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Everyone Can Build a Million Dollar Nest Egg

by Goh Yang Chye, Chief Executive Officer

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Annuity, or longevity insurance, has been a hot topic since it was first mooted in this year's National Day Rally speech. As the government works out details of how the scheme is to be implemented, the issue of whether Singaporeans have enough retirement savings continues to linger.

The government has proposed to delay the Minimum Sum drawdown age progressively from 62 to 65, so that the payouts from this existing scheme will be able to last longer for CPF members.

One proposal is to set aside a sum of money from an individual's Minimum Sum to buy a compulsory annuity, which will ensure that those who live beyond 85 years enjoy a lifelong payout of $300 per month. If one dies before 85, the amount goes into a pool for payouts to those who are still alive.

The purpose and benefit of an annuity to Singaporeans is clear: To ensure that those who live beyond 85 do not outlive their savings. While the debate on whether the annuity should be compulsory or an opt-in scheme continues, the real question is this: Are Singaporeans prepared for their retirement? At least half of Singapore's population is not prepared for retirement, according to the AXA RetirementScope 2007 global survey. Among the 600 Singaporean working adults and retirees profiled, only half indicated that they are planning for retirement. In contrast, 85 per cent of workers in the United States have started retirement planning.

The likely reason for this dismal number is that Singaporeans are not aware of how much income they will need for their retirement. Nor do they know how to begin retirement planning.

Start by asking yourself what kind of retirement you want. Do you wish to have a similar standard of living as what you enjoy today? Based on your desired retirement lifestyle, you can work out your retirement goal – and start building your retirement nest egg. If calculating your nest egg (using one of the many online calculators) puts you in a state of shock, remember that time is an important ally when it comes to investments.

Take a look at this illustration: Investors A, B and C decide to invest $1,000 per year. A starts immediately, B waits for 10 years, and C waits for 20 years before investing. After 40 years (assuming investment returns of 7 per cent per annum), A will benefit from compounding and his funds will grow to $214,000. In comparison, B and C will only have $101,000 and $44,000. By procrastinating, the difference to their investment returns is staggering.

One must also realise that inflation is a reality that will impact one's future purchasing power. According to the Singapore Department of Statistics, the average rate of inflation from 1961 to 2006 was 2.66%. By leaving your money in a savings account earning, say, 0.5% interest per annum, your money is actually losing value at approximately 2% a year.

Thus, the principal reason for investing is to ensure that you can at least maintain your purchasing power. Some of the most common investment tools available include insurance plans, stocks and property. Your insurance agent will most likely introduce you to plans that have an investment component; your stockbroker will offer 'hot tips' to help you make a quick buck; and you just might be tempted to go into the property market seeking significant capital appreciation.

Think again. Insurance plans are designed for protection, and that is what they do best. While there are products that offer an option for investments, many people are not aware of the built-in costs. Why pay for an investment-linked insurance product if what you want is good returns? Notwithstanding the above, insurance has its place in one's retirement planning. A critical component is medical insurance – comprising a critical illness plan and hospitalisation cover – which one should take up early in life. An often overlooked aspect is that one may not be able to be insured later on in life due to age or health conditions.

While stocks seem like an appealing option with the potential for significant returns, one must not forget the inherent risks involved. In his research paper, 'Just How Much Do Individual Investors Lose by Trading?', Terrence Odean from Haas Business School of the University of California made a discovery that every retail investor should know.

By studying a complete trading history of all investors in Taiwan, Prof Odean and his researchers realised that individual investors lose about 3.8% a year (as compared with losses of about 2% p.a. for US investors). Prof Odean stated in his report: 'Over a savings horizon of 20 or more years, an annual return shortfall of 2 to 3.8 percentage points will result in a tremendous reduction in a worker's retirement wealth.' Prof Odean's report also revealed that over a 140-day portfolio holding period, the mean daily trading profits made by institutional investors was NT$178.7 million (S$8 million) – which was exactly what individual investors lost over the same period.

This study shows empirical evidence that institutional investors gain from the trading and market timing losses of individual investors.

Some Singaporeans seem to equate retirement planning to buying investment properties. They have forgotten the painful lessons of the property bust in 1997, which left many in negative equity. The current housing glut in the US and the collapse of the US sub-prime market is another stark example that property investment is a high stakes game susceptible to cyclical fluctuations and sudden market downturns.

A more considered retirement planning approach is this: One must conscientiously build a nest egg through the ongoing process of asset allocation, adopting sound investment strategies that diversify risks while maximising returns. Portfolio management is defined as how your investment portfolio is constructed and subsequently administered by your financial adviser.

Your adviser must be able to understand your financial goals and recommend the right financial products from the gamut of investment vehicles available in the market. Unless your financial adviser has the combined expertise of an investment analyst, economist, as well as fund manager – which most do not have – it is near impossible for him or her to provide in-depth counsel on all aspects related to equity investments.

A good financial advisory should have a team of seasoned and multi-disciplinary experts who develop strategies and processes to drive successful portfolio management. Long term asset allocation models also need to be adjusted quarterly, taking into account market trends and events.

With the proper investment strategy in place, it would not be impossible for a financial advisory to achieve an average return of up to 12.5% per annum for its clients.

But good portfolio management does not end here. Periodic rebalancing is essential to maintain risks and returns within acceptable ranges, a process often neglected by investors. For example, an investor may have invested $60,000 in equities and $40,000 in bonds. Over a year, assuming his portfolio returned 20% for equities and 3% for bonds, he would have 64% instead of 60% of his funds in equities, placing his portfolio at higher risk. A good financial adviser should take a disciplined approach to rebalance his client's portfolio and lock in profits.

After one has ensured that his or her overall retirement plan is in place, he or she can then consider adding annuities as further insurance. Everyone can build a $1 million retirement nest egg by investing a fixed sum of money every month. For example, at age 21 and assuming a 10% return per annum, all you would need to set aside every month is $290! A wise saying goes: Planning is bringing the future into the present so that you can do something about it now. So, what are you doing for your future now?

www.gyc.com.sg enquiries@gyc.com.sg +65 6349 1441

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GYC Financial Advisory Pte Ltd | Co Reg No: 199806191-K | 1 Raffles Place #15-01 One Raffles Place, Singapore 048616