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THE RETIREMENT SPECIALIST

RETIREMENT INCOME

ONE SIZE FITS ALL

OR DO YOU NEED ALL OF THE COLOURS IN ALL OF THE SIZES?

In all manner of areas, a particular way of doing things or a certain technology can come to dominate its space; the VHS format for video recorders for example, or Apple with smartphones. Often, it's not necessarily the best solution [Betamax was viewed as superior technology to VHS] but it reaches a tipping point first and establishes itself as the default choice until something changes.

Guy Anderson, Director
Retirement Income Distribution

In the area of retail asset management solutions, we can observe a similar situation. Underpinning the whole customer journey, from the establishment by the adviser of a client's risk preferences, right through to the recommended fund or portfolio for them to invest in, Modern Portfolio Theory [MPT] has come to dominate proceedings. MPT was the brainchild of US economist Harry Markowitz in the early 1950s. The cornerstone of his hypothesis was the concept of the Efficient Frontier and at the heart of that, the mathematics evidencing that a well-diversified portfolio of non-correlated assets produces the highest level of return for the lowest level of risk.

For a portfolio to nestle nicely on the Efficient Frontier, seeking a basket of negatively correlated assets is key, be that from within the same assets [equities for example] or from across asset classes. The logic for this is pretty obvious, with elements of the portfolio responding differently to others. This provides some balance and reduces wild swings in returns over time, compared to putting all your eggs in one basket. Price volatility is therefore reduced and as price volatility is a measure of risk, risk is also reduced.

Is diversification itself the silver bullet?

So, much like the well worn mantra when buying a property... Location, Location, Location, the retail asset management space may have created their own version. Diversification, Diversification, Diversification. They have dined out on it to such a degree that, as Mark Dampier expresses in a recent Money Marketing article[1], the message may no longer cut through. He also suggests, more worryingly, that diversification itself may not be the silver bullet it has been held out to be. Finding assets that are truly non-correlated is proving more difficult in the current economic climate, especially between equities and bonds which often make up the bedrock of many a retail multi asset offering.

Persistent negative correlation

Sean Markowicz CFA from Schroders showcases a graph in his recent article2 which makes it very clear that the persistent negative correlation between equities and bonds that asset managers have witnessed for the last 20 years, is more the exception rather than the norm when you look back over the last 90. He goes on to suggest that with a move to a more procyclical monetary policy, the continuation of this negative correlation should be questioned.

Investing in a basket of assets rather than just one will obviously still reduce volatility and therefore risk, but increasingly positive correlation between the assets in the portfolio will push those portfolios to the right on the Efficient Frontier.

This means they have a greater level of risk relative to their predicted return. Also, it has some significant implications for those retail investors who are taking regular withdrawals from their portfolios to support their retirement lifestyles.

Implications for taking regular withdrawals

The first implication is one of investor expectations, which is particularly relevant with the FCA Consumer Duty framework taking shape. Existing risk assessment tools provide would-be investors with risk descriptions which are predicated on bonds providing down-side protection. So, those investments with a high bond content are given a lower risk score than those with a higher equity content. However, as borne out by the first six months of 2022, the challenging macro-economic and geo-political environment has seen bonds no longer able to provide that downside protection, resulting for example in the lower risk Vanguard LifeStrategy 20 fund suffering a greater drawdown than the LifeStrategy 100 version[3].

The second implication and the one that could actually harm investors rather than just upset them, is where the wider current investment environment and the increasingly positive correlation between equites and bonds combine to increase the volatility of returns, exposing retirees to potentially heightened sequence risk. For those who are in the later stages of their retirement, suffering a poor sequence of returns doesn't really change too much. They may have to cut back a little, but the pain would generally be manageable. But, enduring a poor sequence of returns within the first ten years of a typical 30 year retirement could be catastrophic. If you're interested in reading more detailed research that quantifies the importance of the sequence of returns in the first decade of retirement, check out the link at the end of this article[4].

Responding to the challenges

To respond to these challenges, many investment managers are looking towards other asset classes as a way of bringing negative correlation back into their portfolios and provide some down-side protection. These 'alternative' asset classes, some of which can be quite esoteric, have very different characteristics to the bonds they're replacing and may alter the portfolio risk, whilst also being too complex for many investors. They may be suitable alternatives where growth is the only objective, but with most retirees having wider, sometimes competing goals and objectives, other more conventional and established alternatives should also be given consideration.

Measures of risk

Think about the appropriate measures of risk in decumulation. A focus on capital volatility may be less helpful than a measure of the sustainability of income for example. Consider too whether being a slave to MPT is the only way forward as those institutions who have to grapple with meeting cashflow liabilities out of their assets over unknown timeframes look elsewhere for their frameworks, to approaches such as Liability Driven Investing [LDI] for example.

Triple threats

The favourable market conditions from 2010-2021 have made it appear that it's perfectly suitable for retirees to continue to invest in the same, rather vanilla portfolios for decumulation, as they had while accumulating their wealth, especially when innovation in the area seemed lacking. However, with the triple threats of spiralling inflation, rising interest rates and growing volatility caused by declining down-side protection from bonds now starting to make themselves felt, is it not time that retirees need [and should be offered] more personalised options to meet their retirement income needs? One size [or one way of doing things] should no longer be seen to fit all when it comes to decumulation.

If you'd like to know more, we'd love to talk to you. Please get in touch with your usual Just contact, or go to justadviser.com and search 'meet the team', call 0345 302 2287 or email support@wearejust.co.uk.

[1]https://www.moneymarketing.co.uk/opinion/mark-dampier-2/

[2]https://www.schroders.com/en/us/insurance/insights/equities/what-drives-the-equity-bond-correlation/

[3]https://citywire.com/new-model-adviser/news/get-ready-for-lower-bond-returns-vanguard-lifestrategy-team-says/a2392966?re=99453&refea=375377

[4]https://finalytiq.co.uk/technically-buggered-historical-evidence-sequence-risk-retirement-portfolios/

FOR MORE INFORMATION

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