JUST.

THE RETIREMENT SPECIALIST

RETIREMENT INCOME

STICK OR TWIST

THE RISK OF DOING NOTHING IN RETIREMENT

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Recent history is littered with many well known examples of those who failed to read the signs that things around them were changing. Hanging on to outdated practices or having to concede they may have misjudged things, Kodak, Blockbuster and Woolworths are just a few names people will recognise.

But it's not just well known businesses that can fall foul of the risk of doing nothing.

As David Brett from Schroders points out in his article in June[1], the first half of 2022 has been the worst start to a year for investment markets since the Great Depression, leaving the industry staple 60/40 equity/bonds portfolio down over 13% according to FE Analytics[2].

60/40 portfolio year to date performance

-13.81%

In such challenging times, advisers are, quite rightly, busy supporting their clients, reassuring them that these market movements happen. It's all been allowed for within their goals based financial plan and that they just need to sit tight. Or even invest more if they can as it's a buying opportunity. This approach may be absolutely valid for those who are still accumulating or growing their wealth, but is it as sound for those who are now living off that wealth, especially those taking regular withdrawals and who have only recently started to do so?

A key question is whether this is just normal market volatility or something more significant?

This stalwart of financial planning, the 60/40 portfolio, has proved to be a reliable selection for many advisers and their average risk clients as part of a centralised investment proposition. The bond content has provided valuable down-side protection to the growth focused equity components of the portfolio, due to bonds providing negative correlation, but due to macro-economic and geo-political circumstances, things appear to be changing.

In his article in July[3], Sean Markowicz CFA, also from Schroders, provides some interesting and compelling commentary that those economic conditions and a move to a more procyclical monetary policy means the continuation of negative equity/bond correlation should be questioned.

So, putting it simply, increasingly positive equity/bond correlation means both asset classes start moving in the same direction rather than opposite, and bonds stop providing the portfolio with down-side protection. The impact of this can be seen in a recent Citywire article[4] which looks in detail at the performance of Vanguard's five LifeStrategy funds from Jan-July this year.

Contrary to conventional risk measurement techniques, the strategy with the lowest equity content and therefore the lowest down-side risk normally, has suffered the greatest drawdown.

Long run historic performance data will often support a recommendation to 'stick' rather than 'twist'. This again is fine for clients in wealth accumulation/consolidation, but for those spending down their wealth another factor looms large, that old chestnut sequence of returns risk.

Impact of sequence risk

Although it's now five years old, Abraham Okusanya created what is widely regarded as the definitive research on the potential impact of sequence risk[5]. With rather colourful language he concluded that it's the sequence of returns experienced in the first decade of a 30 year retirement that will determine the success or otherwise of the journey. His research identified an 83% positive correlation between the sustainability of a 30 year withdrawal strategy and the real returns earned in the first ten years, compared to only a 26%

positive correlation when looking at the second decade, and a negative correlation in the last. In other words, it matters little what happens in the last ten years of a 30 year decumulation journey. Success or otherwise is largely baked in as a result of what returns are earned in the first ten years. So, for those who have only recently started living off their investments, the next few years are and will be crucial!

Tackling sequence risks

To tackle this sequence of returns risk, some planners will use a time bound withdrawal strategy, often referred to as bucketing, and hold a number of years income in cash to avoid selling down assets at a loss. This can help manage a client's emotional fear during turbulent times but there's a balancing act between holding enough cash to ride out market drops whilst not holding too much that overall portfolio performance is compromised. David Brett looks at this area in his article already referenced. Although the data is from the US, it does show that it took the S&P 500 over four years to recoup the loses experienced during the 2001 and 2008 recessions. So, is the typical two years in cash going to be enough going forwards from where we currently are?

'Alternative' asset classes

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 be too complex for some advisers' clients. Outside of infrastructure, energy, hedge funds and private equity, there is another 'alternative' that could be used within a retiree's flexi-access drawdown portfolio, as a replacement for some of the 40% normally held in bonds.

Guaranteed income

That alternative is the purchase of guaranteed income. The ability to pool the main retirement risks, backed by an insurance covenant, can be shown to improve overall portfolio resilience and efficiency and can lead to better customer outcomes in a wide range of circumstances. Importantly, it's well proven, easily understood and negatively correlated to all other assets within the client's portfolio.

Let's think about those clients who have only recently started drawing down on their wealth:

- **How will they feel about their first years of retirement?**
- **What could they experience while they await negative correlation, and therefore down-side protection, to return to the equity/bond relationship?**
- **How will their experience sit within the new FCA Consumer Duty framework?**

If they 'stick' with the conventional 60/40 portfolio, what could that do to the first decade of their retirement? What could be the longer term implications for them, their future income requirements and their relationship with their adviser? If seeking 'alternatives' to bonds is seen as the way to protect against sequence of returns risk, what alternatives could best meet the clients' various goals and objectives over the next 30 years, but especially the next ten?

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.schroders.com/en/insights/economics/the-bear-market-story-and-what-next----in-six-charts/

[2]Data provided by FE Analytics, bid-bid TR, 01 Jan 2022 to 20 Jun 2022, in GBP

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

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

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

FOR MORE INFORMATION

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