speculate to decumulate?

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Asset allocation in retirement planning, as with all investment, requires a structured approach in line with client expectations. Graham Bentley explains.

I have heard it said that the decumulation phase of retirement planning (also known as the income phase) requires a very different investment process than the accumulation phase. In fact, the process is exactly the same. The portfolio needs to grow. The only difference is that the investments have to work harder to recover the shortfall caused by the withdrawals, such that they are sustainable for the life of the recipient.

The more salient issue is that of portfolio selection. It is now widely recognised (see Myners and Sandler reports, amongst others) that academic studies by Brinson, Singer and Beebower et al have found that asset allocation is responsible for over 90% of the variability in returns from a global, multi-asset portfolio. Despite this, many still adhere to the alchemist's route to investment success – avoid higher risk markets, have a 'home market bias' and generally spread the investment across a number of funds from star managers. This so-called 'cherry-picking funds' approach is risky; if they're lucky, and equity markets go their way, a number of fund managers will be out-performers. But remember, fund managers are human (mostly). It is all too easy to be self-congratulatory when funds do well, but blame the market when they don't. It could be argued that a fund manager's performance is down to luck as well as a result of their stock-picking skills.

I calculate that if you were to take 1,000 fund managers who were all slow losers, guaranteed underperformers over time, after four years, by chance alone 41 would have made money in spite of themselves. These 'lucky' managers would look like geniuses; we would then hang on their every word, eager to drink from their well of knowledge. New investors would be persuaded that these were the ideal managers with whom to invest. In year five, more than half of the 41 would bomb. Would we call them unlucky? Would we give them another 12 months to get back to winning ways – after all, they're skilled when markets rise, and unlucky when they don't?

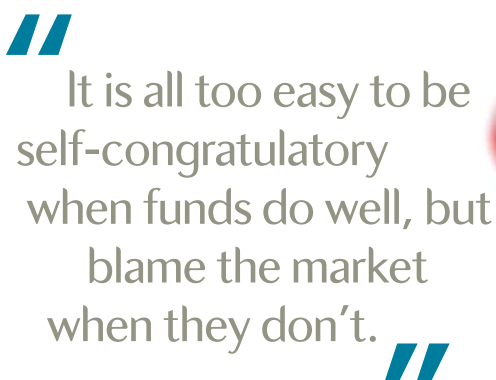
reducing risk

To significantly reduce the risk of being at the mercy of skill or luck, it makes sense to adopt a strategy that considers how the right spread of assets can help combat unwanted volatility. Risky assets can be combined in such a way as to 'cancel out' the respective peaks and troughs of the underlying funds.

Critics point out that this approach can result in a portfolio which appears to be uncomfortably high in a particular asset class. However, the maths tells you not to view funds in isolation; an asset allocated portfolio is less risky than the sum of its ingredients. A portfolio which is 87% exposed to overseas equity may have the same risk as UK equities, but with a higher expected return. Another charge is that investing in overseas funds adds currency risk. This is a myth; exchange rate risk does not add much to equity risk. In fact, if the exchange rate is less volatile than the fund, or their covariance is negative, overall risk is reduced.

goal-based planning

So what is an appropriate investment process? It's no good recommending an off-the-peg managed fund to a client, irrespective of their attitude to risk or aspirations. Firstly, principles are about aspirations, and hence asking the right



questions. If a client is investing for retirement, the next question should be 'what is it you intend to do in retirement that requires you to have money?'. If the client intends to watch Sky Sports all day, then all you need to fund for is a set-top box and a settee. If, on the other hand, they want a holiday home abroad for the winter months, golf at Wentworth three times a week and a cottage nearer their grandchildren, then that has a different requirement for money. But what if there isn't enough money at retirement to play golf at Wentworth three times a week? If his response is 'oh well not a big deal' then you shouldn't fund for it. Why take risks with a client's money when they're not that bothered about the result? This approach is known as goal-based planning, and it's worth bearing in mind that different goals over different time horizons may require different risk levels.

attitude to loss

The next stage involves identifying the client's attitude to loss, not risk. How much downside could be tolerated in the next 12 months of the investment? This is important because it sets the downside limits of the portfolio. At this point, stock selection and fund picking are irrelevant. If you are in the wrong asset class, it doesn't matter which fund you're in.

Asset allocation tools use this data to come up with a recipe for a portfolio which, with a relatively high degree of confidence, is least likely to breach this downside limit. Although different tools will produce a slightly different asset allocation the principles are the same. It is about combining all the attributes and behaviours of the various asset classes within a mathematical framework known as mean variance optimisation (MVO). The output from this is that for each level of risk/acceptable loss, there is a portfolio with the highest expected return, and vice versa.

Fund selection does matter, of course, but you can't expect to see major outperformance purely from fund selection. The chances of randomly selecting the best performing sector, let alone fund, three years in a row is almost 27,000 to 1. The odds on randomly selecting the best performing UK Equity Fund three years in a row is approximately 155 million to 1. The odds on choosing the best performing fund in each of the asset classes over three years isn't worth thinking about.

Whatever your clients' attitudes to loss and risk, there is a risk-matched allocation strategy that should meet their needs – don't speculate to decumulate!

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