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Should my retirement plan be fixed or flexible?

Choosing how to invest for retirement is a crucial and complex decision. Understanding the distinctions between retirement annuities (RA's) and unit trust portfolios is vital when deciding on the most appropriate way to grow your nest egg.

What's an RA?

There are two types of RA. Traditional 'policy RA's' are policies or contracts with an insurance company which you commit to contribute towards until retirement. 'New-generation RA's' are investment-linked portfolios.

Both are structured specifically for retirement and need to comply with Regulation 28 of the Pension Funds Act (follow the link for a full discussion of the rule). This regulation places limits on how much of your money can be placed in certain asset classes (there's a 75% cap on exposure to equities, and no more than 25% can be invested offshore). The idea is to ensure that your retirement savings are carefully invested.

What's a unit trust?

Unit trusts are portfolios of assets such as equities, bonds, cash and listed property, in which investors can buy units. They can be purchased for a specific goal or for retirement. Unit trusts don't need to follow the same guidelines as RA's – unless their mandate is to be Regulation 28 compliant, in which case they can be used as the underlying investments in new-generation RA's.

Key differences

The differing asset allocations of RA's and discretionary unit trusts can have a significant impact on their performance. Some analysts think that that the equity and offshore limits imposed on RA's have a negative effect on performance, while others believe that Regulation 28 compliant funds ensure a diversified and less risky approach and deliver good returns in the long term.

The obvious difference between an RA and a portfolio of discretionary unit trusts for retirement is that the funds in an RA can only be accessed when you're 55 or older. At this point, you're allowed to withdraw one-third of the funds as a lump sum and need to purchase a compulsory annuity with the balance of the fund. The drawdown from your compulsory annuity becomes your retirement income.

Conversely, all of the funds in a unit trust for retirement can be accessed at any stage. You may decide to retire early, use the funds to pay off expensive debt or cater for an emergency expense.

Pros and cons of RA's

One of the major advantages of RA's is that your contribution to an RA is tax deductible – in real terms, this means that you can invest more into the RA than you could into unit trusts.

There are also tax advantages within RA's which may have a positive impact on the growth of your funds. There is no tax on the interest earned by the investment, and there is no capital gains tax within the portfolio. You thus enjoy tax-free growth as well as the opportunity to invest more into the fund.

The tax benefits of RA's are not quite as appealing when you reach retirement. Should you withdraw the maximum one-third amount, it may be subject to a lump sum tax at specific rates depending on whether you have made any previous withdrawals from pension funds and other RA's.

Pros and cons of unit trusts

There are no lump sum taxes when you withdraw from discretionary unit trusts, and the capital gains tax you pay on each withdrawal to fund your retirement is lower than the income tax on the drawdown amounts from your compulsory annuity.

The most significant advantage of investing directly in unit trusts is the variety they offer. You can choose between money market funds, bond funds, balanced funds including Regulation 28 funds, and high equity funds. These can be local or offshore funds. Your choice could be based on your risk profile and the time you have until retirement.

Another advantage of discretionary unit trusts is the flexibility of contributions. You can decide when, where and how much to invest and you can stop or change contributions at any time. Not all RA's offer this flexibility and some can penalise investors if they stop or reduce their contributions.

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Which is right for me?

There's no hard and fast answer to this question, but one major factor to consider is your buying behaviour. The rigidity of an RA works for people who're tempted to dip into their savings for incidental expenses; while a disciplined saver or an investor looking for a higher equity and offshore exposure often prefers the flexibility offered by unit trusts.

The good news is that you can invest in *both* RA's and unit trusts. Some investors choose to contribute the maximum amounts that qualify for tax deductions into their pension funds and/or RA's, and then put extra savings into discretionary unit trusts.

Are you interested in investing towards retirement in a unit trust or a unit trust linked RA? Speak to a financial adviser or find out more about Prudential's unit trust funds by contacting our Client Services Team on 0860 105 775 or at query@prudential.co.za *for more information.*