Should I cash in my pension fund and invest in my mortgage?

We are often approached by analytical clients with this question. For those with an accounting or actuarial background the motivation for such a move is more often than not, a no-brainer. The first and only requirement is (should be) that the rate of return on your pension fund must be less than the interest rate that you are paying on your mortgage.

My standard answer to this question is usually a self-assured NO, but this has nothing to do with the financial merits, but rather human behaviour, which I have been fortunate to observe over the last 15 years. However, financial planning is not just about a GUT feeling, but rather following a more comprehensive exercise and weighing up the PRO'S and CON's of such a strategy.

Keep in mind that pension and retirement funds are administered in line with Regulation 28 of the Pension Funds Act. This Regulation prescribes the minima and maxima allocation towards certain asset classes. The result of this regulation is that, at best, even if you are an aggressive investor your portfolio would be viewed as “balanced”.

Taking this into account, I've taken the best, worst and average performing balanced unit trust fund over the last 10 years (taken from Morningstar) and compared the outcome to a scenario where you withdrew pension fund money 10 years ago, paid withdrawal tax on it and invested the rest in your mortgage (at a rate of Prime – 1%).

The exercise is a bit over simplified - I used the current tax tables and assumed a conservative admin / advice fee of 1% which I simply deducted from the published performance of each fund. But the result does however make for interesting reading.

The graph below shows the 4 scenarios. The red, green and blue bar depicts the fund value of a R 750 000 investment in the three balanced funds whilst the purple bar shows the fund value of (or the amount available in) your mortgage for an initial investment made with an after-tax amount of R 611 400.

Feel free to contact the Author, should you have any questions or comments on this month's article in the TwoCents.
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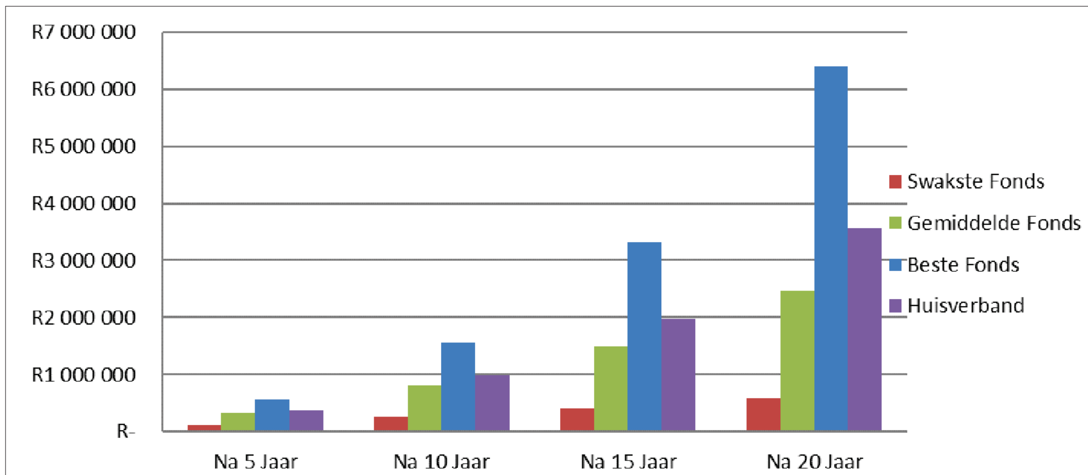

Note: The graph only shows the **return** on the investment and the **interest saved** on the mortgage and not the initial capital.

What is quite evident from the graph above is, **if indeed the next 10 years would look the same as the past 10 years** (in terms of returns and interest rates), is that if you picked the average or worst performing unit trust fund in your pension fund, it would have been more favourable to withdraw these funds and invest in your mortgage.

I, however, want to make the point that when it comes to financial planning, a "one size fits all" approach or computer generated proposal often ignores personal circumstances. There are circumstances when withdrawing funds from a pension funds makes sense.

The argument AGAINST a withdrawal is usually the following:

- Pension Funds are protected against insolvency. Even if you lose your house, car and sailboat, creditors can't put their hands on your pension fund money. To withdraw pension fund money if you are cash strapped, could be catastrophic.

- If you are, like most people, invested in the "Big 4" Balanced Funds (Allan Gray Balanced, Coronation Balanced Plus, Investec Opportunity and / or Foord Balanced Fund), you would have received an above average return the past decade and outperformed the interest rate on your mortgage. If this relative out performance can continue it would make sense to leave the funds where it is.

- One of the biggest reasons why people don't have sufficient retirement capital is because they use their pension fund money (when they move from employers) for dubious investments. Most people simply don't have the financial- or self-discipline to reserve these funds for retirement but end up "investing" in life style assets, like cars, holidays and swimming pools. The human behaviour in this situation is grossly underestimated.

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- The sins of the past leave scars. If you withdraw your preservation fund now, this withdrawal will have an impact on the tax-free amount when you retire out of your current pension- or provident fund.

- If interest rates decline; this will decrease the attractiveness of investing in your mortgage. The strategy can unfortunately not be reversed.

PRO arguments of withdrawals are the following:

- Only a portion of retirement funds are tax free upon retirement (R 500 000). The balance of these funds is taxed at your marginal rate. More tax friendly option exists for discretionary funds.

- No restrictions are applicable on the asset allocation of discretionary funds. You can for example invest 100% of your funds in property or offshore equities, which is not the case with funds in a pension or retirement annuity environment.

Your own circumstances

The following aspects should be considered before you even THINK about withdrawing your pension fund money to invest elsewhere:

How good is your track record when it comes to financial discipline? Will you be able to resist the temptation to withdraw the funds if your neighbour bought a new off-road trailer? If you tend to spend your bonus 3 months before it arrives, don't touch your pension fund money.

What is the relative performance of your pension fund (after costs) to other balanced funds? If your return is below the average, it might be a good time for action. By action, I don't necessarily refer to a withdrawal.

How does the rest of your investment portfolio look like in terms of asset allocation?

The time horizon is important. The closer you are to retirement the less likely alternative strategies will yield favourable results. Over the last 10 years, the markets have been relatively favourable for investors that were patient. The next 10 years might be a bit more challenging so don't be too optimistic about returns.

The cost of money is important. Lower interest rates will reduce the attractiveness of this strategy.

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To conclude, if you consider this strategy, walk on the line of caution. Be realistic about your financial discipline and conservative about assumptions of growth. For most of the people reading this article, this strategy will probably not make sense, but for sophisticated investors or clients with unique needs, this might be an opportunity to create additional wealth.

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