portfolio construction forum

Managing the money-weighted return problem

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In this Thought Piece, filmed exclusively for and released at PortfolioConstruction Forum Conference 2013, Alan Brown – Senior Adviser with Schroders Investment Management based in London – argues that what really matters to people is money-weighted rates of return, minimising volatility and, in the decumulation phase, how naturally arising income can help to manage pension outcomes provided it doesn't damage total returns

I think it was Einstein who said "Everything should be made as simple as possible, but not simpler." Our industry has been guilty of making portfolio construction too simple – certainly in the area of strategic asset allocation.

In the next few minutes, I want to show why standard strategic asset allocation models are really not worth the paper they are printed on. Then I want to think about what really matters – maximising money-weighted real rates of return, minimising volatility and, in the decumulation phase, how naturally arising income can help to manage pension outcomes, but only provided it doesn't damage total returns. And then finally I'll conclude with a few thoughts on what that means for our industry and the way that we operate.

So – what's wrong with what we do today?

Today's approach takes finance-based equilibrium models to predict returns out to infinity. Because we're predicting returns to infinity, forecasts don't change much. We have a real case of garbage-in, garbage-out. In the four decades that I have been in this industry, the forecasts you would have used at the beginning of each decade would have borne no relation to the actual outcomes at the end. We would have massively overestimated returns in the 1970s and the noughties, and underestimated them in the 1980s and 1990s.

This highlights a real problem. It's normal to have secular bull and bear markets lasting between 10 and 20 years and the impact on individuals can be huge.

As an industry, we focus on time-weighted rates of return which are nice and simple and convenient. But what actually matters to an individual is money-weighted rates of return. When you start thinking about money-weighted rates of return, you get some startling results.

In the first 20 years of a saver's life, a 1% change in contributions has about the same impact as a 1% change in investment returns. But, in the second 20 years, when the returns are impacting on a much larger pot of money, a 1% change in investment returns has about six times the impact of a 1% change in contributions. So two things matter – the overall levels of returns and the order.

Our clients cannot know in advance what the return environment will be like for the 60 years or so of their own personal saving and dis-saving experience. They know neither the level nor the order of returns. This immediately highlights how difficult it is for individuals to manage their way to a real level of savings to retire on, as the impact on investor returns in the final years to retirement will swamp whatever they can do through contributions. And, of course, the money-weighted impact is greatest at the beginning of the decumulation phase when the pot of money is largest.

What can we the industry do about this? And what should we be concentrating on?

It goes without saying that we need to focus on maximising real rates of return - but even this is something of a departure from what we spend so much of our time doing today. Maximising real rates of return is about thinking about the intrinsic value of investments, not relative value. And, when we think about intrinsic value, the most important consideration by far is valuation. This shouldn't come as a surprise to anyone. In an equity context we know that PE multiples are bounded; they can't rise or fall for ever. So it stands to reason that unless you think PE multiples are well correlated with future levels of earnings growth, which by the way they are not, then PE multiples are much more likely to fall when they are already high and rise if they are already low. It is PE multiple expansion or contraction which almost always determines whether you're in a secular bull or bear market environment. It's not rocket-science.

But, it challenges us, if we are to smooth out the return experience of our clients. We have to be much more dynamic in our asset allocation than we've typically been in the past - that's the first point. The second and related point is that we have to do more to try and manage volatility. Put simply, absent volatility, there would be no money-weighted returns problem. To me, managing volatility means three things - managing a risk-based allocation strategy rather than asset-based one, using the full array of asset classes available, and again, prepare to be more dynamic in asset allocation in response to significant changes in valuations.

A word now on naturally arising income in the asset decumulation phase - dividends and coupons. If you have a nice big retirement pot which can throw off all of your income needs from dividends and coupons alone, then you can head for the beach and, provided the dividends and coupons are sustainable, you don't have to worry about capital values. It's nice if you can do that, but that's not realistic for the great majority of people. Most have to top up their income by drawing down on capital over time - and that's where the money-weighted problem can be viscous. If you start your retirement in a bear market, you can very quickly eat into your capital as you have to sell assets into a falling market. To the extent that you can boost the natural income being thrown off the portfolio, you can minimise this problem but it has to be emphasised that it should always come second to valuation arguments. Beware then chasing yield when yield becomes expensive.

So what then does this mean for us and our clients?

The takeaways for me are the following:
- the money-weighted return problem is a huge one.
- We need to educate our clients on this and we need to organise ourselves to do what we can to help.
- That means moving to a risk-based, rather than asset-based allocation strategy.
- It means focusing more on volatility.
- It means using the whole array of asset-classes open to us
- And, it means being prepared to be much more dynamic in asset allocation that we have been. We simply must respond to valuation outliers when they come around, which is more frequently than many of us acknowledge.

And, if you agree with me, then all this means that many of us are going to have to reorganise our firms to deliver this.