.mca

The bucket approach

- *focusing on achieve the financial needs*

March 2020

When it comes to investing, the "bucket" approach is a good way to think about your investment strategy.

Rather than have a single portfolio, where all assets are invested together, and the focus is on the overall or average return, we believe it is better to think in terms of three buckets. Each bucket is for one of the three distinct needs an investor has (liquidity, income, inflation protection). This does not stop anyone investing the assets as one portfolio for efficiency reasons, but if they do, there are still advantages in thinking about the portfolio as being the sum of the three buckets. This lets the consequences of investment-market risk be managed better. This bucket approach is particularly beneficial in retirement.

Each investor has a combination of three needs: liquidity, income and inflation protection.

The bucket approach lets you target a specific need/goal and so choose the types of investments that are right for that need. This in turn increases the chance that your total needs/goals are met when markets go down or there is a financial crisis. Capital should be allocated to each bucket and the outcome of each bucket should be measured relative to its purpose.

Investor needs

The three buckets provide for the needs of:

Liquidity: You should have a bucket for the capital that provides for your immediate expenditure and your "rainy-day" fund. As immediate access, short-term certainty and safety are important, this bucket will normally be invested in cash assets.

Income: In your income bucket, should be your investments designed to balance the need for medium-term certainty with the need for a higher income return above that of cash. The focus will be on income generating assets, particularly bonds that are likely to have only moderate volatility in a 'bad' year.

Inflation protection: As part of your expenditure will occur well into the future, protection against inflation is important. This bucket should focus on long-term, real returns and be less concerned about the short-term temporary return. Shares and property may be the focus.

Each bucket will generate income (interest, coupons, rent, dividends etc) and it is normally a good idea to have this paid to the cash bucket. If too much capital ends up in the cash bucket, relative to your immediate expenditure needs, it can be invested back to the bond or share buckets.

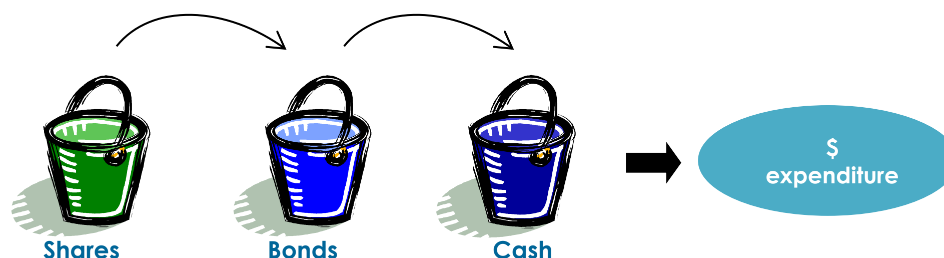
The focus is on expenditure patterns

One driver of the theoretical investment strategy is the period to go until you will spend the money. Under the bucket approach, as you get older your theoretical investment strategy should change. More is needed in cash and bonds, and less in shares and property. This is because the number of years of your remaining retirement that are more than 10 years away, become fewer. Shares are normally suitable only for expenditure that will occur well into the future, when inflation is the biggest risk, or where the assets available are significantly more than those that are required to be spent.

Note: *The analysis and comments in this article are of a general nature only and constitute "class advice". They do not take account of your specific circumstances.*

If you require personalised financial advice, you should seek advice from an appropriately experienced Authorised Financial Adviser.

It is also important not to automatically rebalance the overall portfolio to the theoretical strategy. Because money allocated to the property/share bucket is only for expenditure beyond 10 years, if the share market has gone down, rebalancing can be delayed until the share market recovers. As you have 10-years' expenditure in the cash and bond buckets, rebalancing from shares to bonds to cash should only be undertaken when the share markets have risen.



In all cases, before adopting a specific strategy, it is important to understand what the expected returns are in terms of income and capital movement. Also, what the range of the potential returns are, from one year to the next, around the expected. In many cases, investors may want to hold a little more cash in case their circumstances change, and their time horizon becomes shorter.

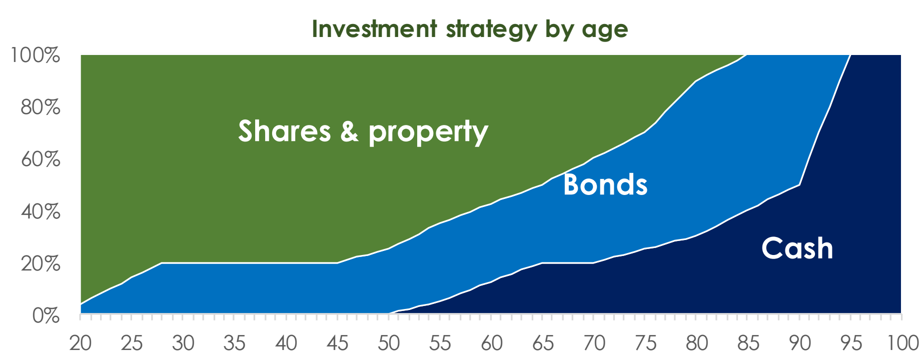
The investment strategy matters.

Suggested investment strategies

While there is no magical investment strategy that is right for all investors, it is possible to develop a series of sample strategies for generic circumstances that can form a basis for an investor determining their appropriate strategy. Assuming retirement occurs at age 65 and an investor saves sufficient to meet their expenditure over and above what NZ Superannuation provides, sample strategies are:

Age	20	30	40	50	60	65 retirement	70	75	80	85	90	95
Life expectancy[1]	83.0	83.5	83.9	84.5	85.5	86.3	87.3	88.6	90.2	92.4	95.1	98.6
Years to retirement	45	35	25	15	5	0						
Asset class 'bucket'												
Cash	0	0	0	0	12.5	20	20	25	33	40	50	100
Bonds	4	20	20	25	30.0	30	40	50	57	55	50	0
Property/shares	96	80	80	75	57.5	50	40	25	10	5	0	0

[1] *NZLT 2010-2012 less 3 years*



The above asset allocations reflect investment strategies for savings made for retirement. In many cases, particularly at the younger ages, savings will be for other goals (eg a deposit for a home) and less short-term volatility and therefore a lower exposure to property and shares will be appropriate. The principle is to align the returns and liquidity from the mix of cash, bonds, property and shares, with the expected expenditure and to invest based on the period until each item of expenditure, is what is important.