The role of smoothing

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Using wave theory as an analogy, we see that higher amplitude waves have more energy and can travel further, but they may be more uncomfortable in the shorter term, due to loud noise. In the same way, volatility in an investment portfolio can be uncomfortable in the shorter term, but we need this volatility in the form of growth assets in order to protect the investor's purchasing power over the longer term. The challenge lies in de-risking the portfolio smartly, without putting the long-term sustainability at risk.

Volatility and investments

Volatility is important for a portfolio, but the sequence of volatility – or when it occurs – is far more important. We refer to the risk of negative returns early in retirement, or just before retirement, as sequence-of-returns risk. Sequence risk is particularly important when drawing an income.

When comparing investments with the same expected returns and the same level of volatility, but where drawdowns happen at different times – it can be seen that investments with an early drawdown (i.e. shortly after retirement) suffer more than the investments where the drawdown happens later. Suffering an early loss due to poor market returns has a detrimental impact on future capital values.

While volatility is merely uncomfortable for most investors, it manifests into a very real risk for clients drawing their income, either decreasing their available capital, or their income.

How does a smoothing mechanism reduce risk?

Excess returns are used to build a reserve which can then be used to supplement returns during the poorer performing months. This averages out the returns over time, with a "smoother" investment journey for the client.

By managing and reducing volatility, we're able to invest in more growth-orientated assets to ensure the long-term sustainability of the retirement income. This therefore enables us to address both the longevity and the sequence-of-return risks.

Multi-Managed Smooth Growth Fund

The Multi-Managed Smooth Growth Fund provides a high exposure to growth assets, but with reduced short-term volatility; a return objective of CPI + 4% over the longer term; and has less market volatility but bonusses can be zero or negative during periods of extreme market drawdowns. It has low to negative correlations with other funds used, and therefore provides excellent diversification benefits in a portfolio.

There will be times when this fund underperforms its peers, but over time, the average return of the fund is very similar to other balanced funds. On average, performance is in line with, or better than, its peers. So, while it may underperform in the short term, the longer the client remains invested in the fund, the more they'll get out of the averaged returns over time. The volatility is not removed, it is merely spread out over time.

In conclusion

We acknowledge that volatility is a real concern when it comes to drawing an income – but it needs to be managed rather than avoided. Key to this, is managing the sequence or the timing of the drawdowns. This is achieved through the use of a smoothing mechanism which addresses both volatility and sequence risk, but without reducing the overall exposure to growth assets in the portfolio. This therefore makes smoothing a beneficial addition to a Living Annuity portfolio.

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