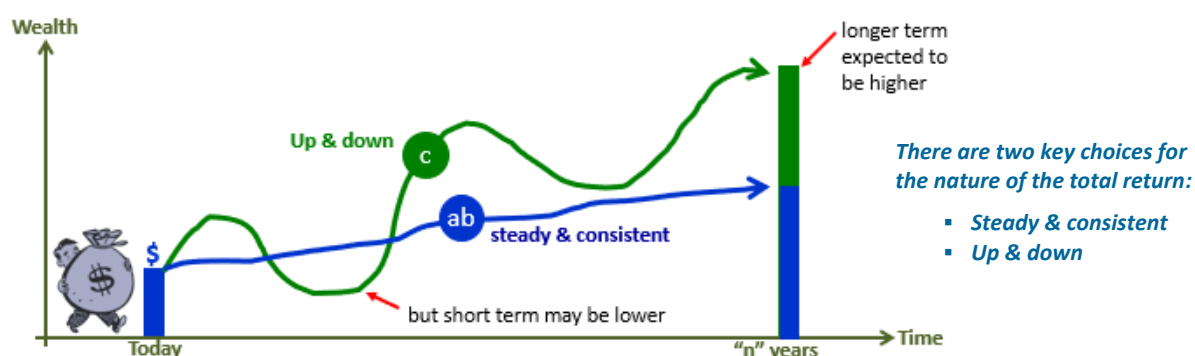


The fundamental investment return choice

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When investing, the pattern of the total returns of an investment portfolio received fall into one of two categories. Returns may be positive and steady, with no nasty surprises (ab), or returns may be up and down and unpredictable (c), with the expectation of ultimately receiving a higher average return.



There is no guarantee that the average return of portfolio 'c' will be higher, particularly over the short-term, but to get a higher average return, you have to be willing to see the value of your investments go up and down. Also, in the process of being in a position where you may get a higher return, there is likely to be a period where the returns actually received are less than those on 'money in the bank' (ie cash).

A portfolio that provides the positive and steady returns, is likely to be made up of cash and/or bond investments. Portfolios that provide the higher average expected returns, are likely to have greater exposure to property and share investments.

Between the two options (labelled 'ab' and 'c'), there are an infinite range of combinations. Each combination provides a different level of volatility in the year by year returns (ie the size and frequency of ups and downs) and therefore in the expected average return. In the market, these different portfolios are often referred to as defensive, conservative, moderate, balanced, growth and high growth (or aggressive) portfolios, or a variation of this terminology.

The question is, "do you choose 'ab' or 'c', or, where in the spectrum between 'ab' and 'c', do you pick?"

While the diagram shows the choice of returns as a choice or combination of two, in reality the choice might be better considered to be a choice of three (A, B and C):

- A. Portfolios that target a positive return over all periods, including the very short-term (eg over every month).
- B. Portfolios that target a positive return over all periods that are longer than 1 to 2 years, but might occasionally have a low or slightly negative return over periods shorter than this.
- C. Portfolios that target a higher average return over the long-term but likely to experience significant ups and downs, and therefore negative returns, over periods that are short to medium-term.

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.

The challenge

While the challenge is posed as an either/or question, it is better expressed as “what is the combination of ‘ab’ and ‘c’ (or more importantly A, B and C)?”

To solve the challenge, the market practice is to go through a risk profiling exercise, to determine whether the investor is conservative, balanced or growth and invest in a single fund made up of a combination A, B and C investments, to reflect that risk category.

For a range of reasons, that practice of a single investment fund made up of a combination of A, B and C (ie multi-sector fund), is flawed for many investors. A better practice is to have three portfolios; one for A investments, one for B investments and one for C investments (ie single sectors). The question then becomes “of your total capital, how much is allocated to A, how much to B and how much to C?” At MCA, we call this the “three-bucket” approach to investing. As part of the three-bucket approach, there is also a need to be put in place a decision framework for determining how you will rebalance and how you will change or review the allocation over time between the portfolios.

One advantage of managing your total investments as three portfolios, is that when the value of portfolio C goes down because, say, shares go down, as they will, you still see the positive returns in A and B, and are therefore less likely to panic. If you manage your investments as a single portfolio and shares go down, the value of the overall portfolio goes down. It might go down less, but still goes down and all you see is a negative return. The principles can also be illustrated by a simple example.

Assume that there are two investments A and C. Investment A provides a low but certain return that averages 4% but varies between 3% and 5%. In contrast, investment C provides a higher expected return (say 8%) but varies between -10% and +26%. Also assume that the investor can invest in two funds and allocate 30% to A and 70% to C, or in units in a multi-sector fund which in turn invests 30% in A and 70% in C. The expected average return of each is the same. The actual average return will however be different, particularly where there are negative cash flows such as in retirement when money is spent.

In the year where A returns as expected (say 4%) and C has a bad year (say -10%), the outcomes of each approach are:

Multi-sector fund

- If the investor invests in a multi-sector fund, \$1,000 at the start of the year ends up being \$942.00 at the end of the year (split \$282.60 in A and \$659.40 in C, ie 30%:70%). If the investor needs to spend \$50, they need to take it out of the \$942.00 leaving \$892.00 (split \$267.60 in A and \$624.40 in C, ie 30%:70%). This is because the investment is units in the single fund.

Single-sector funds

- If the investor invests in two single sector funds, the \$300 in investment A ends up at \$312.0 (ie \$300 plus 4% interest) and the \$700 in investment C ends up at \$630.00 (ie \$700 less the 10% loss) giving the same total of \$942.00.

In both cases, the total is the same before the payment of the \$50 (ie \$942.00), but with the single sector implementation option, the investor has the choice of taking the \$50 out of investment A and giving investment C time to recover, or taking part out of A and part out of C. The investor should take the \$50 out of the investment A. In the multi-sector implementation option, the investor has no choice and it is automatically taken out of each proportionately.

If the following year, the markets recover and so the returns are 4% for A and 26% for C, the multi-sector implementation option sees the \$892.00 increase to \$1,065.05, before the next \$50 is paid out. This compares to the single sector implementation option where the \$262.00 in A grows by 4% to \$272.48 and

the \$630.00 in C grows by 26% to \$793.80 (ie \$1,066.28 in total). At the end of year 2, the logical option is to take the \$50 out of C and possibly use the opportunity of the strong returns from investment C to rebalance the total investment balance back to the long-term target strategy of 30%:70%.

In the example the bad period was a -10% return and after 2 years the difference was small, but it illustrated the principles. In real life, shares often (about twice every generation) halve in value (ie -50% and \$1,000 becomes \$500 before going on to recover). When the volatile investment is shares and there are expenditure needs, the single-sector approach (ie bucket approach) to implementation can lead to a significant return and risk advantage.

Even though the single sector implementation option gives investors a clear advantage, particularly when there is negative cash flow (ie expenditure), not all investors will want to become involved in that level of detail and may be willing to give up the return and risk advantage, for the convenience of having a single conservative, balanced or growth fund, or a fund where the manager manages the rebalancing allowing for cash flows. Investor preferences to short-term volatility are also important.

Investment strategy

To allocate your capital between A, B and C, two of the possible methods are:

I. Based on where you, or your adviser/investment manager, think will give you the higher return, allowing for the minimum return and the frequency of the negative returns tolerable (ie consistent with the risk profile). This method leads the investor to the 'conservative', 'balanced' or 'growth' approach.

or

II. Based on when you are likely to spend your capital (ie money) allowing for your risk preferences and what is best for that pattern of expenditure.

Of the two approaches, the better approach is normally approach II. The main reasons for this include:

- No one knows what will happen in the markets and therefore what returns will be generated. Most, if they guess right for one period, are likely to guess wrong in other periods.
- The true risk is not whether the return is low or negative, but in not having the money available to be spent when it is needed. Minimising the chance of not meeting the future expenditure requirements should be the focus of risk management.
- The purpose of investing is to provide for future expenditure. The reason that people save (ie do not spend money today) is so they have money to spend in the future. The investment strategy (combination of cash, bonds, property and shares) and the investments within the strategy, should be targeted at maximising the probability that the money is available to be spent at the time that it is needed. Ideally, without being forced to sell an asset at a loss, to meet some of the expenditure.

The expenditure approach leads to thinking about the appropriate assets for each year's expenditure individually and as a whole, and whether it is essential or discretionary. This will probably see:

- Investments for expenditure in the next few years, say 0 to 3 years, are probably best to be in investments where there is minimal, or no chance of a negative return and the investments are readily realisable – **type A investments**.
- Investments for expenditure that will occur in the medium term, say between years 4 and 10/12, are probably best to be in bond investments where the yield (coupon) is above the cash interest rate and

the volatility (change in value) is low, and any negative return through interest rate rises, corrects before the bond has to be sold to meet expenditure – **type B investments**.

- Investments for expenditure in the long-term, say beyond 10/12 years, are probably best to be in property and shares that are also more likely to provide protection against the risks of inflation– **type C investments**. For most investors with long term expenditure needs, the main long-term risk is that their investments do not keep up with the impact of inflation.

For more information on the three-bucket approach see the MCA article ‘the three bucket-approach’.

The importance of income

While common practice is to focus on the total return and pattern of the returns (steady & consistent, or up & down), also relevant is the split of the total return between natural income (ie interest, coupons, rent and dividends) and growth (ie the change in the market value of the asset).

$$\text{Total return} = \text{income} + \text{growth}$$

The split of the total return of each sector is:

	Income	Market movement (growth)
Cash	Interest	Nil
Bonds	Coupons	Up and down, but sums to zero over life of bond
Property	Rent less expenses	Expected to be positive on average, but up and down short-term
Shares	Dividends	Expected to be positive on average, but up and down short-term

For investments like shares, that can experience significant ups and downs, in a year where there is a down, there is normally a positive income return that can be applied to meet short-term expenditure needs. For example, take a New Zealand share portfolio that produces a total return of -5% net-of-tax one year. It is probably made up of:

Dividends (net-of-tax):	4.0%
Market movement:	<u>-9.0%</u>
	-5.0%

Therefore, in the year where the share market returns minus 5.0%, it probably goes down by 9%, partially offset by a 4% dividend. The dividend is available to be spent, invested in ‘safer’ assets (ie lower volatile assets), or reinvested in shares. This is a choice that can be made at the time, but only if, when implementing the portfolio, the make-up of the total return is considered.

The fundamental investment return choice

The fundamental investment return choice is not a choice about return patterns of ‘ab’ or ‘c’, but a choice of what level of income return is required, when is the capital invested is required to be available and what protection against inflation is needed. By allocating capital between buckets, reflecting the nature of the return needs and not looking to second guess the market, a more certain outcome relative to the future cash flows required is achieved.

Choosing investments should not be about either/or, but about which are better aligned to the future cash flow liabilities and objectives.