

Saving for the duration of old age

Last week we sketched the key asset classes and considered their appropriateness to the discipline of saving for old age. Many mistakes are made on the journey of retirement saving. Perhaps one of the most serious of these is treating retirement as if it were a single date rather than a term of unknown duration. Retirement is a period, not an event.

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What is the difference between the respective conceptions of retirement as an event or as a period? Technically speaking, 15-20 years. Let's say you are 55 today. You may plan for a retirement date ten years into the future, but the average delay between the present and the time income is received may be 25 years or more. Rather than planning **for** a retirement date, we should be planning **through** this date, blending the accumulation and decumulation periods into a single, coherent strategy.

Conventional approach

In the last article we looked at the major asset classes available to investors. We concluded that some types of assets, notwithstanding price volatility, are appropriate for long-term investment where we have time to ride the ups and downs in pursuit of returns that reflect economic growth (and more) over time. Equities represent such an asset class. Property is another, though with important liquidity constraints.

It makes sense then for a high proportion of pension saving to be allocated to a diversified portfolio of equities, also called shares. Now share prices are volatile, so we should not be unduly dependent on shares if we need access to our savings soon, within a few years say.

What can possibly go wrong? Under the conventional approach to retirement saving. It is typically assumed that most of a member's saving is used at retirement to purchase a lifetime annuity and that the balance is taken as cash, up to the maximum available under tax rules. Under this assumption, as retirement draws nearer, a members' assets are switched out of volatile assets like shares and into safer classes. For a good fit, we would use bonds to match the expected annuity purchase and money market assets to fit the expected cash withdrawal.

We don't need to go into the technical reasons for using these asset classes, except to say that they best protect the member against the risks associated with the big changes to come, the shift into annuities and the withdrawal. For the purist, index-linked bonds – whose income grows at the rate of inflation – may be a better fit for lifetime annuity offering similar growth.

At what stage should the shift from shares to these other asset classes commence? First, we are not suggesting that members' assets should be wholly in equities. That is not only unduly risky but not permitted under regulations. However, holding shares until the date of retirement if cash is to be withdrawn and an annuity to be purchased is exceedingly risky. Thoughts vary on the timing of the transition, but a gradual shift out of equities over a period of between five and ten years is typically considered appropriate.

In summary, the conventional approach proposes an equity-rich strategy until several years before retirement followed by a gradual shift into a sound mix of bonds and cash at the date of retirement.

Coherent approach

What might be the problem with this approach? Where retirees have the choice, most of them do not purchase annuities. They transfer their savings to a living annuity and draw down from this fund, probably also taking some of their retirement proceeds as cash. One of the reasons for the living annuity is the opportunity to invest in shares. So now a carefully managed transition from equities to bonds and cash is undone by a sudden shift back to shares. Not only is all the cost of the shift out of shares wasted, but the risk of the corresponding switch back to shares is enormous, because it depends entirely on the state of the market at a moment in time.

The bottom line is that the conventional approach to investing for retirement is generally inefficient, expensive and highly risky to those members that will use a living annuity after retirement. The coherent approach is to plan ahead, recognising that the member plans an equity-rich living annuity and that the investment plan prior to retirement should be appropriate for this strategy. This typically means retaining a higher proportion in shares than under the conventional approach.

A shift out of equities is still appropriate, but it can now take place both before and after. The lifetime approach to asset allocation is a sound, coherent solution that better meets the needs of the member.

It is admittedly difficult for a retirement fund to treat all members as individuals, with unique needs and plans. As members bear the risk, however, they should be thinking a little more along these lines. They should at least be equipping members to manage their own risk, to plan ahead and to act more effectively today. Rob Rusconi