

HOW SHOULD YOU REALLY THINK ABOUT INVESTMENT RETURNS?

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Except in very specific circumstances, investment returns usually do not come in a straight line. Despite this, for almost all my investment career, I have been taught that long-term averages are what matter (make sure you take enough market risk!), and don't worry too much about volatility around these data points.

In my personal life too, I'd be hard placed to recall specific details of where we camped ten years ago, how we celebrated my son's fifth birthday, or the first book my daughter read aloud, but (as I would try to convince my spouse) that doesn't mean I haven't felt the joys and challenges of bringing up a family.

It turns out details matter, and the sequence of investment returns are perhaps more important than we often give credit for. Instead of me worrying whether over my lifetime equities will deliver an average real return of 6,5% p.a. (its long-term average) perhaps I should have been much more preoccupied about when the above average equity returns in my lifetime took place.

This insight, while seemingly obvious, is crucial for those funding their retirements. And for parents deciding on the appropriate gift for their five-year-old.

I blame my class 4 maths teacher. We all learned in school that $A \times B$ equals $B \times A$. This commutative property suggests that the order of returns shouldn't matter. However, for those accumulating assets during their working lives and decumulating them in retirement, the sequence of returns is critical.

Consider two investors who start saving in their mid-twenties, contributing the same amounts monthly and experiencing the same set of returns over 40 years, just in a different order. If Investor A experiences the highest returns early on and Investor B experiences them later, their outcomes will differ significantly. Investor A's best returns are wasted on initial small contributions, while Investor B benefits from compounding the best returns on a larger accumulated capital.

If all returns were the same, the order wouldn't matter. But because almost all investment returns vary, there is sequence risk. Risk-averse investors try to smooth their returns to mitigate this risk, often reducing both the average expected return and the potential for outsized returns later in life.

In retirement, the order of returns also matters because withdrawals are being made. Investors planning to exhaust their assets in retirement are particularly vulnerable to early negative returns. Experiencing the best returns early on (or preventing significantly negative returns) can significantly improve on how long your retirement assets will last.

For those with substantial intergenerational wealth, the timing of returns however is often less critical. Their sizable legacy assets' compounding effect outweighs any additional contributions they make in their lifetimes, and their post-retirement withdrawals don't impact on the ability of the legacy capital to grow in real terms. These investors need not worry too much about sequence risk.

However, for most of us, the sequence of returns during both accumulation and decumulation phases is vital. The asset management industry in which I have worked for over twenty years has largely been set up as if investors need not concern themselves with sequence risk.

Fortunately, as more investors are now approaching retirement after having accumulated their assets in a defined contribution environment, and intend to decumulate their assets through retirement, the industry is increasingly looking to solve their sustainable post-retirement journey.

Crucially, most of us cannot afford to invest in solutions that eliminate sequence risk entirely. This is because these solutions give up too much in terms of average returns, and negate the benefit from experiencing outsized positive returns, especially around the retirement event.

The post-retirement solutions we have brought to market place a significant emphasis on our ability to find managers with skill to improve the chance of experiencing above average returns while limiting downside risk. One consequence is that these solutions tend have material allocation to alternative strategies like hedge funds where we can reduce downside volatility without giving too much up on the upside return potential.

The key objective for these solutions is mitigating large negative returns that cohorts of investors could experience early on in their retirement, while still taking on sufficient risk to meaningfully compound returns to last through the retirement journey.