance choices

When an unexpected event has a disastrous impact on your finances and lifestyle, in most cases it is because you made the wrong choice or failed to make any choice at all, Bruce Cameron says.

For example, you are hit by the proverbial bus, leaving you badly injured and unable to work, and you have a young family to support, but you did not take out life assurance against disability.

The sad fact is that most South Africans are dramatically under-assured, Cameron says.

A recent study by actuarial company True South Actuaries & Consultants found that the average South African is under-assured against death by 55 percent.

Cameron says this means most South African breadwinners have made the choice to leave their families destitute if they die early.

He says you need risk assurance, primarily against death and disability, to cover debt, to meet your financial goals - such as your children's education - and to ensure that your dependants can maintain their standard of living should you die or be unable to work.

But you should not use risk assurance to make your dependants wealthy; its purpose is to enable them to maintain their current standard of living.

Cameron says you should reassess your risk life assurance needs every year or at least when there has been a major change to your personal circumstances; in particular, events such as getting married, the birth of a child and when your children leave home.

Another reason to constantly revise your risk assurance is that the life assurance market is now very competitive and you may find that your existing policy does not provide the benefits you could obtain from another company, Cameron says.

For this reason, he says, you should avoid combining risk life assurance with life assurance in one universal policy, because life assurers will include the risk premium when calculating any surrender penalty. If you cancel a pure risk policy, there are no confiscatory penalties.

Cameron says the other things you should not do are:

- Cancel an existing policy before you have a new one in place. If you cancel an existing policy before buying a new policy and your state of health has changed for the worse (without your even knowing it), you may be uninsurable or you may have to pay higher premiums and/or certain health conditions may be excluded from the policy.
- Accept the policy with the cheapest premium. The cheapest may in the end be the most expensive. Risk assurance premiums increase mainly on the basis of your age. If your premium is guaranteed for a fixed period, it may, in fact, be cheaper over the full term than an unguaranteed premium, which will increase rapidly year after year.
- Buy products, such as accident assurance, that pay out a double benefit. You either need R1 million in the event of your death or you do not. If you need double the amount, take out assurance for it.
- Mislead a life assurance company about your state of health or any potentially dangerous activities in which you engage. The life company will discover the truth and will repudiate the policy, leaving your dependants

destitute.

Your key financial choices

Cameron says the key choices you have to make include:

- Spending what you have now versus deferring spending so you will have money to spend later (particularly when you retire).
- Living within your financial means versus living in debt.
- Starting to save from your first pay cheque versus starting to save only when you reach your 30s or 40s.
- The risks you can afford to take on your own versus the risks you should share with others by taking out insurance.
- One investment product, either generic or branded, versus another. For example, do you choose a tax-incentivised retirement vehicle to save for your retirement or do you select one without tax incentives (a provident fund)? And then what branded product do you choose?
- Versatile collective investments, such as unit trust funds and exchange-traded funds, versus contractual life assurance investment products, which levy confiscatory penalties if you fail to keep your money invested or do not pay your premiums.
- An actively managed investment, with higher costs and potentially lower returns, versus a passively managed, low-cost index investment, which will give you the performance of the market.
- Higher-risk investments that potentially provide higher returns versus lower-risk ones that provide more stable but lower returns.
- Early retirement versus retiring later. If you retire too early, you may not have saved enough to see you through retirement. If you live longer than the average, you may run out of cash. If you save too little and/or do not preserve your retirement savings during your working life, you face poverty in retirement. But if you save too much, you may make unnecessary sacrifices before retirement.
- Your current lifestyle versus the lifestyle you would like your heirs to enjoy.

Cameron says it is not that one choice is right while another one is wrong. Like the chocolates in Forrest's box, there are different flavours. What is right, or tasty, for one person will not suit the tastes of another. The point is to make the choice that is appropriate for you.

The choices you make will also be affected by your circumstances. For example, most people will marry and have children; some will get divorced; some will have very successful careers, while others will be retrenched; some will die early or be disabled, while others will live seemingly forever; and some people's children or parents will be dependent on them for longer than they expect.

Then, Cameron says, there are other factors over which you have absolutely no control, such as inflation, interest rate fluctuations, stock market volatility, natural disasters and accidents.

He says the choices you make should take account of your needs, based on the lifestyle you can afford, as well as the factors that can adversely affect that lifestyle.

Your retirement choices

Just as sad as the fact that most people do not have sufficient risk assurance is the fact that most South Africans will reach retirement with insufficient savings, Cameron says.

Cameron says research by retirement fund administration company Alexander Forbes shows that most people retire from the last retirement fund to which they belonged with a replacement ratio of 28 percent. This means their retirement benefits will provide a pension equal to only 28 percent of their final pensionable

salary. (Your pensionable salary excludes any allowances you may receive, such as a travel allowance.)

Alexander Forbes found the main reason people do not have sufficient savings at retirement is that they do not preserve their retirement savings. In other words, when fund members change jobs, they cash in their accumulated retirement savings and spend the money.

This problem is compounded by people saving too little, starting to save too late, choosing the wrong type of investment and product and/or retiring too early.

Research by Old Mutual on behalf of Personal Finance last year shows that delaying retirement by five years can have a significant impact on your retirement savings, Cameron says.

For example, if you are aged 20 and start saving for retirement today, you will have a replacement ratio of 77.8 percent if you retire at age 60, while your replacement ratio will be 111 percent if you retire at 65. If you start saving at 40 today, you will have a replacement ratio of 29 percent if you retire at 60, but your replacement ratio will be 74 percent if you retire at 65.

Cameron says choosing to delay saving for retirement means you will either not save enough or you will have to save a lot more. This is because you will not have compound interest working for you. If you are 20 years old today and aim to have a replacement ratio of 103 percent when you reach 60, you will need to save 10 percent of your annual pensionable income. But if you postpone saving until you reach 30, you will have to save 12 percent of your annual income. And if you leave it until you are 40, you will have to save 20 percent of your annual income.

Cameron says your investment choices do not end on the day you retire. At retirement, you often have to decide on the type of pension you will buy. For example, you can choose between a traditional guaranteed annuity (which, in turn, comes in a variety of structures) and an investment-linked living annuity (Illa), which does not guarantee that you will receive a pension for life.

And if you choose an Illa, it may not be suitable for your entire retirement, he says. In your 70s, you will probably need to consider changing, either fully or in part, to a guaranteed annuity.

Even with a guaranteed annuity, you can make the wrong choice. If you choose a level annuity, inflation will reduce your buying power year after year until, if you live for a long time, your pension will become meaningless, Cameron says.

You need good financial advice

Every decision you make about your finances should be made with careful consideration and, for most people, with expert guidance. It is important to obtain good advice from a well-qualified financial planner. The most capable advisers are those who have been awarded the Certified Financial Planner (CFP) accreditation by the Financial Planning Institute. You can find a CFP-accredited adviser in your area by going to www.fpi.co.za

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