

# Investigating retirement ability of high net worth individuals in South Africa

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## ABSTRACT

It is a sad fact that even the richest among us might struggle to retire in the style they are accustomed to. Many try to maintain their usual lifestyle for some time after retirement, with negative financial consequences later on. Longevity improvements have caught many individuals by surprise and are rarely built into retirement plans. Skinner (2007) confirmed that most households with wage earners holding post-graduate degrees fall short of the wealth needed to smooth spending through retirement. Edwards & Barney (2012) found that more than half of High Net Worth Individuals spend more than 100 percent of pre-retirement income while still working. Moreover, many poor think they are barely surviving financially before retirement and cannot possibly save, while many rich believe that, given their assets, they need not save for retirement. The Retirement Confidence Survey (Helman & Greenwald, 2013) reports that only 23 percent of pre-retirees obtained advice on retirement planning which suggests that three out of four people might have little idea of how much to save for retirement. Without a savings goal a comfortable retirement is unlikely, even for the rich.

This investigation focuses on examining South Africa's High Net Worth Individuals: their retirement planning and their subsequent ability to retire. We compare expenditure with spending ability, and the effect of certain choices earlier on in life on retirement ability. For example purchasing a car only 5 percent cheaper than what you would have from the age of 23, and channelling this towards retirement savings, could replace 30 percent of your retirement income at the age of 65. This and other examples highlight the importance of retirement planning and saving from an early age, even for the rich.

## KEYWORDS

High net worth individuals; retirement ability; retirement planning

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## 1. INTRODUCTION

1.1 In this study we focus on the retirement ability of high net worth individuals (HNWIs), including professionals like doctors, chartered accountants, lawyers, and other high earners such as entrepreneurs and farmers. These individuals often have university degrees, are specialists in their field of work, and earn above average salaries. They form much of the client base of Financial Advisors (FAs) who usually focus on financially literate, high earners, because of the potential of higher commission earnings.

1.2 Being “able to retire” is a complex matter that depends on many factors and individual perspectives. A person may think he can retire comfortably based on his children’s income. A person earning minimum wage may think that State Old Age Pension (SOAP) is sufficient for retirement. Another person may consider his assets sufficient for retirement, but all these individuals might well be wrong. Our definition of “able to retire” or “retirement ability” is

... to have sufficient assets and savings to *sustain lifestyle post retirement* and cover all expenses, including medical and caring costs, until death.

1.3 Retirement ability will be affected by choices pre-retirement, at retirement and post retirement. Borrowing on future potential income, using credit facilities, clothing accounts, personal loans and overdrafts has a negative effect on retirement ability. Borrowing reduces future savings and increases lifestyle above what can be afforded on the current salary. Since retirement ability is based on lifestyle, and a higher income would produce a higher lifestyle, the absolute value of income at retirement is not of great importance. After retirement, most people would like to continue living in the lifestyle they are used to, whether that is above or below current income or salary. In fact, Skinner (2007) has shown that more than half of all retirees spend more than 100 percent of final salary after retirement. Chances are they had the same propensity prior to retirement, by means of debt.

1.4 The question addressed in this study is whether HNWIs, as defined here, can maintain their current lifestyle during retirement given the provisions made for

retirement. The study also looks critically at the calculations involved in retirement planning, planning which spans our whole life, and attempts to find reasons and solutions for the lack of retirement ability.

1.5 Section 2 gives a brief breakdown of the retirement planning timeline. Relevant recent research is summarised in the literature study of section 3. The results of a survey of FAs are discussed in section 4, and in section 5 some choices with high impact on retirement ability are presented. Section 6 concludes with final remarks.

## 2. RETIREMENT PLANNING TIMELINE

### 2.1 Retirement Ability of HNWI

2.1.1 The financial environment in South Africa currently does not encourage saving, with a very high debt to disposable income ratio of 75 percent (Reuters, 2012). Many people on low incomes believe they do not have enough to save, since their income barely covers the essentials. The well-known economic *marginal propensity to save* varies between people, and Dynan et al. (2004) show that it rises linearly as income increases. This finding implies that HNWI save more than people on low incomes, suggesting that the rich save more and may be able to retire in comfort while the poor might never be able to retire. Yet, according to FAs, the figures do not look that promising for HNWIs.

2.1.2 As will be seen in section 3, previous studies show that highly educated individuals, in particular postgraduates and professionals, tend to not save enough to maintain their pre-retirement lifestyle during retirement (Edwards & Barney, 2012; Skinner, 2007).

2.1.3 Before continuing, consider first the person included as a HNWI. The definition of HNWIs in the present study may be wider than what is common. Encompassing only a very small percentage of the South African population, we simply define HNWIs as “the client base of an FA”. According to Statistics South Africa, in 2010 a monthly salary above R13,000 placed a person in the top 10 percent of earners in SA, and a monthly salary above R18,900 in the top 5 percent (Statistics SA, 2010). These are typically the client base of FAs and can be considered the “rich” in South Africa. The retirement ability of these “rich” individuals is under the microscope here.

2.1.4 In reality, retirement ability is perfectly known only in hindsight and at death. Prior to death it can merely be estimated based on the judgement of three stakeholders: the client, the financial advisor and the actuary. To estimate retirement ability presumes knowledge of *expected* future (post retirement) outflow. Actuaries are among the few who have the skill set to calculate and estimate future outflow with a fair amount of accuracy. Their know-how will typically be used to create retirement analysis packages, retirement calculators and other forms of assistance and training

to the sellers of retirement products, which they have developed. In this study these sellers are the financial advisors (FAs). The FAs are then expected to advise the client regarding planning for his/her retirement.

2.1.5 The lay person normally has no training in calculating and discounting future cash-flows. Unassisted it is therefore almost impossible for the lay person to know if he can retire comfortably, and gathering his opinion on his ability to retire may not bring us closer to the truth. The financially apt will make estimates about future expected lifetime, but even they may not understand the true risk of longevity and are likely to underestimate the long term care (LTC) requirements for example, late in life. These observations indicate the importance of the FAs in providing such assistance.

2.1.6 The know-how of FAs will be as good as the help and training provided by the insurance industry and their financial training requirement. This knowledge will be applied throughout retirement planning, divided here into three parts: prior to retirement, at retirement, and post retirement.

## 2.2 Stages in Retirement Planning

2.2.1 Planning for retirement might start late in life, but the earlier it starts the better. Starting late shortens the first and essential part of any retirement plan: saving. The second part of the plan is made at retirement, when usually large cash sums can be taken tax free and are up for investment and annuitisation. At this point the term and nature of future expenditure is estimated to determine how much will be needed. Frequently this is not matched with what can be afforded. This stage is sometimes gradual, taking a few years for someone to move completely out of the work force. The third part of the retirement plan, very often neglected, is post retirement, when careful planning and monitoring needs to occur. The figure below shows the timeline clearly.

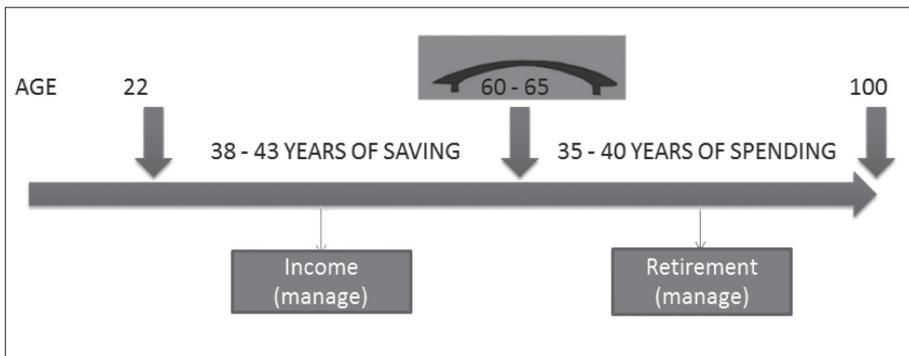


FIGURE 1 The retirement planning timeline

### **2.2.2 SAVING STAGE PRE-RETIREMENT**

The FA's advice on saving pre-retirement is critical. The importance of starting saving early is well-known, but since most people have low incomes early, they might consider visiting an FA not worth their while. Young people may not view saving as much of a priority. However, as will be shown later, starting saving only a few years earlier can make a substantial difference to retirement ability. Since an FA visit is unlikely until later in life, the importance of general education to the public becomes essential.

### **2.2.3 RETIREMENT AGE**

If there are insufficient savings at retirement, the situation can still be salvaged, although possibly to the detriment of post-retirement lifestyle. Often people view only the pre-retirement saving as retirement planning, and forget the careful planning required *at retirement* and *post retirement*. At retirement FAs have to create a clear picture of the future, with careful planning of future expenditure, since usually no further income accrues apart from the return on pre-retirement investments. Attempts to salvage the situation by high risk investments can end up in great disaster.

### **2.2.4 POST RETIREMENT**

It is useful for a financial advisor to visit clients who are already retired, even though such visits may have little to no financial incentives. A person retiring at 60 may well live to 100, requiring 40 years of careful expenditure planning. Commission to FAs on funds under investment will quickly decline without close attention and planning, which might provide some incentive. Again, this is an important stage, and less attention is required only if future income is guaranteed and will maintain purchasing power. In October 2012 the Actuarial Society of South Africa (ASSA) stated in a media release that Living Annuities attracted 85 percent of retirement assets in the previous year. But living annuities leave the choice of post-retirement spending with the "man in the street". As a bonus, longevity and investment risk is thrown into this package.

## **3. LITERATURE STUDY**

### **3.1 Introduction**

The exact date when the idea of retirement was born is not known, but as individuals started to live longer they eventually stopped working for their whole life. The usual retirement age was around 65 years, although initially the average life expectancy might have been lower. Therefore, only a few enjoyed the privilege of retirement, and needed retirement planning. Today retirement is a well-known concept, and many financial products are built around this concept.

### **3.2 Before Retirement**

3.2.1 This section focuses on the pre-retirement behaviour of HNWI's: on when HNWI's start to save, on their consumption and on the potential reasons for not starting to save earlier, or not saving at all.

3.2.2 Previous studies have shown that highly educated individuals, in particular postgraduates and professionals, tend to save not enough to maintain their pre-retirement lifestyle during retirement (Edwards & Barney, 2012; Skinner, 2007). However, one must also guard against obsessive over-saving, that is, against not making the most of what one can afford while working. The challenge of retirement planning lies in striking the correct balance (Skinner, 2007).

3.2.3 When starting to work and earning an income most people focus on accumulation of wealth. In doing so many individuals fail to recognise that the wealth they are accumulating must generate a long-term income stream to ensure sufficient income during retirement. What may also not be realised is that a number of factors might lead to a situation where the accumulated wealth cannot sustain their lifestyle during retirement. Factors that have been mentioned in previous studies include outliving the assets, high withdrawal rates, financial surprises, unanticipated future events and inadequate saving (Edwards & Barney 2012). These factors will be discussed later in this section. Accumulating wealth requires investment, and this investment is not just of a financial nature, but requires focus and hard work as well. According to a survey conducted for U.S. Trust Insights on Wealth and Worth, cited by Edwards and Barney (2012), nearly 50 percent of people stated that they did not take enough time off, did not spend enough time with their family, and as a result suffered health problems.

3.2.4 The question arises: what do HNWI spend their wealth on? Do they save? Do they invest in assets that may produce a passive income in the future and thus help provide a steady cash flow during retirement? Edwards and Barney (2012) showed that more than half of all HNWI retirees had spent 100 percent of their pre-retirement income while they were still working. They thought of retirement as a problem to be addressed once they get there. Skinner (2007) found that most households with income earners with postgraduate degrees fall short of the wealth needed to smooth spending through retirement. He goes on to argue that greater accuracy is needed to calculate retirement saving rates and that saving incrementally more is a good strategy, because it “both raises wealth accumulation, and makes it easier to sustain consumption in the future”.

3.2.5 According to Munnell, Webb & Delorme (2006) the Center for Retirement Research at Boston College has developed the National Retirement Risk Index. The index measures the percentage of working-age households who are at risk of not being able to maintain their pre-retirement standard of living. Munnell et al (2006) reported that 43 percent of American households are at risk of a substantial decline in retirement income, even after taking account of financial and housing wealth, cited by Skinner (2007). A sensitivity analysis of the indexed results shows that changing retirement- and savings-behaviour can substantially improve the outlook. The average time period for saving in South Africa is 28 years. This short period is caused by

individuals starting saving too late during their career, or stopping to save for long periods. Ideally one should save for at least 40 years, to ensure that one is able to retire with a monthly pension of around 75 percent of final salary (Van Rensburg, 2013).

3.2.6 A retirement adequacy goal is ‘the wealth or accumulated assets required to meet retirement needs’ (Butler & Van Zyl, 2012b). The retirement adequacy goal is used to evaluate the savings of individuals accumulated during their working career. A number of different ways are available to calculate these goals and to test whether their provisions to date are sufficient. Many tools for evaluation of saving efforts for retirement are available and can be obtained easily. The internet is full of retirement calculators. Turner (2010) investigated 25 cost-free retirement planning programs available on the internet and found that these programs generally do not advise individuals to annuitise. He also found that many of these programs ignored longevity risk. The balance sheet methodology can be used to ensure that net resources at retirement are sufficient to meet retirement goals (Loury, 2008). This method takes into account all assets and liabilities of the HNWI and then calculates their net resources available at retirement.

### 3.3 Debt

3.3.1 Debt has been found to have a negative effect on retirement and indebtedness encourages labour force participation in older segments of the population (Mann 2011). According to the South African Central Bank, South African debt stands at 75 percent of disposable income, and experts worry that the debt ratio could get worse as banks increasingly market unsecured loans (Reuters, 2012). Without adequate wealth reserves, borrowing could render households vulnerable in later years (Mann, 2011). Debt at retirement is becoming one of the biggest obstacles to maintaining pre-retirement lifestyle during retirement (Butler & Van Zyl, 2012a; Reuters, 2012). Cohort effects in debt accumulation might reflect acknowledgement of the weakening of the support systems for retirement (Warner & Hofmeister, 2006). Many individuals do not adapt their spending behaviour in difficult times and thus may be forced to take on debt which is often repaid using retirement savings (Van Rensburg, 2013). Debt essentially borrows into future income.

3.3.2 Saving is a mindset and need not be the focus, but rather spending less (Le Roux, 2012). Le Roux (2012) states that only 6 percent of South Africans will retire comfortably and individuals on average save only 8 percent of their annual income. In South Africa 48 percent of adults are worried that they will have insufficient savings for retirement (Clark, 2012). The survey also indicates that, from 2004 to 2012, penetration of pension funds grew from 9 percent to 12 percent, provident funds from 6 percent to 10 percent, while retirement annuities grew from 6 percent to 9 percent.

### 3.4 Financial Planning

The survey conducted for U.S. Trust Insights on Wealth and Worth stated that HNWI make the mistake of not consulting FAs on how to preserve their wealth. In Australia more than half of individuals in their 50s and 60s have not yet planned key aspects of retirement (Agnew, Bateman & Thorp, 2012). While planning facilitates better judgement and higher satisfaction in retirement, high levels of work involvement or job satisfaction can dampen it (Topa et al., 2009). A very important issue in the advice process appears to be the trust factor, as receiving advice does not necessarily translate into the application of the advice: only 17 percent of HNWIs near retirement who have consulted a financial advisor, do implement the recommendations (Yakoboski, 2011). The world wealth report of 2010 shows that there were 96 000 HNWIs in South Africa with investible assets above US\$1m (around R7 000 000 at the time). This was an 11 percent drop from the previous report (Shirley, 2010). According to Clark (2012), 83 percent of South Africans do not have any formal retirement products. Shlomo and Thaler (2007) state that most employees have little training for making informed decisions. For more conservative investors, asset returns in general, but in particular bond yields, have declined over the past two decades, thus a given accumulation of retirement assets will yield less income (Munnell et al., 2006). In contradiction to the findings of the above studies, Joo & Grable (2005) found that high levels of education and high income were positively correlated with having a retirement savings plan. However, these authors found that larger households were less likely to have a retirement plan. Lack of information, together with ignorance of basic financial concepts, affect the ability to save and secure a comfortable retirement (Lusardi, 2008). According to Yakoboski (2011) the two issues that concern individuals with higher education most as they approach retirement, is drawing retirement income from savings and to pay for healthcare expenditure during retirement.

### 3.5 Cost of Saving

An important concern for individuals who are saving for retirement is the cost of saving (Rusconi, 2005), about which they are often completely uninformed. The conversion of retirement savings to retirement income seems to provide more security than withdrawal of the funds needed directly from savings (Edwards & Barney, 2012; Turner, 2010; Yakoboski, 2011). This form of retirement income can be achieved using defined contribution (DC) platforms (Yakoboski, 2011) or by annuitisation of savings at retirement (Turner, 2010). Overall costs of saving in South Africa are high compared to international benchmarks. Rusconi (2005) uses the term “charge ratio”, which represents the percentage of the accumulated value at maturity that is lost due to charges. He uses the following example to explain these costs and the effect it has on saving for retirement:

If an individual starts with a contribution of R200 per month and this grows by 7 percent each year and earns 10 percent per year compounded for thirty years then the nominal value at maturity will be R848 032. This projected maturity

value reduces to R631 956 by up-front charges of 3 percent of each contribution, a monthly policy fee of R7 growing at 7 percent a year and annual management charges of 1 percent on the value of the assets. This shows a reduction of 25.5 percent on the charge-free maturity value, using the charge ratio. (Rusconi 2005)

### 3.6 Defined Benefit (DB) vs. Defined Contribution (DC)

3.6.1 A system of pooled accounts is much cheaper to manage than individual DC plans. In 2004, the US Congressional Budget Office estimated that administrative fees for DC schemes reduced assets at retirement by 23 percent, compared to just 5 percent for DB schemes (Ghilarducci, 2007). Inflation also erodes the provisions that individuals are making and needs to be taken into account when investing. According to Van Rensburg (2013), investments must be relatively aggressive to achieve higher real returns, although too much risk is not advisable; as the individuals approach retirement investments should become more conservative.

3.6.2 Although the current percentage of the workforce covered by a pension has not changed for over 20 years, the type of coverage has shifted from defined benefits (DB) schemes where workers received a life annuity according to years of service and final salary, to defined contribution (DC) schemes. DC schemes put individuals in charge of their own savings, which can be dangerous. Studies show that most of the working-age population saves virtually nothing outside their employer-sponsored pension plan (Munnell et al., 2006, Shlomo & Thaler, 2007). Regulations and tax subsidies favour the wrong kinds of retirement programmes (Ghilarducci, 2007). As a result, DC plans, which were designed to supplement and not replace traditional pensions, are growing at the expense of DB plans. The shift from DB to DC plans shifts the risk from the employer onto the individual. Thus inflation, financial, longevity and employment risks that were once pooled by larger entities are now on the shoulders of individuals. Furthermore, DC schemes might earn negative real returns in the stock exchange for long periods of time, and any recovery depends on how close to retirement individuals are. Van Rensburg (2013) reports that DC schemes currently provide only an average of 40 percent of an individual's final salary at retirement. These individuals were not saving enough during their working years. This lack of saving may largely be due to individuals managing their own provisions and not having the proper education in financial planning and provisioning for these circumstances. They might never have had contact with an FA or followed his/her advice.

### 3.7 Tax

3.7.1 Saving for retirement entails tax benefits and incentives. Any study of retirement planning may be incomplete without considering tax incentives. Limited details of the South African regime are provided below. Proposed changes are currently under discussion, which will make membership of a pension scheme a compulsory condition

of employment. The changes would also remove the preference for provident, pension or retirement annuity funds.

### 3.7.2 CURRENTLY

#### 3.7.2.1 For the employer:

Up to 20 percent of contributions towards pension and provident funds can be deducted.

- Contributions to retirement annuities can be deducted as part of salary expenses.
- No Rand value cap applies to deductions that can be made. (National Treasury, 2012)

#### 3.7.2.2 For the employee:

- Employees can claim up to 7.5 percent deduction on taxable income from contributions to a pension fund.
- Employees cannot claim this deduction on contributions to a provident fund. (National Treasury, 2012a)

### 3.7.3 PROPOSED (TO COME INTO EFFECT 1 MARCH 2014)

#### 3.7.3.1 For the employer:

- Employers will be entitled to claim a deduction for *all* contributions to a retirement fund for the benefit of employees. *No limitations* will apply in respect of the amount that may be deducted; and
- Any amount contributed by the employer to *all types* of retirement funds will now be *taxed as fringe benefits*.

#### 3.7.3.2 For the employee:

The many details are beyond the scope of this paper. However, one of the main differences that needs pointing out is the change in the disparity between low and high income earners that existed. Previously the low income earners enjoyed little tax benefit from the lower marginal tax bracket at retirement, and opted for provident funds, where annuitisation was not forced and 100 percent of savings could be taken tax free at retirement. The typical HNWI would on the other hand opt for annuitisation, still get one third tax free and benefit from the lower tax bracket on retirement income. In reality the lower earners were the ones who needed annuitisation more. The changes effectively levelled the playing field, with the ultimate goal to encourage retirement fund savings under a simplified regime.

3.7.4 The National Treasury proposes to bring back “preservation” to ensure that individuals will have some form of pension at retirement. Full vested rights with respect to withdrawals from retirement funds will be protected. The amount in retirement accounts at the date of implementation of the legislation and the growth on these accounts can be taken in cash. Thereafter individuals will only be able to make one withdrawal per year subject to specified limits.

### 3.8 At Retirement

3.8.1 In South Africa eligibility for state pension starts at age 60 but this does not mean that one has to retire at age 60. Case law has determined that retirement age is stipulated in the contract of employment. A challenge for many individuals is the transition from employment to retirement, where the difference between actual and required savings is referred to as the “retirement-income gap” (Edwards & Barney 2012). The average anticipated decline in consumption is larger than the average realised decline in consumption (Hurd & Rohwedder 2003, Amerik, Caplin & Leahy 2002). This means that individuals are saving less because they think are going to spend much less during retirement than they actually will.

3.8.2 According to Van Rensburg (2013) a Sanlam survey suggested that the average retirement age in South Africa is 59. This figure is substantially below the norm of 65 used in many developed countries (Van Rensburg, 2013). The official retirement age in 34 OECD countries is 64.4, the average age at which social security or the government starts paying out to retirees (Anon, 2011). The average actual retirement age is 71.5 and 71.4 in Mexico and Korea respectively. In the US and Australia average retirement age is 65.2 years, and in the United Kingdom 63.6 years.

3.8.3 The accumulation of retirement savings is one measure of preparedness for retirement, and more general planning behaviours are another (Noone, Alpass & Stephens, 2010). In South Africa households without children planning to retire will find a 75 percent replacement ratio inadequate (Butler & Van Zyl, 2012b). Another study by Anon (2010) states that 90 percent of retirees will not have sufficient funds to maintain living standards at retirement, let alone to enhance them. Thus, the options are either to save more while working or to increase the age of retirement (Butler & Van Zyl, 2012b). Butler and Van Zyl (2012b) state that, on current retirement saving rates, retirement before age 67 is unlikely to be affordable for most households.

### 3.9 After Retirement

3.9.1 After retirement individuals experience a variety of risks that may cause their provisions for retirement to be insufficient. A worrying statistic in South Africa is the number of individuals above the age of 60 who are dependent on the state’s older persons grant (2,647,000), namely 72 percent of the population above 60 (3,694,968), (Social Pensions Database, 2012). In 2013 the older persons grant is set at R1260 per month.

3.9.2 The most common risks that are associated with the decrease in the living standard after retirement are described below.

### 3.10 Healthcare

A significant threat to retirement income is medical expenses. Many households have higher healthcare cost after retirement than before (Butler & Van Zyl, 2012a; Skinner,

2007; Edwards & Barney, 2012). Healthcare expenses have been found to rise significantly after retirement, although this increase depended on membership of medical schemes. This finding contradicts beliefs that households can comfortably accept lower incomes at retirement in South Africa (Butler & Van Zyl, 2012a). Health insurance policies and products are costly to purchase in the individual market (Ghilarducci, 2007).

### 3.11 Longevity

Increasing longevity implies that individuals become more likely to outlive their assets (Edwards & Barney, 2012). Current retirees might be able to afford a decent retirement; however, this situation will change as the Baby Boomers and Generation Xers reach retirement age during the coming decades (Munnell et al., 2006). Predictions reflect the trend towards longer retirement and therefore likely declines in retirement incomes relative to pre-retirement earnings. This is known as replacement rates. The pooling of risk makes it possible for employers or the government to insure workers against longevity risk while taking advantage of economies of scale (Ghilarducci, 2007). Ghilarducci (2007) points out that although it is possible to insure against longevity risk by purchasing annuities, these are costly to obtain. Guaranteed Retirement Accounts are automatically converted to inflation-adjusted annuities to ensure that workers do not outlive their assets or see them eroded by inflation (Ghilarducci, 2007).

### 3.12 Long Term Care

Long term care (LTC) and longevity are interconnected. LTC or frail care is commonly required by individuals who live to high ages, while in turn quality LTC prolongs life even further. LTC represents one of the largest uninsured financial risks facing the elderly in the United States (Brown & Finkelstein, 2007). Furthermore, Brown and Finkelstein (2007) showed that typical policies are expensive relative to actuarially fair levels, as they would call it, whilst they tend to cover only one third or less of actual LTC expenditure risk. In South Africa very few financial products exist that are dedicated to saving for frail or long term care specifically. There are however some LTC-like benefits on certain life policies.

### 3.13 Inflation

In the US, Guaranteed Retirement Accounts use inflation-adjusted rates of return guaranteed by the federal government (Ghilarducci, 2007). Individuals are too conservative with their investments during retirement and as a result they often earn at a rate of return lower than inflation (Van Rensburg, 2013). Therefore retirees must be more active in managing the investment of their savings and their returns. This is a critical point where FAs may be able to assist, since often the elderly know very little about investments and fall prey to empty promises of high returns. Earning a rate of interest lower than inflation will over the long run erode the value of retirement savings. Thus retirees will either run out of income or will have to draw a lower income just to ensure that they will receive an income until death.

## 4 SURVEY AND ANALYSIS OF RESULTS

### 4.1 Introduction

We conducted an e-mail survey among financial advisors. Most of these were independent, while some were tied to one or more companies. Out of approximately 80 e-mails sent, 22 completed forms were returned. Insurance consultants were also contacted from various companies, who forwarded the e-mail to many of the financial advisors they service. Some FAs also e-mailed their friends to complete the form. Responses were received from Gauteng, Mpumalanga, Limpopo, Western Cape, Northern Cape and Free State provinces. The questions were kept short and the survey followed the general scientifically suggested methods by Eiselen et al. (2005). The response rate was low, typical of e-mail surveys, but sufficient for some interesting findings. The questions are given below with analysis, results and comments.

### 4.2 What Percentage of Clients can retire?

#### 4.2.1 The questions were:

Q1: What percentage of your <i>salaried</i> clients can retire comfortably?	Average = 19.7%
Q2: What percentage of your <i>business</i> clients can retire comfortably?	Average = 26.0%

4.2.2 Clearly very few clients can retire according to FAs, with salaried workers less so. Even though more business clients can retire comfortably, the potential business failure can change this picture, forcing business owners to dig into retirement savings.

### 4.3 Determining Disposable Income

In a retirement analysis to determine disposable income, for what percentage of clients:

Q3: Would you <i>do</i> a cash-flow analysis?	Average = 64.0%
Q4: Would you <i>ask</i> their disposable income amount?	Average = 77.4%
Q5: Do you know their current salary?	Average = 91.3%

4.3.1 A surprisingly high percentage of retirement plans seems to exclude a financial cash-flow analysis. The spread was wide, with some FAs doing hardly any cash-flow analyses, and 25 percent of them always doing one. The question might have provided more information if it had distinguished between pre- and post-retirement cash-flow analysis.

4.3.2 Questions 3 to 5 merely try to establish how disposable income is determined. In fact, a snapshot cash-flow analysis is not really sufficient for proper retirement planning; a proper cash-flow analysis requires projections up to and post retirement. It should take into account the run-off of mortgages, reduced accommodation requirements, increased medical costs and inflation, to name but a few aspects. Yet such detailed analysis may be less necessary if a simple salary replacement could be projected. For

some clients the current income is not known, for example in the case of business clients or farmers, who often pay themselves according to need. However, this problem brings us back to the cash-flow analysis to determine the income requirements for the current lifestyle, and to calculate a “lifestyle equivalent” salary.

#### 4.4 Determining Working Lifetime and Retired Lifetime Length

4.4.1 Question 7 focused on calculating the length of period available for saving and at the same time the length of lifetime allowed for post-retirement. In a retirement analysis to determine retirement length, for what percentage of clients:

Q7: Do you allow for . . .	
Retirement age 60?	Average = 21%
Retirement age 65?	Average = 65%
A different retirement age?	Average = 14%
Normally an age of ____ years	Most answered: 70
<b>Total</b>	<b>100%</b>

4.4.2 For most individuals, FAs allow for retirement at age 65. For salaried workers the reduced retirement age clearly shows, since it is hard to believe that all these individuals have sufficient funds to retire at 60. Retirement packages would clearly indicate the large difference between retiring at 60 compared to 65. Almost all FAs suggested an age of 70 or higher where a different age was used.

#### 4.5 Determining Age at Death

4.5.1 Death and taxes are certain, and both of these will apply in post-retirement calculations. All retirement packages base their calculations on expected future lifetime. It is important to understand how this part of retirement spending is determined to be sufficient. For what percentage of clients . . .

Q8: to determine maximum age . . .	
Do you ask up to what age they will require income?	Average = 43%
Do you use the <i>software package</i> projected age?	Average = 40%
Do you suggest the age up to which they will require income?	Average = 27%
<b>Total</b>	<b>100%</b>

4.5.2 This question suggested some knowledge of health and family history, and in 43 percent of cases this information was assumed sufficient for prediction of future needs. Thus retirement planning is based on the *client's* predictions, which may create the impression of having sufficient funds to retire, when in fact this is not the case. Looking at family history and longevity ignores the effect of medical advances and longevity risk.

4.5.3 Another 40 percent of people used the package projected age. Many people are healthier or frailer than the population average used by a package. In this case personal knowledge may prove valuable for relevant adjustment. What it does show is the trust that FAs have in the software packages they use.

4.5.4 However, the use of an average age only makes sense if longevity risk is pooled and given away to the insurance world in the form of a *guaranteed* life annuity. This is done by only 15% of pensioners by capitalisation.

4.5.5 By keeping the risk of longevity and poor investment performance the downside risk needs to be quantified. Without going into the depth of VaR or TailVaR, a simple age and probability of reaching each age could be used. One could for example specify the age at which the client may outlive his/her funds with 5% probability. Alternatively specify the probability with which the client is satisfied and calculate the age accordingly. These calculations can then allow for increasing expenditure and LTC at advanced ages.

4.5.6 By using an *average* future expected lifetime, combined with a living annuity or other form of draw-down to a specific age, a very large proportion of those who apparently had sufficient funds to retire at 65, will outlive their funds. These calculations rarely even begin to allow for increased costs closer to retirement and for frail care.

#### 4.6 Do we follow advice?

4.6.1 Q1: What percentage of clients would do what was recommended? \_\_\_\_\_%

Only 39% of clients on average seem to follow advice suggested by their advisors. This will of course be linked to the advice given, which may or may not be adequate.

#### 4.7 Correlations

4.7.1 The following correlations were found in the data:

- There was a high correlation between following the advisor's advice and ability to retire. Advisors who had more clients following their advice, also indicated that more of their clients are *able to retire*.
- There was a positive correlation between those advisors who use the computer package suggested age of death (future expected lifetime) and clients following the advice. This suggests that people may place high value on a computer projection, calculated typically by actuaries in the background, of future expected lifetime. The opposite was also true: with negative correlation between those who are asked up to what age they need a pension and then in fact following that advice.
- Advisors who had a large proportion of clients who retire at age 60 suggested more of their customers could retire. Those who had more clients retiring at age 65 suggested that fewer of their customers could retire comfortably. This

anomaly could be explained if those who retire at 60 were part of defined benefit schemes, like government employees.

- There was a positive relationship between advisor suggesting salary and retirement ability. The salary requirements calculated and suggested by a financial advisor proved invaluable. These FAs suggested that a higher percentage of their clients can retire in the lifestyle they are used to.

4.7.2 The above findings indicate the value of a financial advisor, as well as the value of relevant tools, such as retirement calculators/packages. However, care should be taken with projections and illustrative values. A projected monthly pension amount may sound great if the projected future lifetime is underestimated.

## 5. CHOICES THAT MAKE OR BREAK

### 5.1 Introduction

Choices pre-, at and post-retirement will determine whether we will outlive our funds. A few basic choices that play tug of war with HNWI savings will be considered in more detail.

### 5.2 Simple Choices that affect Retirement Ability

5.2.1 This section focuses on two basic needs: accommodation and transport. Whether we rent or buy, from an early age our salary has to cover accommodation and transport costs. The choice we have is to forego certain luxuries and rather buy a small apartment, or rent a much more luxurious and expensive one. We can buy a luxury car or just a basic one. Secondly, our car will lose value whether we buy new or second hand. The typical loss within 5 years is about 50% of purchase value, based on most recent (2013) dealer manuals showing trade and retail values. This loss is almost independent of model and make, and is slightly influenced by when a new model is released.

5.2.2 Since our aim is to simply replace as much of salary at retirement as possible, the absolute value of salary is not really important. The investigation therefore considers the *percentage* of salary spent on accommodation and transport rather than the absolute amount. The choice of the cheaper option versus the more expensive one creates a difference, which is assumed to be put into savings towards retirement by the person choosing the cheaper option. This income stream is then discounted to the present to produce a lump sum value. The lump sum value is in turn projected to retirement to create a final salary replacement value, i.e. the choice of 10 percent cheaper accommodation would convert into 5 percent of final salary at retirement, paid for life and increasing with inflation.

### 5.3 The Difference between renting and buying a Property

5.3.1 Assumptions: Age 23 earning R10,000 per month, spending 30% of salary on accommodation (rent or buy). Mortgage payments will be calculated at prime of 8.5%.

5.3.2 Since rent will currently increase at roughly 8–10% we will use an average of 9% rental increases. We also assume that the person buying a house will pay an additional 9% per annum into his mortgage, to match the cash-flow of the renter.

5.3.3 By increasing the mortgage payment by 9%, the person who bought the property (buyer) will have paid off the property after exactly 10 years, and then purchase a second, or increase the size of the first. At this time the initial property bought for R345,000 growing at 10 percent annually would be worth R894,000. The person who rented (renter) will have zero in savings. Both will have the full 30% of salary available again for a new mortgage.

5.3.4 At this time the *renter* will purchase his first property and the *buyer* his second. However, the *buyer* will earn an additional rental income of 4%–5% on the second property including capital growth, without allowance for tax on secondary properties, while the *renter* will only have capital growth. Should the buyer at this point increase the size of his primary residence then the difference between the renter and the buyer is simply the capital value of the single paid-off property in the first 10 years.

5.3.5 On the above assumptions at retirement this property worth R894,000 can purchase a pension of roughly R3,400 from age 65 onwards in current terms, increasing annually with inflation. If the buyer does not annuitise the property but rather rent it out, he can earn 4%–5% rental income on the initial property; at 4% rent it will provide an income at retirement of R2,980 and at 5% an income of R3,750 in current terms. These amounts may not look very large, but if the buyer's salary grew to about R21,590 after the initial 10 years, at an assumed 8% salary growth, then R3000 replaces 13.9% of salary, R3400 replaces 15.7% and R3750 replaces 17.4% at retirement. At current annuity rates quoted in the market, R894,000 could purchase a fixed annuity of roughly R6,300 per month, but this fixed annuity option is not considered since it will lose value very quickly due to inflation and the long post retirement period.

5.3.6 The second option of the buyer is not to increase primary residence size, but rather purchase a secondary property and rent out the first, earning a 5% rental income stream up to retirement. The rental income of 5% was calculated as R3,750 monthly, which augments saving up to retirement, and would produce an additional current value of  $R3750 * 12 \text{ months} * 32 \text{ years} = R1.44 \text{ million}$ . (This calculation assumes that the extra rental income is invested back into the mortgage and therefore earns prime, and is discounted at prime, effectively ignoring interest.) This choice creates another R5,543 in retirement value, replacing another 25.7% of salary.

5.3.7 In summary, purchasing property early, at the age of 23, rather than renting, could replace 40% of retirement salary within 10 years of saving, by spending 30% of salary on buying accommodation rather than renting.

#### 5.4 The Difference between buying Secondary Property and increasing Primary Residence

5.4.1 Assumptions: Consider two persons who purchased property early and increase primary residence up to age 35, allowing for extra needs as they age due to children, parents living in, and lifestyle. Following the example above and annually increasing mortgage payments, this property will be paid off after 10 years at age 45. At this stage one person invests additional funds into a second property or other savings elements, while the second person keeps on increasing primary residence up to retirement.

5.4.2 The first person could diversify by saving elsewhere, which reduces risk. Secondly, in a secondary property/equity it would again create the extra income stream of rental income/dividends up to retirement, additional to any capital growth. The second person will only receive capital growth on his property, and potentially over-capitalise, receiving lower capital growth than expected.

5.4.3 The value from age 45 up to age 65 of the rental income will amount to 5% per annum of the value that could be afforded in the form of a mortgage. Ten years later at age 55 the second property will also be paid off and again 5% is earned on a third property. Since the absolute value of salary is not important we can follow the same argument as above, so the first property will produce  $R3750 \times 12 \text{ months} \times 20 \text{ years} = R900,000$  which is close to R894,000 above and therefore roughly replaces 15.7% of salary. Similarly the third property will run for 10 years and replace half of this, which is 8% of salary.

5.4.4 In summary, by continuing to invest in the primary residence may not be optimal, and doing so one can forego about 20% replacement value of final salary. Buying a house at the seaside with no rental income is effectively the same as increasing a primary residence.

#### 5.5 The Cost of Luxury Transport

5.5.1 A car loses approximately 50% of its original purchase price in 5 years' time. Purchasing a second-hand car would produce the same results. The slightly smaller drop in value could be substituted by higher maintenance cost. Therefore, if we spend R200,000 on a car, rather than R300,000, our saving will amount to 50% of the difference, or R50,000 every 5 years. Since these are absolute values, they need to be converted and seen as a percentage of salary, and the relative effect of saving.

5.5.2 Let us assume that 20% of salary goes towards the purchase of a vehicle. The 20% will account for R2,000 in a salary of R10,000, which can purchase a car costing approximately R100,000. If the person spent 25% of salary on vehicles, this will account for another 5% of salary. The extra 5% buying power will not make much difference in luxury, but from the age of 23 onwards, this saving would replace 30% of salary from a

retirement age of 65. In fact, a 2% reduction on the cost of vehicles throughout our life, channelled into saving, would replace 12% of salary post retirement.

5.5.3 In summary, a small difference in our spending on cars and channelled into saving would make a very large difference in retirement ability.

**5.6 The Cost of Early Retirement**

5.6.1 Retiring early has a two-sided effect: it allows for less savings time, and creates more spending time. In the UK a 4%–5% reduction in pension is allowed for each year of early retirement before age 65. This means retiring 3 years early would reduce the pension by between 12% and 15%, and by reducing the retirement age to 60, like in South Africa, would imply a minimum of 20% reduction in pension income. Consider the table and corresponding figure below. The percentage below age 65 for retirement and corresponding to age 20 is 14.50%. This means that if we start to save at 20 and plan to retire at 65, we need to spend 14.50% on savings to replace final salary.

5.6.2 The table and graph indicate the effect of starting to save early, and retire a bit later. These are the sort of figures that should be available to FAs, stratified by age, gender, smoker-status and income level. The categorisation should depict the future expected lifetimes of a particular person. Furthermore, should the person not chose a guaranteed annuity, it should create a probability of surviving the projected future lifetime, giving the person a clear picture of what he/she can expect.

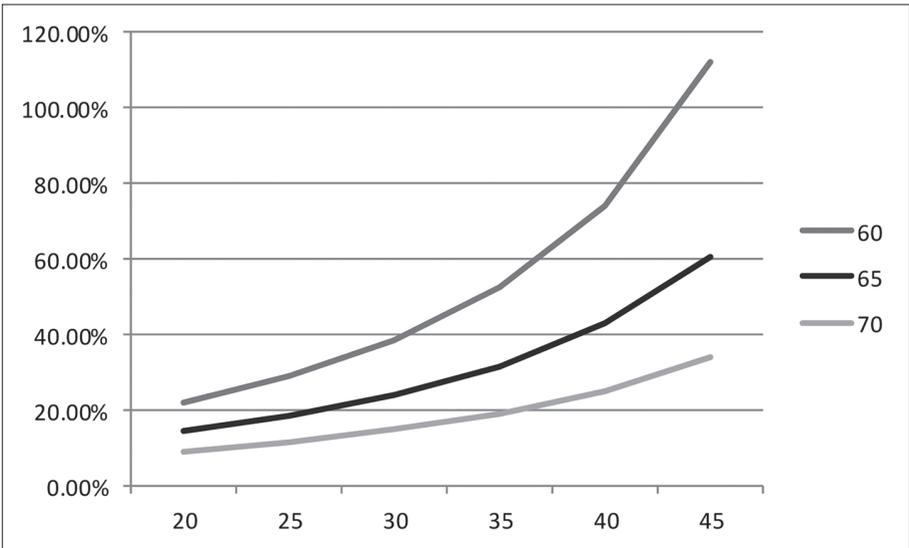


FIGURE 2 Percentage saving required: Start age vs. retirement age

**TABLE 1 Savings percentage of salary from start age to retirement age for 100% income replacement at retirement**

AGE	RETIRE		
	60	65	70
20	22.20%	14.50%	9.30%
25	29.00%	18.60%	11.70%
30	38.50%	24.10%	14.90%
35	52.40%	31.70%	19.20%
40	74.10%	43.00%	25.20%
45	112.0%	60.60%	33.90%

## 6. CONCLUSION

6.1 All *individuals* have the responsibility to save from the earliest possible time. The easiest method might be in the form of property, which forces a monthly saving. Foregoing current luxuries can substantially improve the ability to retire, and increasing standard of living faster than salary allows, by means of borrowing into future income in the form of clothing accounts, personal loans and other forms of debt, can be detrimental. Individuals should be educated by FAs, government and even in the school system to understand the importance of starting to save early.

6.2 It was shown that *financial advisors* will have to play an increasing role at various stages to improve retirement ability, and not only in the savings stage. They should provide advice to individuals earlier, and not neglect those who are already retired. FAs play a crucial role in retirement planning. They are trusted more by their clients than they might think. They should be assisted by training and tools from the insurance industry to maximise the pre-retirement savings, and optimise post-retirement spending and investment performance, making use of the detailed knowledge of their clients.

6.3 *Actuaries* and the insurance industry should provide relevant assistance through software packages that convey full information of post retirement expenditure and expected future lifetimes and expenditure as far as possible. The trust instilled in FAs and these IT packages should not be neglected and could be used as an vital tool in marketing and helping HNWI's and the poor alike to retire with ease. Where the risks of longevity and investment are carried by the individual, they should be assisted by the probability of outliving the available funds. Better knowledge will promote better decisions. In the looming opportunity of longevity and LTC, the insurance industry could find product solutions for these risks, rather than shy away from it.

6.4 Very little research was found on South African HNWI's. This could be due to the small proportion they make up of our society, or due to internal company

investigations which are never published in the public domain. Any such research would be invaluable to all planning retirement. More research is required on post retirement spending, in particular on the form, nature and term of medical and caring costs in South Africa. This will allow for a more accurate prediction of whether someone as really “able to retire” or not.

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