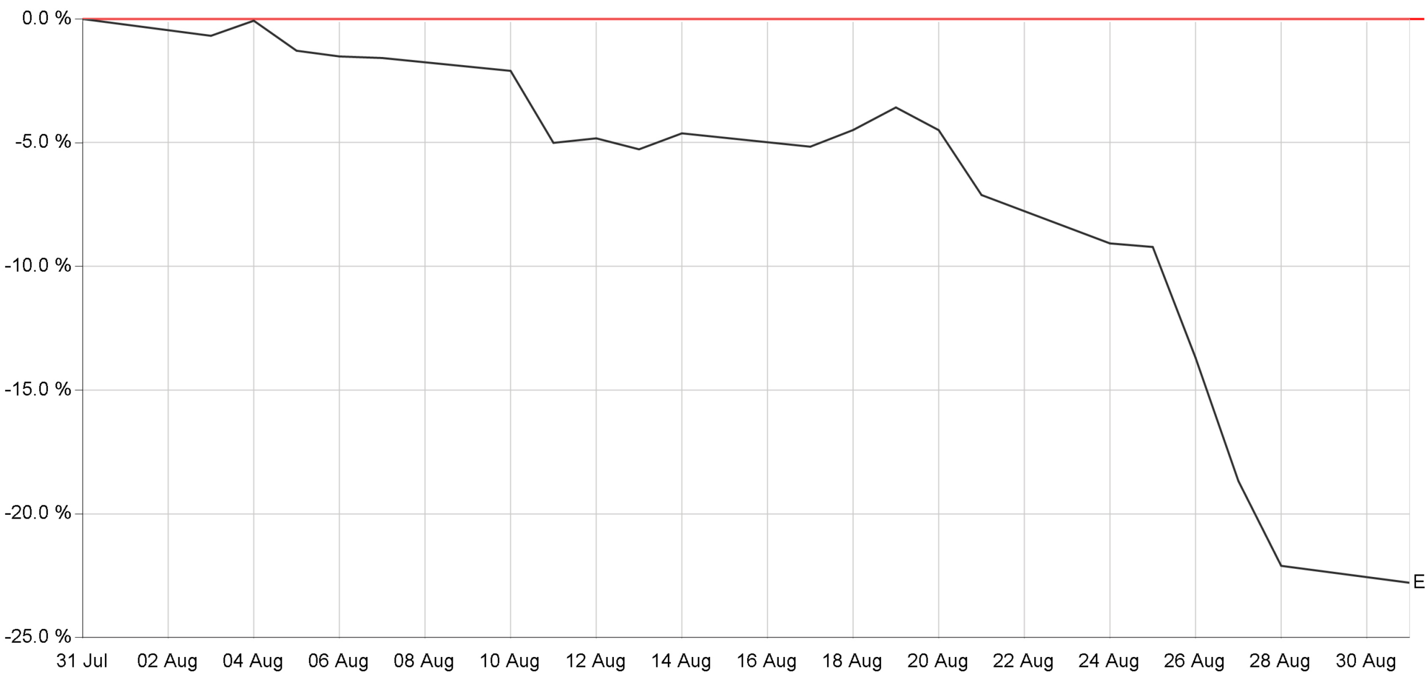
February 2018

Protect your capital through a phasing approach

Much of our time is spent understanding the intricacies of fund management, seeking out those managers worthy of managing investor savings. However, there is a crucial investment decision which is often overlooked, and which lies outside of the control of the fund manager. Cashflows into, and out of, investor portfolios can have material negative consequences if not managed with due care, and can far outweigh the gains expected of the fund manager.

Where an investor makes a new investment, or decides to withdraw a material part of an investment, this exposes the investor to the volatility inherent in the markets.

As an example of this cashflow risk, an investment made on 31 July 1998 of R1m, would have been worth just R770,000 a month later.



EM Crisis: Average of the ASISA Multi-Asset High Equity Sector: 31 July 1998 to 31 August 1998. Source Profile Data Analytics

This was of course the Emerging Market crisis of the time with Russia leading markets down while in financial distress. The average retirement fund was down by one third over this short horizon, causing widescale panic amongst investors and retirees. In some respects we have recently seen an event like this, albeit much subdued with just 5% capital loss at the bottom of the market in early February. The loss feels larger than it really is as markets have exhibited low levels of volatility for some time.

Roll forward from the EM crisis though, and this investor portfolio had recovered to around R1.03m after 1 year; R1.30m after 3 years and R1.5m after 5 years, having also weathered the Dot Com bubble of 1999/2000.

Recovery: Average of the ASISA Multi-Asset High Equity Sector: 31 July 1998 to 31 July 2003. Source Profile Data Analytics

Today that portfolio would be worth around R8.5m, having beaten inflation by over 5% per year for 20 years.

However, waiting it out does not make it easier or better for the investor, and the evidence tells us that the negative emotional response to this paper loss is the real cost. The instinct is to move to safer investments such as cash when events like this happen, thereby locking in lower returns and foregoing any form of recovery in the portfolio which has just fallen.

There is an alternative though, one which uses phasing to spread the timing risk of investment as illustrated above. For example, if the investment had been made in three equal tranches across three consecutive months (the Phase In investor), the value of the portfolio today would be greater, at R9.7m, with the lowest point being R929,000 after 1 month compared to the R772,000 experienced by the Lump Sum investor. This improved outcome is due to the investor having less exposure to the investments which fell during the EM crisis, and a higher proportion in cash which was protected:

	R1m lump sum		3 month phase in	
	Portfolio Value	% Change	Portfolio Value	% Change
Initial	1 000 000		1 000 000	
after 1 month	772 160	-23%	923 387	-7%
after 1 year	1 031 103	3%	1 175 654	18%
after 3 years	1 308 761	31%	1 492 236	49%
after 5 years	1 507 250	51%	1 718 552	72%
today	8 496 374	750%	9 687 481	869%

This example highlights a few important points:

1. If you invest your money and the market falls, it is not the end of the world. With enough time and the right strategy, staying the course will allow your portfolio to recover and deliver in future.
2. Phasing your money in protects you against these sudden events which can cause anxiety. Note however that this could also come with a cost or rather a 'missed opportunity' in the event that markets rise strongly after your investment is made.
3. Withdrawing after a negative event is a sure-fire way to lock in losses and create a permanent capital loss.

There are a few other considerations when making the choice to phase or not. Firstly, the sensitivity of the investor to near term losses is heightened when moving into retirement due to the need to withdraw capital as income. Phasing should be a more important consideration at this stage.

Secondly, it also depends on what form the source of funds for the investment takes. If the investment is coming out of cash holdings, this is a much higher risk timing event than if the investment was already exposed to the equity market and phasing should be strongly considered.

Thirdly, phasing is not only limited to portfolios and shares specifically, but also to currency or any other volatile asset for that matter. The Rand is one of the most volatile assets in which to deal, and local investors are most often on the receiving end of a sharp correction in the Rand's value relative to hard currencies such as dollars and sterling. When making the decision to take money offshore, or to repatriate, phasing can spread the risk of our volatile currency by averaging in the price you get.

Phasing applies to both new investments and withdrawals. For withdrawals, the risk is that capital is required by the investor when the market is weak (a large disinvestment in August 1998, for example).

The nature of phasing is one of caution: mitigating against unforeseen events. Investors need to be prepared to give up potential opportunity from being underinvested in the early days, with the payoff being a more graceful entrance into riskier assets.

Lastly, there is also an element of trust required in that when markets fall, our assumption is that they will recover and therefore investors are best served staying put. This assumption holds in all but the most extreme cases meaning common sense does still need to be applied. For example, there is a difference between investing in a good fund and the market falls, where your expectation for recovery should be high. Investing in a poor fund, or a poorly suited fund, does not necessarily mean the prospects for recovery are as good. This is where the role of the financial adviser ensures that the investment destination is well suited to the individual's needs.

REDFIN WEALTH

INVESTMENT AND FINANCIAL CLARITY

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data provided by Profile Data Analytics, Reuters and Datastream

MARKET REPORT

28-Feb-18

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.2%	-1.9%	17.4%	6.1%	11.2%	9.8%	10.9%	14.5%
FTSE/JSE SA Listed Property	ZAR	-15.4%	-18.8%	-6.1%	0.7%	8.0%	13.4%	14.7%	15.2%
SA All Bond Index (ALBI)	ZAR	11.9%	5.9%	14.3%	7.7%	7.3%	9.3%	8.2%	7.7%
SA Cash Index (SteFI)	ZAR	1.8%	1.2%	7.5%	7.2%	6.6%	7.1%	0.3%	0.5%
Balanced Benchmark	ZAR	-2.6%	-1.8%	12.2%	6.6%	10.9%	10.1%	7.0%	8.8%
SA Inflation (1 month lag)	ZAR	0.9%	0.8%	4.4%	5.7%	5.5%	5.7%	1.4%	1.4%
GLOBAL MARKET INDICES									
Global Equity (MSCI World)	USD	2.4%	1.0%	18.0%	8.8%	11.3%	6.6%	10.1%	16.3%
Emerging Markets Equity (MSCI EM)	USD	7.1%	3.4%	31.0%	9.4%	5.4%	3.0%	15.0%	22.5%
Global Bonds (Barclays Global Bond Index)	USD	1.1%	0.9%	7.0%	2.5%	0.8%	2.1%	5.4%	6.6%
Global Cash	USD	0.4%	0.3%	1.4%	0.9%	0.6%	0.7%	0.1%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-2.2%	-1.9%	17.4%	6.1%	11.2%	9.8%	10.9%	14.5%
Global Equity (MSCI World)	ZAR	-11.4%	-3.7%	6.5%	9.3%	17.6%	11.2%	13.9%	14.4%
Emerging Markets Equity (MSCI EM)	ZAR	-7.3%	-1.4%	18.2%	9.8%	11.3%	7.4%	13.1%	15.6%
SA All Bond Index (ALBI)	ZAR	11.9%	5.9%	14.3%	7.7%	7.3%	9.3%	8.2%	7.7%
Global Bonds (Citigroup)	ZAR	-12.5%	-3.8%	-3.4%	3.0%	6.5%	6.5%	12.4%	15.0%
COMMODITIES									
Gold (US Dollars)	USD	3.1%	1.2%	5.0%	2.7%	-3.6%	3.1%	15.8%	18.2%
Gold (Rands)	ZAR	-10.8%	-3.5%	-5.3%	3.2%	1.9%	7.5%		
CURRENCIES									
Rand / Dollar	ZAR	-13.5%	-4.7%	-9.8%	0.4%	5.6%	4.3%	14.2%	16.6%
Rand / GBP Pound	ZAR	-11.9%	-2.9%	-0.1%	-3.3%	3.6%	0.5%	15.4%	15.7%
Rand / Euro	ZAR	-11.5%	-3.2%	3.6%	3.3%	4.2%	2.0%	12.9%	13.7%

Spot Rates		1-Mar-18	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	11.93	12.38	13.68	8.48	6.83	4.87
Rand/GBP	Rand	16.36	16.61	16.88	13.72	13.60	8.01
Rand/EUR	Rand	14.53	14.87	14.42	11.19	9.99	NA
RATES							
Libor 6m $	US$	2.22	1.84	1.32	0.51	4.60	5.84
Repo Rate	Rand	6.75	6.75	7.00	5.00	11.00	NA
Prime	Rand	10.25	10.25	10.50	8.50	14.00	19.25
All Bond Index Yield	Rand	8.82	9.35	9.39	7.05	NA	NA
COMMODITIES							
Gold ($/oz)	US$	1,305.33	1,303.46	1,157.49	1,662.41	836.15	289.15
Platinum	US$	969.00	927.00	898.00	1,527.00	1,529.00	362.00
Oil (Brent Crude) $	US$	63.77	66.61	56.71	110.36	93.82	16.41
INFLATION							
SA Inflation	%	NA	4.7	6.7	5.7	NA	NA

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