Sequence of returns risk

▶ Jannie Leach, Head of Core Investments

15 February 2023

Unpacking sequence of return risk

WHO?

INVESTORS WITH FREQUENT WITHDRAWALS

WHAT?

NEGATIVE RETURNS AT START ARE MORE DETRIMENTAL THAN LATER

SO WHAT?

SO WHAT MITIGATING ACTIONS SHOULD BE TAKEN?

- Will reducing the proportion of risk assets (e.g. shares, property) help?
- Will the bucket system help?

The perfect storm example: poor returns start + high withdrawal + high equity fund

R1m in High equity portfolio from Jan 2008 – Jun 2022*

AIM

Withdraw **10%** in year 1 and increased withdrawal by inflation each year

1: Actual returns

2: Equal returns (average return)

3: Sort actual returns from worst to best

4: Sort actual returns from best to worst

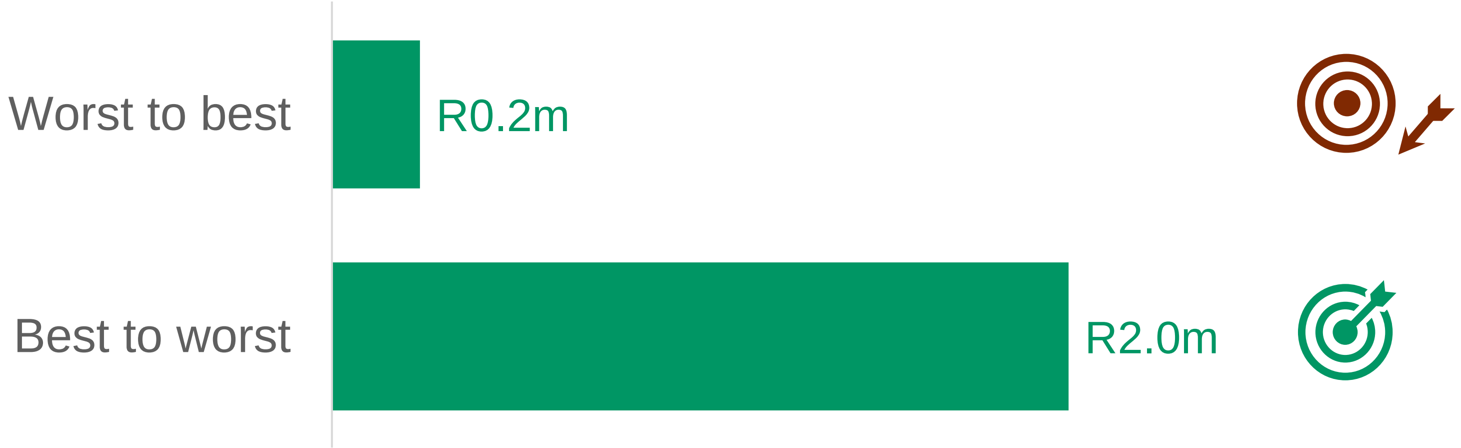
*Nedgroup Investments Core Diversified Fund Class C

The perfect storm example: poor returns start + high withdrawal + high equity fund

R1m in High equity portfolio from Jan 2008 – Jun 2022*

AIM

Withdraw **10%** in year 1 and increased withdrawal by inflation each year



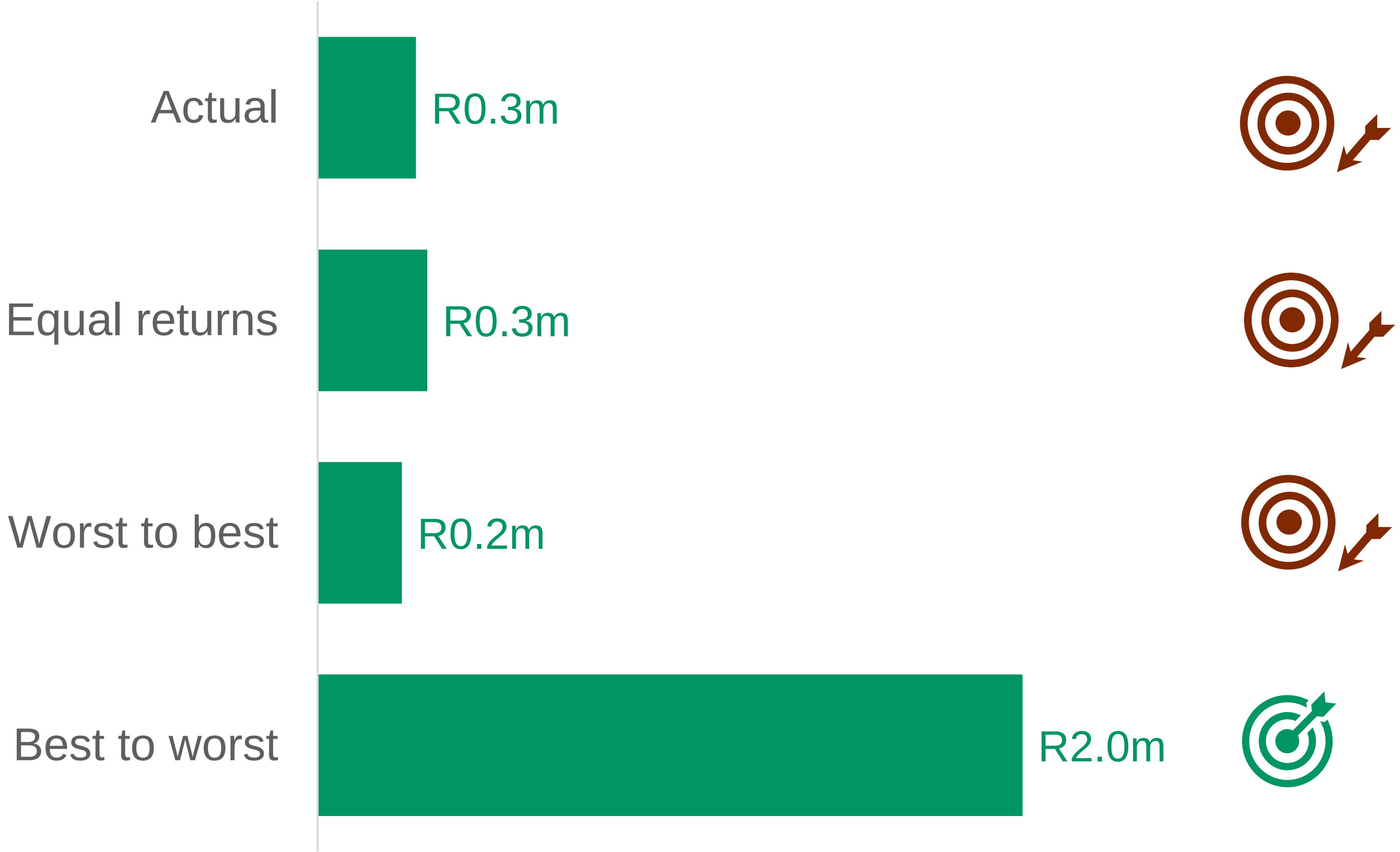
*Nedgroup Investments Core Diversified Fund Class C

The perfect storm example: poor returns start + high withdrawal + high equity fund

R1m in High equity portfolio from Jan 2008 – Jun 2022*

AIM

Withdraw **10%** in year 1
and increased withdrawal
by inflation each year



THE OUTCOME FOR ACTUAL RETURNS AND EQUAL RETURNS ARE VERY SIMILAR

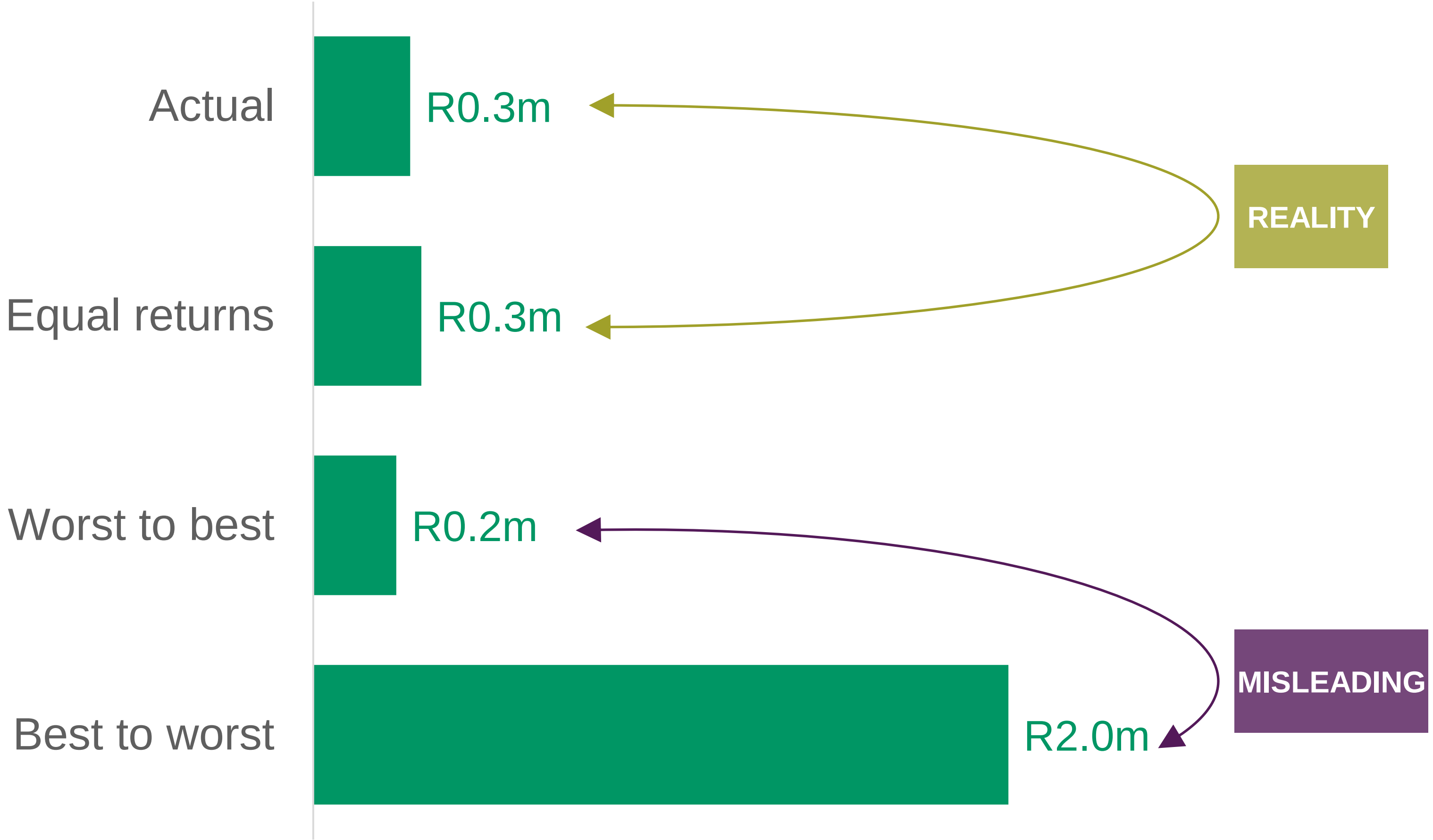
*Nedgroup Investments Core Diversified Fund Class C

The perfect storm example: poor returns start + high withdrawal + high equity fund

R1m in High equity portfolio from Jan 2008 – Jun 2022*

AIM

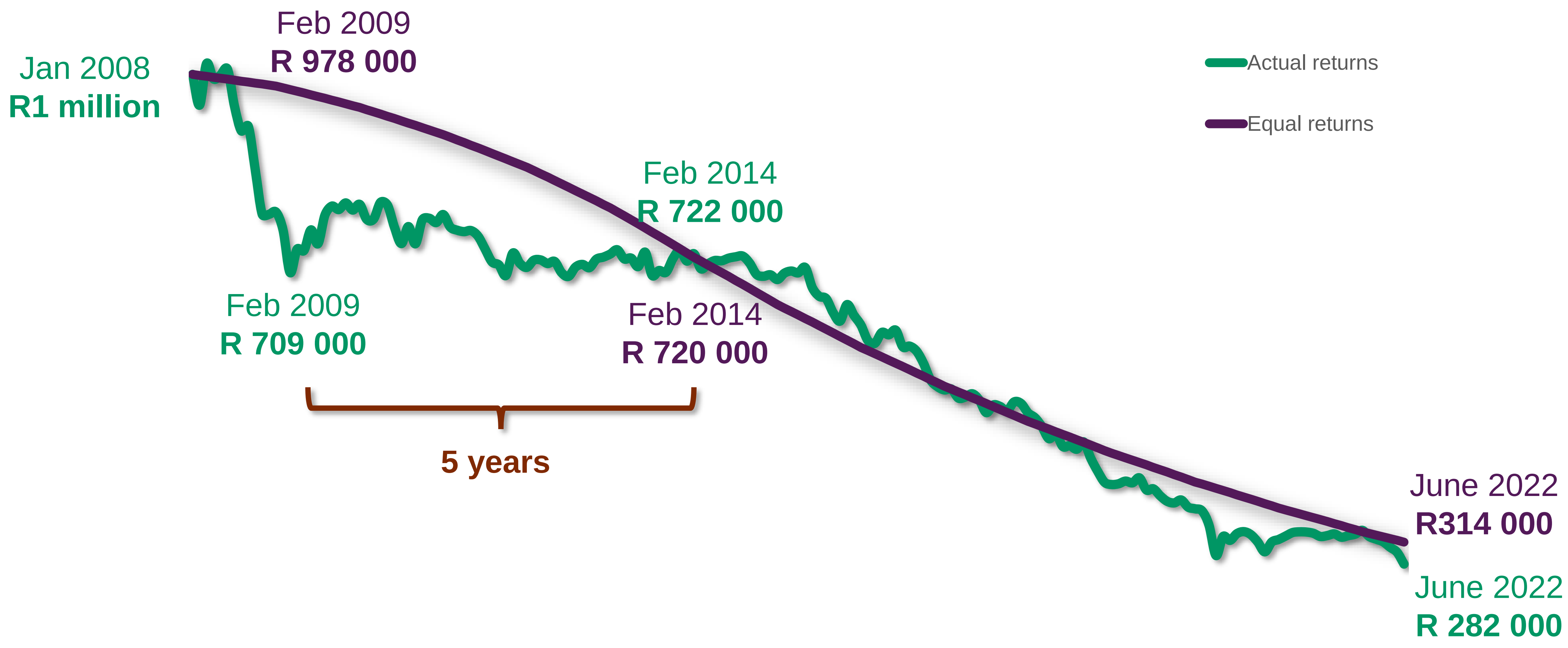
Withdraw **10%** in year 1 and increased withdrawal by inflation each year



*Nedgroup Investments Core Diversified Fund Class C

Very different client experiences on the different paths

Asset value of actual vs. equal returns



So…how much does sequence of returns matter?[1]

HOW MUCH?

10 YEAR RAND VALUE DIFFERENCE

- Not as much as studies often illustrate
- Difference between equal and actual return outcomes is not that large, except when returns were very high.

CRITICAL PERIOD?

FIRST 3 YEARS

- 98% chance that equal returns outcomes are better than actual outcomes if returns in first 3 years are less than drawdown rate[2]

SO WHAT?

SHOULD I STILL TAKE MITIGATING ACTIONS?

- Test reducing the proportion of risk assets (shares and property)
- Test the bucket system for 3 year's income

1 Conclusions predominantly based on this dataset

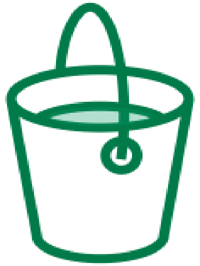
2 Based on 10% drawdown and 10 year asset value

Mitigating strategy 1 – Reducing the portion held in risk assets

	LOW RISK PORTFOLIO	MEDIUM RISK PORTFOLIO	HIGH RISK PORTFOLIO
Typical term:	Up to 3 years	3 to 5 years	5 years +
Risk assets:	< 40%	40% to 70%	> 70%

Mitigating strategy 2 – Testing different bucketing systems

The bucketing system that worked



“Safe” bucket

Fill with 3 years of income[1]

Draw income until depleted[1]

“Risky” bucket

Balance of savings

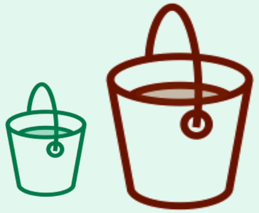
Draw income when “safe” bucket is depleted

1 This is just one example of a bucketing strategy. There are many different ways to illustrate this.

SUMMARY

Significance of sequencing of returns: low to medium

Bucketing method A: can be very valuable in practice



Reducing risk assets: very costly

CONCLUSIONS

Not that critical for a reasonable drawdown (<10%), well diversified portfolio and long enough horizon (10+ years).

However, can be **determinantal to investor behaviour**.

Slightly improves outcomes in poor markets.

Helpful in managing **investor behaviour**.

High cost in terms of reducing how long money lasts.

Not effective at mitigating sequence of return risk over longer periods.

Not an ideal mitigating strategy.

Thank you