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The rational alternative

Four Retirement Annuity (RA) traps to avoid. Quick wealth-building tips.

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Pay close attention to the small details before you sign up for a Retirement Annuity investment. Some have nasty traps, warns BizNews writer Jackie Cameron.

By Jackie Cameron

The Retirement Annuity (RA) is a great invention – provided you choose with care. RAs are savings vehicles with tax perks attached to them, but many of them come with catches.

RAs enable self-employed people to save for retirement in a similar way that individuals contribute through a company pension fund and, at the same time, cut their tax bill. They aren’t exclusively designed for sole proprietors. Advisers often encourage their clients to invest through an RA to top up savings.

An RA is a vehicle that houses assets, like shares or unit trusts that in turn place your money in shares. Performance of RAs varies considerably and depends on a range of factors, from the underlying investments to the fees you are charged by the financial services company offering you this product.

Here are some factors to consider, if you are thinking of investing in an RA:

1. Unit trust-based RAs are better than life company RAs.

Determinations from the Pension Funds Adjudicator have repeatedly shown that RAs with unit trusts as the underlying portfolios are more transparent and generally less costly than RAs offered by life assurance companies.

I was reminded of this when I read a recent ruling on a complaint from an RA investor that returns had been very disappointing. The investor did not succeed in convincing the Adjudicator that maladministration and excessive fees were the reason for the dismal investment performance. However, it emerged in the case that Liberty could not explain how it quantifies a 1% management fee deducted annually from RA savings.

The Adjudicator, Muvhango Lukhaimane, said the Tribunal "noted with concern" that Liberty was "unable to produce a breakdown of costs (management fees) levied on the complainant's investments despite their insistence that it is 1% of investments". This admission "falls short of the openness required by the Treating Customers Fairly (TCF) initiative with which the respondents associate themselves". Liberty was ordered to come up with an explanation.

You may think 1% doesn't sound like much, but this small amount deducted every year adds up. (For more on how small fees decimate returns, read: Five ways to chop investment costs that gobble returns.)

2. Don't invest on a monthly basis; opt for an annual lump sum.

You can invest through a debit order or in lump sums. Saving the money, and contributing once a year in February, can help you cut the cost of commissions. Plus, you get around the problem of being penalised for reducing monthly premiums if you hit a cash crunch later.

Some financial planners or intermediaries may not encourage this choice because there is more money for them if you opt for a contract that locks you into monthly payments.

3. Never agree to taking out an RA beyond 55.

You can always extend the term if you choose to later, but changing the date of retirement to an earlier age will give life companies the excuse to hit you with penalties. So, even if you don't plan on joining the pensioners' brigade prematurely, make sure your RA can.

4. Don't just invest in an RA because of the tax perk.

Don't believe that companies that offer RAs have your best interests at heart. They may produce feel-good marketing material – but, as mentioned, they often wipe out your tax perks by loading up on fees.

An obvious way to boost your savings pot is to keep all the costs to a minimum. Shop around and ask for explicit break-downs of all the charges before making your choice. Some unit trust-based RA providers allow you to invest with them directly, and do not charge you the fees you would be expected to pay an intermediary.

For more ideas on how to manage your personal finances and build assets, see the BizNews wealth building section.

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