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Improving retirement outcomes by not following the herd

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In a recent discussion with my eight-year-old daughter, my wife and I were attempting to instil some individualism by discussing the old adage "if everyone were to jump off a cliff, would you?"

This conversation, which I am not sure sunk in; given her response "it's much easier to do what the others do" provided a stark reminder of the state of investment management and portfolio construction today.

Superannuation and retail portfolio construction are dominated by a strategic asset allocation (SAA) framework that has resulted in most so-called balanced funds and model portfolios holding anywhere between 60 to 80 per cent in a diversified set of growth assets.

Arguably, as superannuation is an accumulation product with a long-term investment horizon of 20+ years; the amount of diversified growth exposures makes perfect sense regardless of the expected pockets of volatility that should be expected along that journey.

Unfortunately, for a growing subset of investors, the corresponding levels of volatility within many "balanced" portfolios can decimate plans for funding retirement.

Namely, those investors that are 10 years on either side of their retirement date, the sequencing risk zone; are at high risk.

The combination of an untimely market loss, less time to make up a loss and the decumulation to fund retirement conspire to destroy their funding plan.

For this growing set of investors, maintaining wealth and earning a stable "real" return are at odds with the conventional SAA accumulation model.

Popular superannuation “balanced” funds experiencing peak to valley drawdowns in the first quarter of 2020 of greater than 15 to 20 per cent, highlight the amount of risk being taken and should be a major warning for these sensitive investors that remain in these options.

For advisers and investment committees, banking on continued central bank interventions and expecting no poor investor behaviour given the expected levels of volatility of growth heavy portfolios, are wishful thinking and suboptimal if your goal is to minimise the probability of shortfall risk for a growing demographic.

Instead of “jumping off that cliff’ with everyone else, there are alternative paths that have provided attractive – if not best-in-class results. As investors age, their individual needs become more important than managing for an average outcome.

As an example, let’s look at a leading superfund’s portfolio construction.

QSuper – one the nation’s largest superannuation firms – has performed at the top of the table for many years and was recently named 2020 Best Pension and Balanced Fund of the Year from Super Ratings and *Money Magazine* respectively.

In the years following the global financial crisis, the QSuper investment team executed a dramatic shift in portfolio exposures, slashing equities while more than doubling fixed income and infrastructure. This was found to be controversial relative to most superannuation funds given the risk-parity type of approach especially given the point in the bond market cycle.

The subsequent results speak volumes. QSuper’s relative equity-light portfolio has not only outperformed “growth risk”-heavy peers through the extended bull market: it has done so with lower levels of volatility and drawdowns.

Yet, within the herd mentality of the superannuation industry few if any have materially sought to emulate such strong results.

Let’s analyse some explicit protection strategies.

As global nominal risk-free rates of return have been near zero for an extended period since the GFC, and fixed income forward expected rates of return remain negative; many asset consultants and investment teams have lowered allocation to bonds and duration. However, given the typical conventional fund’s exposure to growth assets; defensive characteristics need to be gained from other sources to keep portfolios “balanced”.

Over recent periods, we have seen increased allocation to infrastructure, credit, real estate and other illiquid investments to provide bond proxy positioning. However, as the COVID-19 pandemic has gone global impacting global GDP, investors were reminded of the exposure to growth many of these assets held as they were sold off with other risk assets.

Alternatively, some of the best performing managers during the first quarter of 2020 held allocations to explicit protection strategies; namely equity put option overlay strategies and/or other crisis alpha allocations – for example long volatility strategies that benefit in periods of stress.

The explicit protection strategy whether throughput spreads or tail risk options will typically incur an expected negative return or cost. However, given the negative expected rate of return from bond allocations the appetite within this space is finding more participants.

Perennial Solutions Group, an Australian institutional overlay manager highlighted that some superannuation fund clients had been able to gain substantial returns on their investment in options, providing some welcomed offset in recent equity market falls.

More importantly, derivative overlay and explicit protection enable portfolio managers to responsibly hold higher exposure of growth assets and remain more balanced with protection for events seen in February and March. Depending on the level of allocation to these more explicit strategies, funds were able to reduce the worst performance and provide liquidity when needed.

When managing for sequencing risk zone members, capital preservation and volatility reduction provide both financial and emotional wins for these investors.

There is a strong message here for SMSFs and the wealth management sector.

High-net-wealth and SMSF investors have historically tended to hold more absolute return approaches where capital preservation has tended to trump maximising returns. The “keep me rich” crowd which now includes large balanced superannuation members is no longer in the accumulation phase and should seek to sidestep its associated risk exposure.

An example is the “all-weather” approach utilised in the Cor Capital Fund, a Melbourne-based boutique manager; which has ranked #1 Multi-Asset-Balanced Fund category in performance over both one and five years (according to Morningstar data*).

Cor Capital’s defence-first mindset does not rely on a singular focus upon growth to provide stable “real” returns. Instead, the strategy builds a portfolio for all market environments with an ability to harness volatility for an added unique source of return. The fund holds an equal weighting to cash, bonds, equities and real assets (precious metals) in order to be fundamentally diversified and applies systematic rebalancing at various levels of this low-risk portfolio to provide peer leading results.

For the growing set of investors that is in or entering the sequencing risk zone, it is extremely important to first understand the unique risks you now face that are different from accumulation and secondly recognise there are philosophies outside of the “herd” that are more appropriate for your particular risks.

The above examples of QSuper, Perennial and Cor Capital illustrate it pays to be an individual.

*According to Morningstar’s Australian database as at 31 May 2020.

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