PIAS

PROFESSIONAL INVESTMENT ADVISORY SERVICES

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Contributors

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Rethinking risk in retirement: Beyond Volatility

Author | Francois De Bruin, Aviva Investors

The outbreak of COVID-19 and the turmoil it has inflicted on financial markets has provided an unwelcome reminder of the risks facing those either approaching, or already in, retirement.

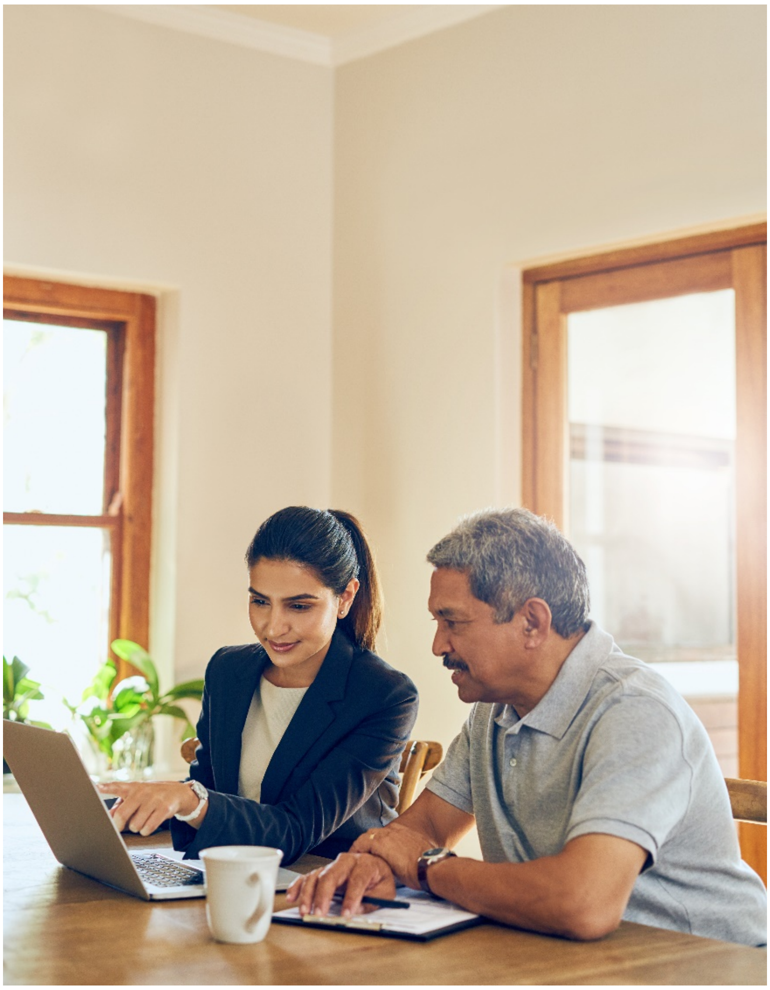
Volatility may not be best metric of investment risk taken on its own

Volatility – i.e. the degree of change in the price of an asset – tends to be the most popular measure of investment risk. The dispersion of returns – or how much investment returns vary around an average – is also a frequent measure. Conventional thinking dictates that an investor approaching or in retirement should reduce their risk, as they have a limited tolerance for volatility and the drawdowns that equity markets can deliver. 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.

Deep risk is more concerning, but shallow risk is inevitable

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 is the volatility, such as we have seen in the last few weeks, that inflicts "paper" or unrealised losses on portfolios – albeit these are losses from which portfolios can recover if they remain invested. By contrast, deep risk is much more alarming, leading to a permanent loss of capital. Bernstein highlights devastation, confiscation, inflation and deflation in this category.

Inflation is a deep risk in retirement planning



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.

Navigating deep risks in retirement

But how should an investor approaching or in retirement think about shallow and deep risks? In practice, the risk they face is that of being unable to pay their bills today, tomorrow or next month. But in an age of increasing life expectancy they also face this risk over a much longer period than many might have anticipated. This adds longevity risk into the mix – the possibility that their money runs out before they die. So we can now distil investors' requirements down to:

- Adequate cashflow to meet their immediate needs
- Long-term capital growth in the investment portfolio from which this income is generated.

This is a challenge to conventional thinking, because it questions whether an investor should really be de-risking in old age. Indeed, an investor looking for long-term growth will need to maintain an allocation to equities and riskier fixed income such as global high yield and emerging market debt. Equities, for example, 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.

Such an approach means that they will remain exposed to the shallow risk of market volatility. But investors can look through such effects provided the cash flow meets their near-term needs. And for their part, portfolio managers charged with looking after their clients' money can focus on navigating the deep risks related to permanent loss of capital and attempting to generate growth in this portfolio from which the income stream is generated.

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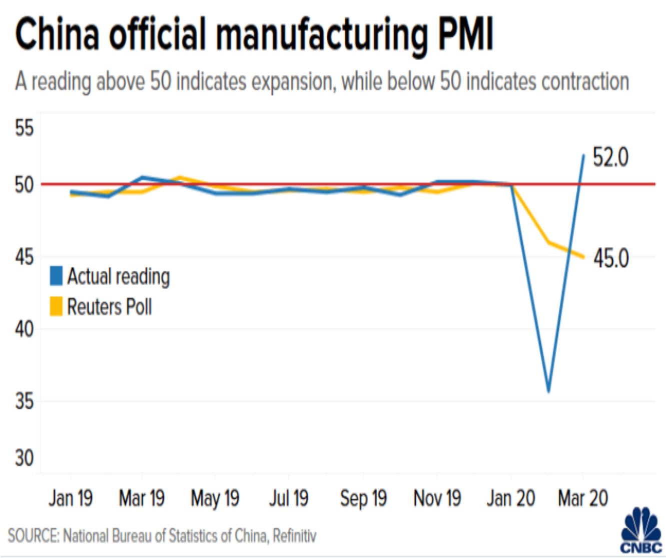
PIAS Investment Outlook (Q2 2020)

Author | Mavis Tan, Investment Strategy, Partnership Management, Professional Investment Advisory Services Pte Ltd.

We started the year with renewed optimisms spilled over from last year, but what followed was a cruel reversal. From trade deals to trade disruptions, earnings growth to work cessations and expansion to recession. Within weeks, we started to grapple with the new reality of closed borders, restrictions to movements and remote working, in the global fight against COVID-19. The migration of the virus from China to many other parts of the world sparked off an undiscerning sell-off in March. Equities, bonds and even gold positions had been wiped off to hold cash, as investors priced in the hefty economic costs of this black swan event. The oil price war between Saudi and Russia fuelled a perfect storm by pushing indices down into the bear territories.

Governments adopted a whatever-it-takes stance and announced a bazooka of stimulus packages, dwarfing those of the 2008 global financial crisis, in a bid to keep businesses afloat with heavy injections of liquidity into bond markets as well as financial assistance to households and individuals. Ben Bernanke, former Federal Reserve Chairman, had highlighted *the importance of getting the coronavirus itself under control so that the policy can do its work*. Despite businesses being halted and GDP contraction globally is expected, markets rallied in response to stimuluses, notably the $2.5 trillion package passed through by the U.S. government.

Caixin/ China Manufacturing PMI (Chart A)



Source: CNBC, National Bureau of Statistics of China, March 2020

MSCI World Index performance (Chart B)

Source: Thomson Reuters Datastream, April 2020

The world looked on as China gradually resumed work in late March for a hint of what to expect after the lockdown. Although March's latest China manufacturing data is better than expected (Chart A), exports to Europe and US had fallen more than 24% and 21% respectively in the same period a year before. This spells one of the drawbacks of globalization, **of how intertwined are the supply chains globally. Trade is expected to remain sluggish as trading partners are still in the midst of a lockdown, contemplating a gradual reopening.** As Italy, Spain, and France are starting to see virus cases and fatalities decelerating, European leaders are drawing up plans for resumption of normalcy, further pushing up the European equities market. Elsewhere, Trump is also pushing for a reopening in spite of cases crossing the 1million mark in the U.S. with weak signs of abating. However, the market seemed to defy this: the S&P 500 has surged 29% while the MSCI World (Chart B) was up 25% from the 23 March lows.

While analysts had unanimously agreed that economies are facing recession, they continued to debate the shape of recovery. Despite warnings of subsequent waves of the spread of the virus, world leaders aimed to gradually resume businesses as soon as possible. In April, markets shrugged off worries that the virus may take a prolonged period of time to be eradicated, arguing for a V-shape to U-shape recovery. Oil prices had also contributed to volatilities in the market in April with the WTI hitting negative levels for the first time in history as global demand coupled with a surge in supply continue to weigh in. The longer the lockdown, the deeper the impact on the energy market. Likewise, the slower the recovery of the global economy, as suggested by an L-shaped recovery, with more companies defaulting and unemployment becoming more rampant. Some analysts also suggested a W-shape, whereby the virus remains on the loose with a second spike in infections and fatalities, possibly due to the premature reopening of the economies.

Timing this market is therefore, extremely challenging. While we remain watchful of the virus situation, **one of the ways to navigate this volatile market could be via dollar cost averaging** as investors attempt to assess the true magnitude and depth of the economic impact of this global health crisis. Dollar-cost averaging (DCA) is an investment strategy whereby an investor make periodic purchases of an asset in an effort to reduce the impact of volatility on the overall purchase. The purchases occur regardless of the asset's price and at regular intervals, removing much of the attempt to time the market in order to make purchases of the asset at the best prices.

DCA is particularly beneficial for investors with a long-term horizon. With China leading the world in "flattening the curve" for containing the virus, we favour allocating into some Chinese equities in tranches to ride on its recovery, in view of the attractive valuations. However, we remained cautious and would also prefer to also allocate some Alternatives to hedge the potential volatilities ahead and also to consider some Healthcare positions as the global search for vaccinations and treatments for the coronavirus continues.

On top of this, we would also like to emphasize the diversification of your portfolio and to avoid over concentration in a particular region/country or sector. We hope that this publication assists you, our clients, in your investment process for the next half of 2020.

Source | Figures extracted from Thomson Reuters Datastream

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