September 2020

Failing to Succeed

For many investors keeping track of their portfolios is an anxious pursuit. Markets seem to behave in a non-sensical way at times, with any manner of factors causing anguish. Inflation expectations, GDP growth, sentiment, the oil price, central bank policy, debt levels, company mergers and acquisitions, cases of fraud and market disruption. These are all examples of news items which can materially impact the value of your retirement savings, amongst thousands of others. Moreover, as soon as you think you have a handle on things today, they change tomorrow. This is a tough position to be in when your retirement savings are at stake. How can we ever gain confidence that the investment strategy we follow will deliver the goods when it is needed?

Chart 1 below shows the rollercoaster ride which an average South African retirement investor would have typically experienced since 1926.[1]

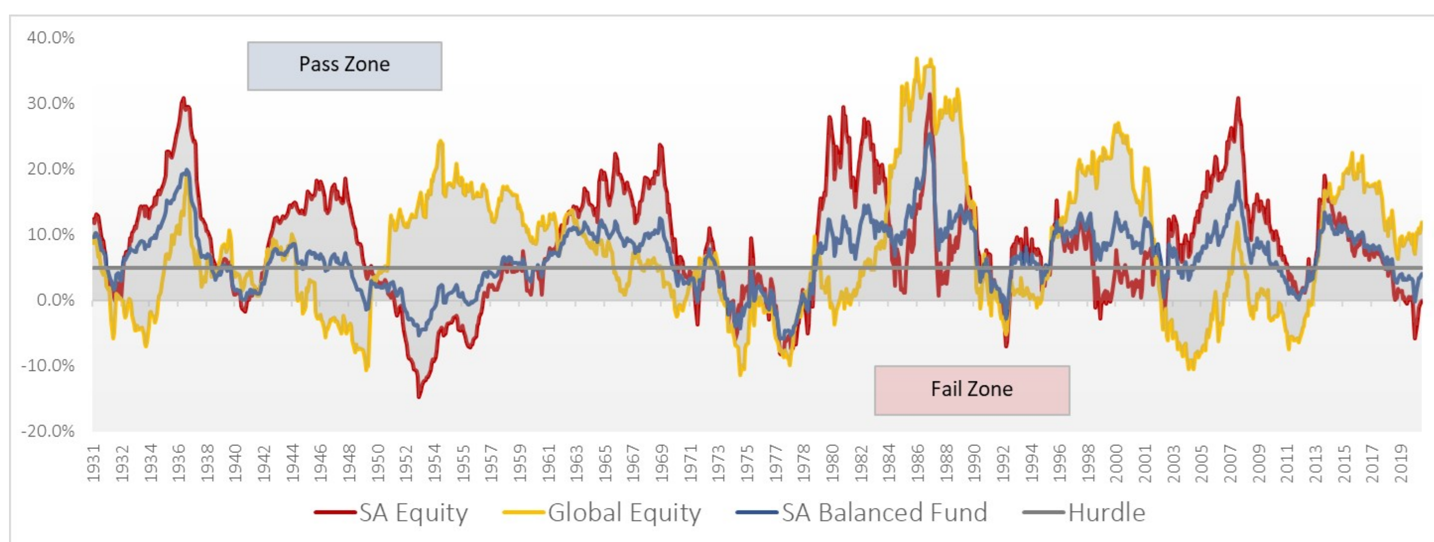

Chart 1: Long term five year returns after inflation. Hurdle rate is 5%, meaning a return of 5% greater than the prevailing inflation rate. The SA Balanced fund is an example of the average pre-retirement investor portfolio. Fundhouse, FE Analytics, Refinitiv

The chart shows four items:

- Local SA Equities, which since 1950 have delivered an average return of 7.2% above inflation per year.
- Global Equities, in Rands. These have delivered 8.3% above inflation per year.
- The average retirement investor's 'SA Balanced Fund' which has delivered 6.5% per year above inflation.
- The hurdle, which we have set as 5% above inflation, which is the typical target for a local retirement investor and given the retirement restrictions which apply to retirement savings.

The investment industry has latched on to various defaults when it comes to reporting investment returns. In this case, a five-year rolling horizon is seen as a suitable period over which to assess an investment portfolio, as we have shown above. It is quite noticeable when doing this, that it really is a bumpy ride. Significant peaks and troughs, and periods where returns are behind inflation for a decade or more. The "Success" rate when evaluating this portfolio is that you will have succeeded in beating the hurdle only 66% of the time. In other words, your retirement portfolio fails to deliver over a third of the time! The 'Balanced' fund by design is supposed to be a more stable investment vehicle, so surely this success rate should be higher?

Equities typically get the blame. Often referred to as "volatile" or "high risk", we are told they are the necessary part of our portfolio and we need to take on this asset class so that we have a chance of beating inflation.

Bonds and cash are then seen as the "risk reducers" given their defensive nature and less volatile returns. When investors are more

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anxious, they tend to seek out bonds and cash in place of equities.

However, as the two charts demonstrate below, this is the wrong way around. Equities are the stable asset class, and bonds are high risk, in terms of how we rely on them for returns:

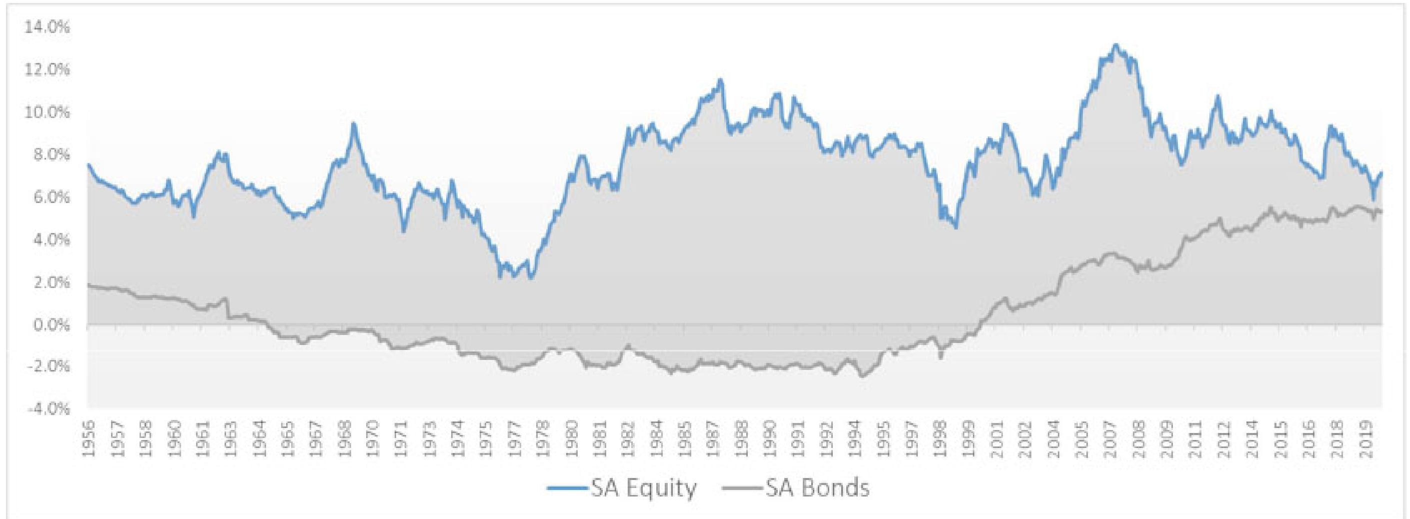

Chart 2: Rolling thirty year returns relative to inflation for SA Equities and Bonds. Source: Fundhouse, FE Analytics, Refinitiv

In South Africa, over almost 100 years, equities have been remarkably stable in delivering returns in excess of inflation, when measured over a suitable time frame. In this case we have used thirty years, which averages out a lot of the 'noise' in markets and demonstrates the fundamental growth which investors earn from this asset class through dividends and capital appreciation. There is no period where they failed to beat inflation, with the lowest result being a return of 2% above inflation.[2] This also tends to be a more relevant time horizon, given the term over which investors save for retirement, and then draw down from this investment as they retire.

If you consider the bond return profile, you will see that for significant periods, bonds have not beaten inflation. For 35 years from 1964, bonds delivered returns lower than inflation. Only more recently, since the early 2000s, have bonds in our local market recovered relative to inflation.

The global experience is very similar:

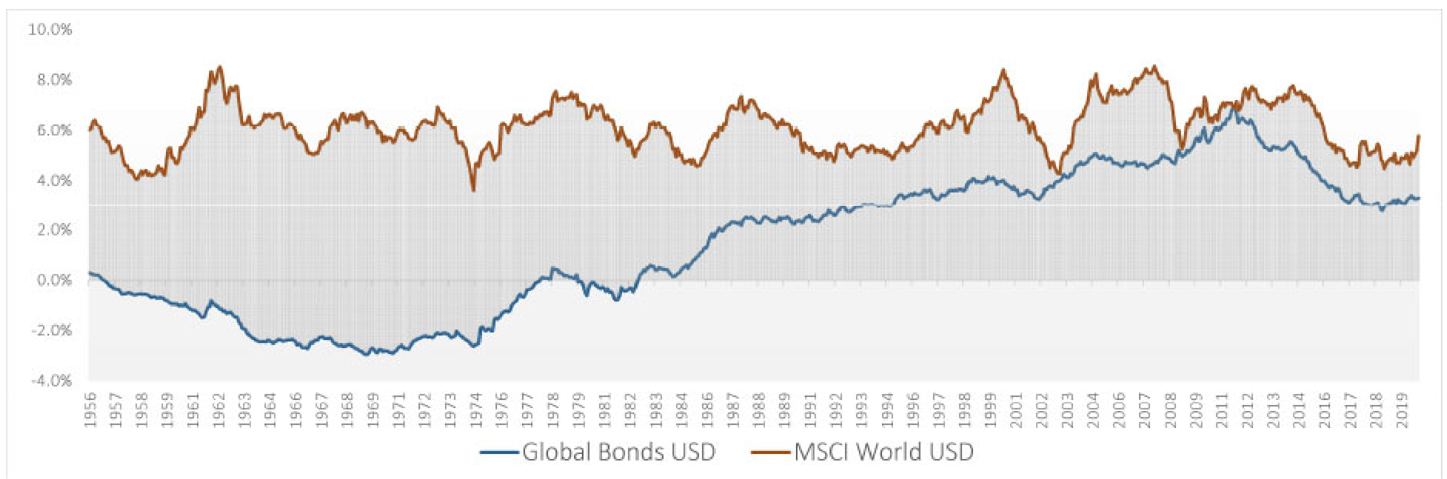

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Chart 3: Rolling thirty year returns relative to US inflation for Global Equities and Bonds. Source: Fundhouse, FE Analytics, Refinitiv

The poorest outcome for global equity investors (in US$, relative to US Inflation) was 4% above inflation.[3] For bond investors however, they lost ground relative to inflation for over twenty years, from 1956 to 1982.

This is a key point: over the short-term equities create much of the noise and with it raise investor anxiety levels, causing our portfolios to miss their performance objectives. However, over the long term it is bond investments which do the damage. By their very nature, equities are more resilient, adaptable and importantly, more diversified than bonds. Hundreds or thousands of individual, idiosyncratic investment opportunities mean that on average, investors are protected against problems with individual companies and can benefit from the group as a whole. Equities are also better able to adapt to the prevailing economic climate than bonds. For instance, companies can pass on much of their inflationary pressures to consumers, whereas bonds cannot.

Bonds on the other hand are less flexible: their prospects often determined by governments and policymakers, not CEOs and open capital markets.

Chart 4 below shows how damaging bonds can be:

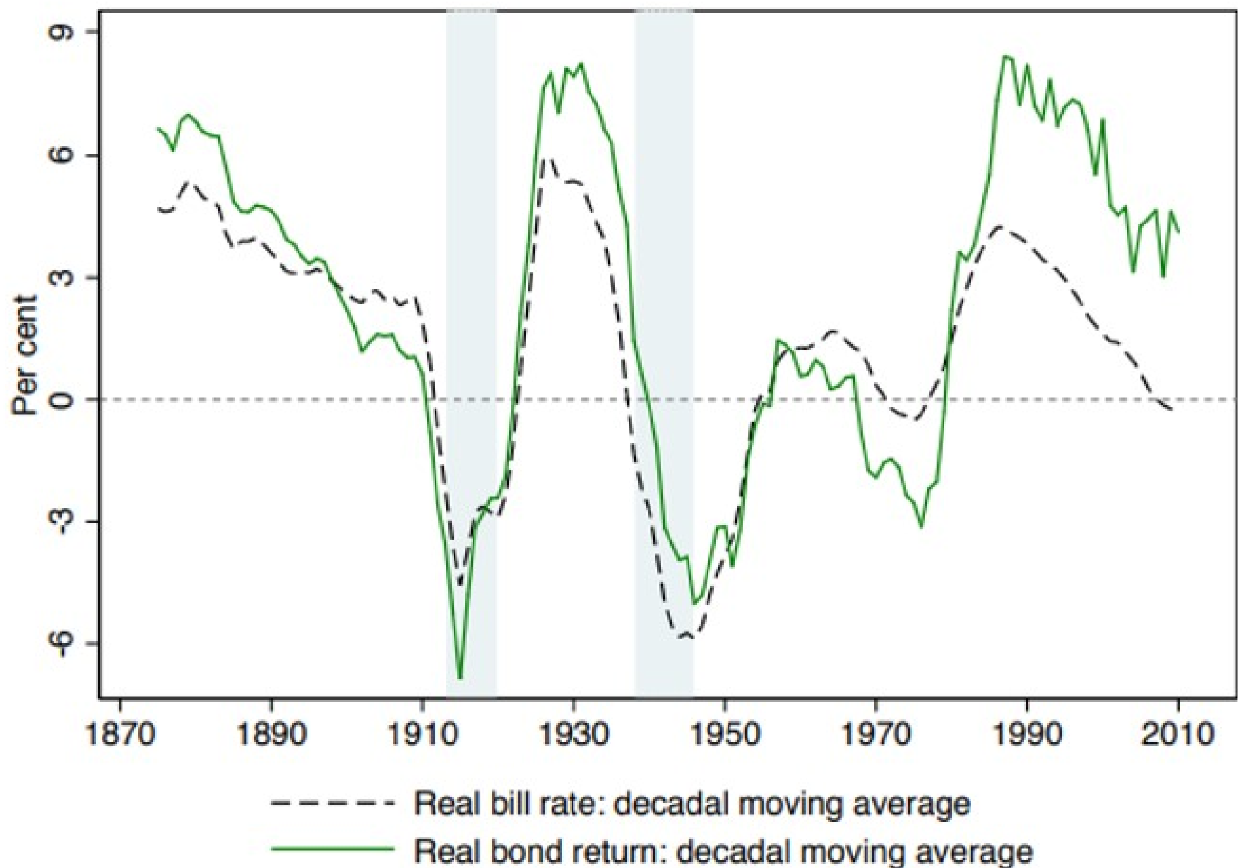

Chart 4: Rolling ten year returns for Global Developed Market bonds and cash net of inflation. Source: The Rate of Return on Everything, 1870 – 2015. Jorda, Knoll, Kuvshinov, Schularick and Taylor.

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This shows how the inability for bonds and cash to adapt to prevailing economic and monetary policy environments. Investors are then exposed to long, multi-decade periods of negative returns relative to inflation. Bonds have been in a significant bull market for almost forty years.[4] Clearly a dangerous asset class to anchor on.

What this all means for our retirement savers is that context matters. Equities have demonstrated the characteristics and ability to deliver substantial, consistent returns over time, and when observed over a sufficiently meaningful horizon to tune out the market 'noise', should help us gain comfort and worry less around the shorter term volatility in this asset class. Conversely, the 'safe and stable' return profile for bonds should also be questioned from an investor return perspective. They may be safe and stable, and act as a safe haven at times of crisis, but they are also able to detract significantly from portfolios over time if not managed proactively.

Back to our willingness to fail. When we measure a retirement portfolio over five years, we fail one third of the time. However, if we don't take on that sort of failure rate (by allocating a larger amount to equities), we don't give ourselves a chance of reaching our goals to begin with. Extending this measurement period to more meaningful horizons is a useful way to relieve some of this investment anxiety:

Measurement Horizon	Success Rate of achieving objectives
1 Year	57%
3 Years	62%
5 Years	66%
10 Years	79%
20 Years	88%
30 Years	95%

In the near term then, we need to be comfortable failing on our investment strategies, to give ourselves the chance to succeed over time. If we err on the side of caution too often, this will create a substantial long-term headwind to a successful retirement plan.

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[1] We make some assumptions here around what a portfolio historically would look like, in line with current norms.

[2] This was in part due to the early 1970s energy crisis with high inflation levels, which materially eroded investment returns across all asset classes. An OPEC led oil embargo in retaliation to the Yom Kippur War lead to oil tripling in price over a period of 6 months from 1973-1974.

[3] Again, due to the oil and inflation shock in 1973.

[4] Note that the chart above is only up until 2010; bonds and bills have subsequently dropped below the rate of inflation for the first time since 1983.

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September 2020

data provided by Reuters and Datastream

30 Sep 2020

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	-2.5%	2.0%	2.4%	4.8%	9.6%	14.7%	12.9%
FTSE/JSE SA Listed Property	ZAR	-14.1%	-46.4%	-46.1%	-23.8%	-12.8%	1.8%	23.1%	19.2%
SA All Bond Index (ALBI)	ZAR	1.5%	1.8%	3.6%	7.3%	7.6%	7.6%	8.9%	7.9%
SA Cash Index (SteFI)	ZAR	1.2%	4.4%	6.2%	6.9%	7.1%	6.4%	0.2%	0.3%
Balanced Benchmark	ZAR	0.3%	1.6%	3.9%	4.9%	6.4%	10.5%	10.0%	8.5%
SA Inflation (1 month lag)	ZAR	2.0%	2.2%	3.1%	4.2%	4.6%	5.1%	1.3%	1.3%
GLOBAL MARKET INDICES BASED TO USD									
Global Equity (Datastream World)	USD	8.0%	2.1%	11.0%	8.3%	11.1%	10.0%	14.4%	13.6%
Emerging Markets Equity (Datastream EM)	USD	9.7%	-0.9%	10.9%	2.8%	9.4%	2.9%	17.4%	17.6%
Global Property	USD	2.3%	-12.0%	-10.8%	2.5%	5.4%	6.8%	14.4%	14.5%
Global Bonds (Barclays Global Bond Index)	USD	2.9%	7.1%	6.8%	4.4%	3.9%	1.9%	5.4%	5.2%
Global Cash	USD	0.1%	0.6%	1.1%	1.9%	1.5%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	0.7%	-2.5%	2.0%	2.4%	4.8%	9.6%	14.7%	12.9%
Global Equity (Datastream World)	ZAR	3.7%	21.8%	22.1%	16.2%	15.3%	20.0%	16.9%	14.6%
Emerging Markets Equity (Datastream EM)	ZAR	5.3%	18.2%	22.0%	10.3%	13.5%	12.2%	14.7%	13.4%
Global Property	ZAR	-1.8%	5.0%	-1.9%	10.0%	9.4%	16.6%	16.9%	14.5%
SA All Bond Index (ALBI)	ZAR	1.5%	1.8%	3.6%	7.3%	7.6%	7.6%	8.9%	7.9%
Global Bonds (Citigroup)	ZAR	-1.2%	27.8%	17.5%	12.0%	7.9%	11.1%	16.5%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	6.5%	24.9%	28.9%	14.0%	11.3%	3.9%	13.4%	15.9%
Gold (Rands)	ZAR	2.3%	49.0%	41.8%	22.3%	15.5%	13.3%		
CURRENCIES									
Rand / Dollar	ZAR	4.0%	-19.3%	-10.0%	-7.3%	-3.8%	-9.1%	17.1%	15.7%
Rand / GBP Pound	ZAR	-0.4%	-16.4%	-15.4%	-6.0%	-0.6%	-7.0%	17.7%	15.2%
Rand / Euro	ZAR	-0.2%	-24.6%	-18.3%	-7.0%	-4.9%	-7.5%	15.8%	14.0%

Spot Rates		30-Sep-20	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	16.68	17.38	15.16	13.83	6.97	7.22
Rand/GBP	Rand	21.57	21.47	18.68	20.94	10.99	10.68
Rand/EUR	Rand	19.56	19.51	16.53	15.43	9.52	6.37
RATES							
Libor 6m $	US$	0.26	0.37	2.06	0.53	0.46	6.76
Repo Rate	Rand	3.50	3.75	6.50	6.00	6.00	11.75
Prime	Rand	7.00	7.25	10.00	9.50	10.00	14.50
All Bond Index Yield	Rand	11.64	11.64	9.47	8.80	7.95	9.74
COMMODITIES							
Gold ($/oz)	US$	1,899.84	1,783.66	1,473.85	1,114.34	1,301.47	273.35
Platinum	US$	884.00	814.00	900.00	908.00	1,662.00	569.00
Oil (Brent Crude) $	US$	40.99	41.25	60.89	47.52	81.23	29.50
INFLATION							
SA Inflation	%	3.1	2.2	4.1	4.6	3.0	9.4

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