WHITEPAPER

Defying uncertainty in retirement

May 2019

For today's investor

AVIVA INVESTORS

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Defying uncertainty in retirement

The unknowns of the future, complexity of investment markets and unique needs of every individual make 'defying uncertainty' a complicated problem for those looking to retire.

One useful first step for those preparing for it is to frame the issue in terms of something immediate, like checking how much income is 'enough' to meet today's needs. Then look further out and ask, 'And what about tomorrow's goals?' Inevitably, this part is more challenging, as the future might span out five years or more than five decades. But from these markers, investors can start to plan and search for ways to achieve their goals.

For those saving toward retirement, and for those who might have already stepped out of paid employment, this paper introduces some of the obstacles that investors may face in achieving their objectives. It touches on why investment risks and returns are not always equal to investor risks and returns, how a focus on sustainable and growing income can enhance the probability of long-term success, and how constructing a portfolio from the bottom up can help optimise investor outcomes over time.

Risk: Beyond volatility

The most popular measure of investment risk is volatility – i.e. the degree of change in the price of an asset. The dispersion of returns – or how much investment returns vary around an average – is also a frequent measure. But, taken on their own, these metrics fail to capture the practical considerations investors must face; for example, the risk of not having enough income or capital in retirement.

In his book, Deep Risk: How History Informs Portfolio Design, neurologist turned investment adviser William Bernstein provides a useful perspective on the subject. He divides risk into two categories: 'shallow risk' and 'deep risk'. Shallow risk is inevitable. It leads to a loss of capital that an investor might recover quite quickly – as in recent 'flash crashes', for example. Deep risk is much more alarming, leading to a permanent loss of capital. Bernstein highlights devastation, confiscation, inflation and deflation in this category.

Devastation from war or natural disasters, or confiscation, where a government unexpectedly taxes or seizes assets, are fortunately quite rare, and the impact can be mitigated by investing in a diversified global portfolio. Outside of Japan, persistent deflation, where asset values decline, is also not common in modern times. In fact, by far the most likely deep risk an investor is likely to encounter is inflation. As an antidote to it, Bernstein advocates globally diversified equity portfolios.

The idea is that risk is spread, and if inflation takes hold, successful companies can pass the effect onto their customers, so revenue and profit grow, proving a useful and simple inflation hedge. Shares have the obvious advantage of ownership in perpetuity, so investors can reap benefits via dividends for years and years; it is a neat offset for longevity risk.

But a growth-oriented approach introduces complexities related to investor behaviour. Most investors just cannot stomach volatility. They become alarmed when the value of their assets fall and tend to sell at inopportune times. As a result, 'average' investors consistently earn below-average returns.

For example, during the twenty years to the end of 2014, the S&P 500 delivered 9.85 per cent a year, while the average equity fund investor managed just 5.19 per cent.[1] Over two decades, the implications of that are vast. When you consider what that means for individuals' overall retirement pots, this is damning evidence that suggests emotionally-charged investors can carry short-term price fluctuations to long-term ruin.

[1] Quantitative Analysis of Investor Behavior, DALBAR, Inc. 2016.
https://www.qidllc.com/wp-content/uploads/2016/02/2016-Dalbar-QAIB-Report.pdf

Staying alive to sequence-of-returns risk

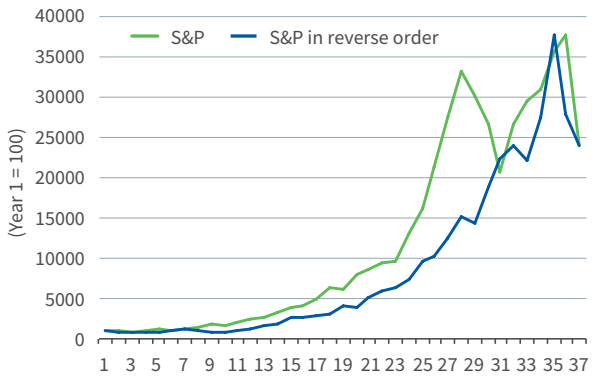
Investors who draw down predefined amounts from their portfolio in retirement could end up selling assets when values are depressed, even if the percentage is well below the average long-term return of the portfolio, which could cause permanent loss of capital. This is known as sequence-of-returns risk.

Debate about the best way to convert assets into income from long-term savings is very much alive, described as "the nastiest, hardest problem in finance" by Nobel prize winner Professor William Sharpe. The problem for investors is that future 'unknowns' – like the pattern of returns – can lead to radically different outcomes (shown below).

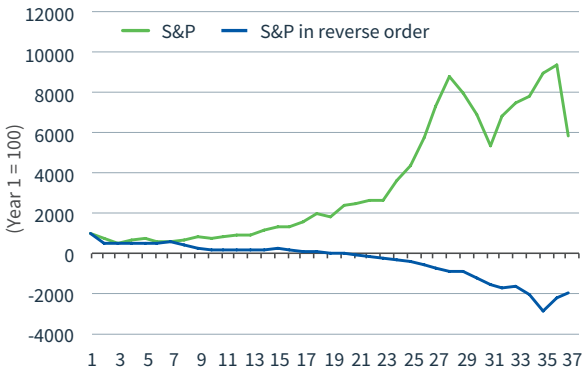
Figure 1. **Sequence-of-returns risk can lead to permanent loss of capital**

- Order of returns matter.
- Drawing down on an illustrative portfolio invested in the S&P500 (shown in green) or in a portfolio with returns stated in reverse order (in blue) can lead to materially different results.
- Note the uncertainty – the outcomes on the right-hand side are quite different.

S&P annual returns



Investor outcome at 6% drawdown rate



Past performance is not an indicator of future performance, the value of investments can fall as well as rise.

Source: Aviva Investors, Bloomberg, Returns from 1st January 1973 – 31st of December 2008.

One potential way of mitigating sequence-of-returns risk is to shift the focus long term; to the precise combinations of assets that will deliver the income investors will need, capable of sustained long-term growth over and above inflation. The income characteristics of each asset, on their own and in combination, are vital.

A carefully constructed multi-asset portfolio with a high allocation to growth assets, including shares in companies with sustainable revenue streams, as well as real assets and high yielding debt, can provide a solution. The idea is that the growth components (including the generous equity allocation) and income combine in a powerful growth engine. The investor can take advantage of the characteristics of different asset classes, while compounding returns grow the savings pot. Ultimately, the saver can draw 'natural' income (i.e. income including dividends and bond coupons, without drawing on the underlying capital) as their own income from employment dwindles.

When compounding compounds: The wonder of growing income

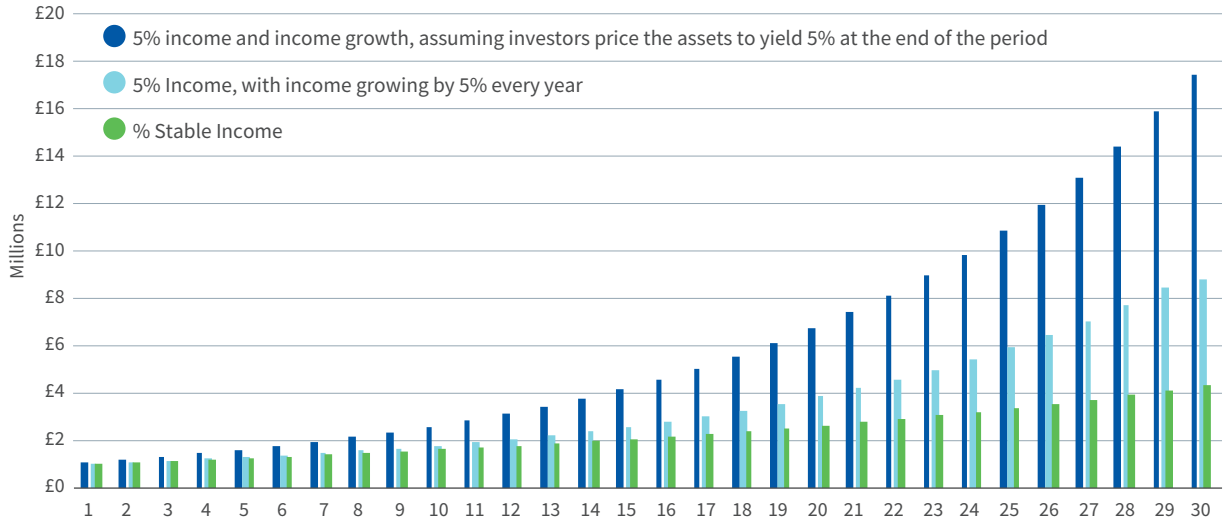
Albert Einstein famously proclaimed compounding interest is the eighth wonder of the world, and in this regard the numbers speak for themselves.

Consider a notional £1 million portfolio yielding a stable five per cent each year for 30 years.[2] It would be worth over £4 million alone when the thirty years was up, if we ignore fees and taxes. However, when introducing a growth assumption to the income stream, the numbers become staggering.

A £1 million portfolio yielding five per cent income, where the income stream grows by five per cent each year and is reinvested, would create a portfolio worth more than double the 'no-growth' portfolio (£8.8 million) over the same period. In practical terms, that would mean income of £420,000 in year 30.

Of course, it is reasonable to expect a portfolio that grows its effective yield over time will be worth more in the future.[3] If we assume the initial assets are still priced to deliver five per cent yield over the final twelve months, the total value of the investment will be worth almost £17.5 million and generate almost £800,000 of income in its final year alone.

Figure 2. **Income and income growth as drivers of total returns**



For illustrative purposes only. Source: Aviva Investors

[2] Key assumptions for illustrative purposes: £1 million portfolio fully invested, yielding five per cent each year for 30 years, all income re-invested, gross of fees and taxes.

[3] If income grows five per cent each year and is fully re-invested, after 30 years the portfolio's effective yield would be 20.58 per cent. The value of the whole would be expected to be significantly higher than in year one, because the investment would produce significantly more income than at inception. This illustration suggests a multiple of 4.1 times income.

Searching for sustainable income

The question is where to find the best assets with sustainable income potential, combined with the propensity for long-term income growth - particularly as income yields are low in absolute terms as well as by historic standards in most asset classes.

The key is to look across a wide variety of assets, working from the bottom up to find value and keeping income characteristics in mind. For instance:

- High yielding emerging market debt (EMD) might be attractive at the outset from an income perspective, but it would have no scope for income growth as the coupons on the debt are agreed in advance.
- An investment in a listed real estate investment trust (REIT) might generate moderate income and have some capacity for future income growth.
- Developed market equity might have a low starting yield, but better prospects for income to grow.

Significantly, blending these opportunities together might deliver an outcome where the sum of the parts is more desirable than the individual components.

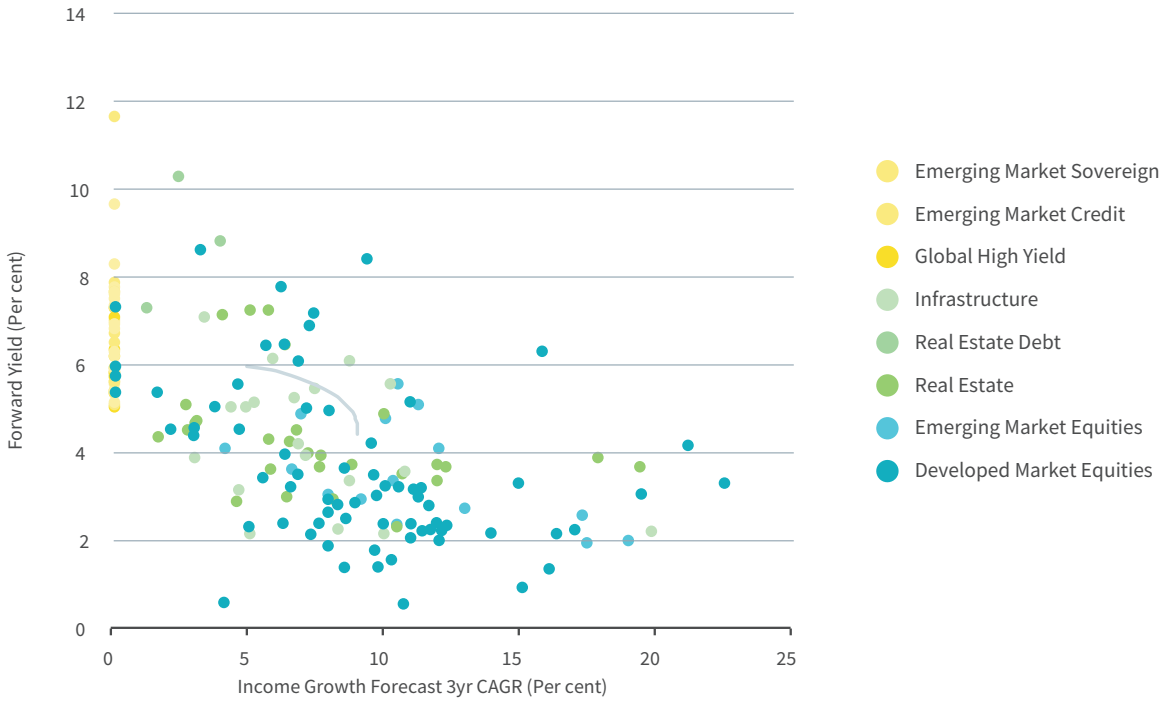
In this context, 'sustainable' might encompass long-term impact on the planet and the ability of each investment to maintain income distributions year-after-year. By addressing these challenges head on, the end investor might have more certainty about what level of investment income they can reasonably expect in the future (achieved from natural income, without asset sales).

In our view, sustainability means investments in organisations where business practices and prospects for long-term cash flow generation could be threatened should be filtered out. One practical way to do this is using the frameworks developed by global ratings agencies; they already take environmental, social and governance (ESG) risks into account, although it should be noted that coverage is not comprehensive in all markets.

The sustainable income approach should allow long-term investors to set 'shallow' worries about short-term price fluctuations aside. After all, they are likely to be short-lived. Instead, the focus is on sustainable income streams. And for those who know how to assess yield prospects across a range of asset classes, this approach might just offer a solution to "the nastiest, hardest problem in finance."

Figure 3. **Combining unique features to create optimal outcomes for income and income growth**

- More income opportunities in a broad investment universe.
- Understanding and combining unique characteristics can bring greater certainty over future outcomes.
- Scope to blend assets with high forward yields but no capacity for income growth (e.g. EMD, in yellow), low initial yields but better growth potential (e.g. developed market equity, dark blue), in range of income-driven combinations.



Source: Aviva Investors forecasts and calculations as at 06/02/2019.

Bottom up: Becoming more confident in an uncertain world

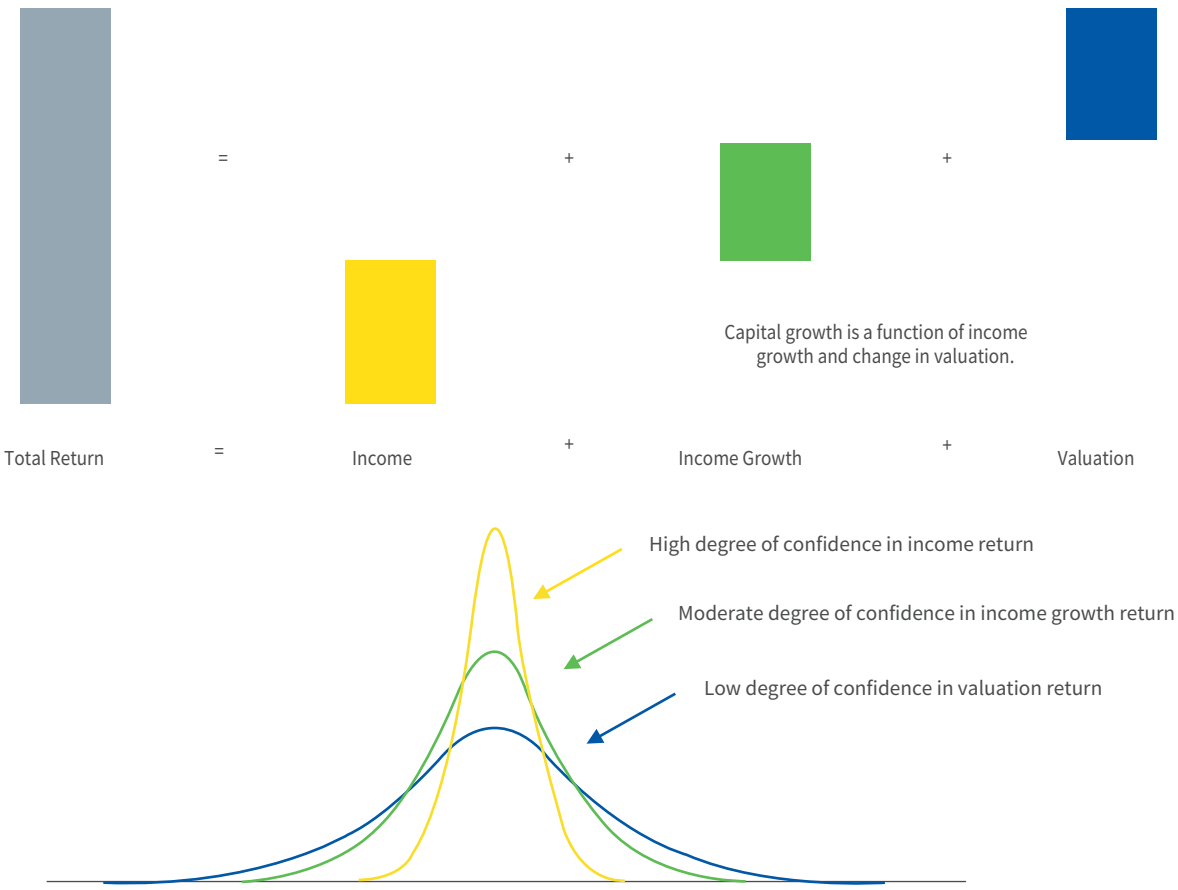
Outside the tidy world of mathematical models, unexpected developments have an unfortunate habit of de-railing life. So how can it be possible for tomorrow's retirees to feel more confident about what income they might expect in the future from their investments?

"There are unique features to each asset class," explains portfolio manager Francois de Bruin. "And it is only through understanding the specific drivers of return at individual asset level that it's possible to build better portfolios. The idea is to combine the best income and income growth attributes, to reduce uncertainty over long-term total return. With a large opportunity set and flexibility, you can exclude whole asset classes and sectors that fail to meet the appropriate sustainability characteristics. You can also step away from the herd and concentrate on building really robust portfolios – working solely through a sustainable income lens."

Reducing the uncertainty over long-term return might mean drawing on the small number of companies worldwide that have managed to grow dividends steadily for more than a decade, as well as younger companies that look set for earnings growth. Accessing property via REITs can generate inflation-linked income without high upfront costs and practical management issues. And some carefully chosen high yield debt might also be additive, where fundamentals look positive and spreads are comfortably above US Treasuries.

Figure 4. **Focus on income return**

- Capital growth is a function of income growth and change in valuation.
- Certainty over those components varies and differs from one asset class to the next.
- Concentrating on fundamental drivers of return at the individual asset level can increase confidence in income return.



For illustrative purposes only. Source: Aviva Investors

Conclusion

Grappling with deep risks like inflation, and uncertainties, like the number of years of life, introduce real complexity into retirement planning. One way to counter them is to consider the precise combinations of income-generating assets that could fund years out of paid work. Assets that can be owned in perpetuity and offer an inflation hedge, combined with higher yielding debt, can enhance and extend the income stream, deferring the point when a saver might need to draw on underlying capital. At the same time, keeping sustainability front of mind makes it possible to feel more confident about future income on the retirement pathway.

Key Risks

The value of an investment and any income from it can go down as well as up and can fluctuate in response to changes in currency and exchange rates. Investors may not get back the original amount invested.

Bond values are affected by changes in interest rates and the bond issuer's creditworthiness. Bonds that offer the potential for a higher income typically have a greater risk of default.

These strategies may invest in emerging markets; these markets may be volatile and carry higher risk than developed markets.

Certain assets held in these strategies could, by nature, be hard to value or to sell at a desired time or at a price considered to be fair (especially in large quantities), and as a result their prices could be very volatile.

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