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Foreword

Welcome to the latest edition of Mindset – STANLIB Multi-Manager’s quarterly thought leadership publication. In this issue, we focus on goal-based investing.

Goal-based investing is still in its infancy but gaining increased traction amongst investors. It emphasizes investing with the objective of attaining specific life goals like saving for education, a new home or even retirement. It differs from conventional investing methodologies, where financial performance is defined as a return against an investment benchmark. So, funding a personal financial goal becomes more important than exceeding a market benchmark return, and the conversations regarding advice between financial advisers and investors becomes more critical than ever.

In this edition of Mindset, our investment team will share our views and insights around goal-based investing. We look at some industry trends, we debunk some myths around goal-based investing, define how we construct goal-based portfolios and elaborate on the research process we follow to develop appropriate solutions for our clients. This is your master-class in goal-based investing.

Joao Frasco, our Chief Investment Officer, sets a comprehensive scene and explains our thinking behind goal-based investing. Malcolm Holmes, Head of Portfolio Management, focuses on the portfolio construction process and the considerations that go into building a goal-based portfolio. Albert Louw, Head of Business Development, examines a changing regulatory landscape and the focus that is needed on the real needs of clients to help them achieve their investment goals.

Finally, Richo Venter, Head of Research and Development, looks at living annuities and a retirement goal in detail, running 10 000 simulations to explain the intricacies of achieving the right outcome for a specific goal.

We will continue to look for the latest insights to share with you every quarter. Please look out for our next Mindset issue at the beginning of the third quarter and send us your feedback. We welcome your inputs and feedback.

Regards,

De Wet van der Spuy
Managing Director, STANLIB Multi-Manager
Understanding goal-based investing

By Joao Frasco, Chief Investment Officer, STANLIB Multi-Manager

This article will explain our thinking behind goal-based investing.

It is important to understand that we are only talking about the investment side of meeting goals here, and that financial planning is a much broader topic that will directly impinge on the ability to meet a specific goal if not directly addressed.

Let’s use a simple example to clarify

Imagine that a client identifies their goal as an income in retirement, and after careful consideration you establish that the income required is Rx per month after tax. If this client has not provided adequately for medical expenses in retirement (hopefully with medical insurance cover or medical aid), the income may be wholly inadequate if the client is faced with a major medical procedure. Financial advice can’t consider meeting goals with appropriate investments in isolation, but must cover all other aspects of financial needs, like appropriate insurance cover.

It is also important to note that in most cases, we will be dealing with constraints that make meeting financial goals less than certain. It would be wonderful if assets existed to meet all conceivable goals, but the reality is far from this. The best we can hope for is for some assets that meet some of the dimensions of goals (liabilities) that we want to achieve, but even this can be rare and often it is also very expensive. Let’s consider another simple example.

Imagine that an individual would like to save to buy a retirement home in the south of Portugal (the majestic Algarve) in 20 years time when they are planning on retiring. Portuguese inflation-linked bonds may seem like a good bet, but there are a couple of problems.

Firstly, the Portuguese government does not issue inflation-linked bonds. Secondly, even if they did exist (hypothetically), they may not have a maturity of 20 years, which would introduce either reinvestment risk (if maturity was less than 20 years) when they matured (and which will nevertheless exist on any coupon payments even if the maturity was 20 years), or market risk if the bonds would need to be sold before maturity (if maturity was substantially longer than 20 years). For clarity, market risk is the risk that the yield to maturity of the bond changes throughout its life (because of many factors that could affect the yield at different durations). The returns on bonds is therefore only somewhat known if they are held to maturity without default.

Thirdly, the Portuguese government could default on the (hypothetical) bonds before expiry, and the European Central Bank (ECB) may not provide any security on this default, in which case some of the capital invested would be lost (hopefully not all of it, although for governments this is a real possibility as bonds are not secured by assets).

Finally, and this is very important, house prices in the Algarve may not increase at the same rate as Portuguese inflation overall (which like all other country inflation is actually made up of a basket of goods consumed by an average household). In fact, given the demand for the majestic coast, house price inflation in the Algarve could be much higher. Clearly what started out as a simple goal, is actually not that simple and in actual fact can be very complex.

To explain goal-based investing, I will begin by describing the objectives of goal-based investing.
and the theoretically optimal solutions used to achieve these objectives, before introducing various constraints that will lead into the final proposal. The reason for tackling the topic thus, is to demonstrate the complexities that exist, so that the final solutions are not misunderstood as being simplistic, but rather as practical. It does however also aid with the understanding of the complexity that exists and that will remain within the final solutions in resolving financial goals.

Understanding goals

It is generally well understood that goals can differ substantially along many different and important dimensions. Let’s begin by exploring these to understand the complexity that this creates. A goal can be of a capital nature (a single payment at some future date), or of an income nature (a couple of, or even many, payments at various future dates). They could be in one of many possible currencies (e.g. rand, dollar, or euro). They could be nominal amounts i.e. fixed amounts whose value is known today, or real amounts i.e. an amount linked to inflation (not only consumer price inflation, but any possible measure of inflation, say medical inflation). The future date/s could be in the near future (say next year), or very far into the future (say 80 years hence for a 20 year old starting their career and wishing to save for retirement and an income for when they are a centennial). The amounts required (capital or income) could be gross or net of tax. Finally, any of the above dimensions could be known with certainty, or completely uncertain e.g. how long will I live and need an income for? Do I know what education inflation will be and how it will relate to consumer price inflation? Do I know what future tax rates will be? Do I know what the price of a life annuity (with an insurance company providing longevity risk cover) will be? And so the list goes on.

It is important to distinguish between the dimensions of the goal(s) listed above, and the investor preferences associated with the goals, and priorities. Different investors may give different goals different priorities, and it is important to understand and respect these when considering how to construct solutions to meet them. When certainty of meeting the specified goal is given the highest weighting (highest priority), the “best” solution will focus on minimising the risk of not meeting the goal. This solution is unlikely to be the same solution as when another dimension is given a higher priority e.g. maximising wealth or returns.

It is however appropriate to understand that the starting point to investing to meet a goal, is to find assets that best match the nature of the goals, as any deviation away from this introduces variability (uncertainty) in the outcomes. It is important to highlight that even the “optimal” solution would not be “risk-free” as uncertainty of meeting a specific goal could never be guaranteed (except in the simplest of cases). We’ll touch on this in more detail below in the section on funding goals, but it should already be evident from the examples given in the introduction above.

The above complexity and conflicting objectives pose a serious problem which is not trivial to solve. To meet the various goals of various investors, you would need a large number of solutions to meet all of the different dimensions and requirements. While enough solutions probably exist globally to get you to a good answer for each goal, you would potentially need to know about and monitor hundreds or even thousands of these solutions. This is clearly untenable, which is why we begin by simplifying the dimensions so that we end up with a manageable set of solutions that will approximately match the dimensions of most goals.

Funding goals

Given the above as a starting point, how can we proceed? There are generally two approaches.

The first approach, which relates back to the theoretically “optimal” solution, would be to model the investments (every asset class available for investing i.e. not just theoretically available) and the goals (liabilities) stochastically i.e. randomly
(introducing their “known” uncertainty). We won’t go into the detail here around the modelling methodology, but it is important to know that modelling requires assumptions which are informed by historical data (or at least should be, and hence why I refer to it as “known”).

This means that the modelling considers all of the uncertainty around returns and correlations between asset classes, as well as the uncertainty of the liabilities and how they may change or evolve (and the correlation between the assets and the liabilities). The optimal solution to the problem is the investment (combinations of asset classes) that provides the best match to the liabilities (goal) i.e. the solution that minimises the uncertainty around meeting the goal, regardless of the cost. Investor preferences can then be factored into alternative solutions that deviate away from this based on other priorities.

The second approach, focuses on the traditional requirement for a discount rate to be used to equate the present value of the investments and goals (assets and liabilities), and does this deterministically i.e. not randomly. It is however important to note that even here stochastic modelling is used for the assets, but this is used to establish the expected risk of the assets and how to combine these efficiently (using a mean variance framework with expected return assumptions).

Mean-variance optimisation

Practically, this means building an “efficient frontier” i.e. a combination of assets that minimise variability (or variance/standard deviation) of returns for a given level of expected return. We actually do this in real return “space” (an abstract construct that looks at returns and variability in real terms i.e. after adjusting for inflation). This is straightforward when working in rand (because we can use SA CPI for inflation), but creates additional complexity when considering global goals and investments (which currency and inflation rate should be used?). It should be obvious from the second approach, that you need a discount rate to equate assets (investments) and liabilities (goals). This creates the need for target returns in the solutions i.e. there is no alternative way (except for the first approach) to translate the goals into specific investment objectives.

Up to this point, things should be fairly clear. We’ve constructed an efficient frontier that provides us with the combination of assets to be used for a given level of risk or return (real). It is important to appreciate the sensitivity of the results obtained, to the assumptions made (and methodology adopted), so that we don’t get too comfortable with the “preciseness” of the numbers i.e. it would be wrong to think of this efficient frontier as being “certain” in any meaningful way as one of the dimensions actually represents uncertainty (risk).

The portfolios on the efficient frontier will then have a corresponding asset allocation to the asset classes used in the modelling, and this is used as the strategic asset allocation (SAA) for the corresponding solution. All that is left to do, is decide on how many solutions are needed, and exactly where along the frontier these be selected from, and we will consider this next.

Mean-variance optimisation may appear dated, but it remains a useful and powerful tool in understanding how to build portfolios under certain assumptions. It can incorporate Monte Carlo simulations using historical data, or parametric distributions based on historical data. It can incorporate historical or expected returns, and can even incorporate stochastic covariances (correlations) between the various asset classes i.e. uncertainty can be introduced into the various dimensions of interest.

Building solutions

So how do we move from the optimisation work, and the resultant possible solutions, to a range of portfolios to meet a varied range of individual goals? One obvious extreme method would be to include just one portfolio (somewhere on the frontier), and force everyone to use this portfolio for every goal.
Clearly this is not very client-centric, and appears to be a little too extreme in terms of simplification. Another less obvious extreme may be to have many portfolios (say 50) along the frontier, hoping to provide a lot of granularity in meeting various risk and return requirements. We hope that it is obvious that this is not practical or necessary, and actually highlights a lack of understanding of the uncertainty present in modelling and dependence on the assumptions.

So, having thrown out the extremes, we can focus on finding a suitable compromise, but let’s consider the compromise I’m discussing in more detail first. Too many portfolios are extremely costly to manage (on various cost dimensions, including indirect costs related to governance), and we therefore want to minimise the number of portfolios to minimise these costs, costs which will need to be passed on to clients. Too few portfolios on the other hand, don’t provide enough granularity in terms of meeting different risk and return requirements. This is what we will need to balance, and find a reasonable compromise around.

On the lower limit, we could build just two portfolios (100% local cash, and say 100% local equities), and every client could be given a combination of these two to meet their specific requirements. It is important to understand the limitations of this possible solution. The first, is that it is sub-optimal in a mean-variance sense (i.e. the combination will not lie on the efficient frontier except for the two extreme cases) because it doesn’t make use of all available asset classes, which provide diversification benefits. The second, is that it could be sub-optimal from a tax and cost perspective because it would require constant rebalancing to maintain a fairly constant allocation to cash and equities.

If we consider 1% real return increments from 1% for local cash to 7% for equities (approximately our long-term real expected return assumptions), we could end up with five multi-asset class portfolios ranging from 2% to 6%, giving us a good range of portfolios to meet most investors’ risk and return requirements (in addition to cash and equities at the two extremes for investors looking for something more). Some people may argue for even greater granularity (i.e. more portfolios at say 0.5% increments), but the above proposal already introduces spurious accuracy i.e. there is already so much uncertainty around what each portfolio will deliver over various time frames.

It is important to understand that there is no “correct” or “optimal” number of portfolios, or where they should be positioned on the efficient frontier. If we are given a specific utility function that captures the client’s preference with reference to competing constraints, it is fairly simple to point to an optimal solution, but generally this is derived through a conversation with clients around the priority of the competing objectives and constraints. To suggest otherwise demonstrates a lack of understanding, and is simply misleading.

**Mapping goals to solutions and understanding the limitations**

Now that you have a range of portfolios along the dimensions of expected risk and return, you need to decide on which portfolio to use to meet each specific goal. I will deliberately sidestep the issue of whether investments should be considered separately for each individual goal (as opposed to collectively which is actually more optimal) as this remains a contentious issue and difficult for many to grasp.

This is where the traditional approach of “risk-profiling” investors enters the advice framework, although I think this will ultimately evolve away from this (another contentious issue I will avoid in this article). The traditional approach considers three dimensions of risk, which includes risk capacity, risk required and risk tolerance (the dimension where psychological questionnaires are used to establish attitude to and appetite for risk).
It is critical for the investor to understand risk as uncertainty at this point, as many investors may believe that this approach to investing for meeting goals removes all uncertainty, where nothing could be further from the truth. The methodology actually enables a discussion around the dimensions of goals and investments, and their attendant uncertainties, so that an appreciation of the complexity can be reached. Financial advisers will be doing their clients a great disservice if they don’t use the opportunity to have this discussion upfront as they may learn later when their clients become disgruntled by “poor” performance.

This is where the use of great tools/aids can assist financial advisers and their clients in understanding these dimensions and risks, and graphical representations of the evolution of the investment and the goal can be very enlightening. Scenario analysis and hypotheticals are two more great tools to help in this mammoth task e.g. showing how the investment would have performed through the global financial crisis (GFC). If a client is uncomfortable with the level of drawdown through the GFC, they should seriously consider lower risk portfolios as this scenario could easily repeat in the lifetime of the goal.

A tool that allows an adviser to flex (change) various dimensions associated with the investor, their goal, and possible solutions, is extremely powerful in trying to find a suitable investment to meet an investor’s very specific requirements. The investor should be able to see (visually as well as understand) the impact of changing the investment or consumption horizon, the initial and ongoing investment contributions (if any), the expected risk and return assumptions, and the certainty (probability of achieving the goal), on the goal value. The investor should then be able to change the question around to ask what the impact would be on any of those same dimensions, if the goal value were changed e.g. if the investor wants a higher amount at retirement, how much longer should the investor work before retiring?

**Evaluating performance and ongoing investment advice**

Once all of the above has been adequately covered, with the investor demonstrating a good understanding of the methodology and how it will assist in meeting their specific goals, a record of advice can be produced for both the investor and the financial adviser. It is critical that this record includes the uncertainty discussed as this is one of the most important dimensions of the exercise and will represent the most discussed issue in the annual review of how the investment is tracking against the goal. It would be simple if the trajectory of the investment progressed smoothly along the expected return path, but this is not only unlikely, but actually practically impossible.

At each review, the financial adviser can therefore consider how far above or below the trajectory the investment is progressing, and whether any corrective action should be taken. There are many things to consider in this process, so I will not be tackling them here, but it again represents a wonderful opportunity for adviser and investor to have a discussion around the initial process and their shared understanding of how the investment would evolve. By spending adequate time doing this, it should prevent any short-term irrational decisions that could be detrimental to the long-term success of meeting goals, which was the initial intention of following this methodology.

**Conclusion**

It is important to recognise what goal-based investing aims to achieve, and the idealised solutions that would theoretically be employed to meet them. It is equally important to understand the practical considerations that are needed when arriving at real world solutions, and the limitations and compromises that have been made to arrive at these. It is then fairly easy to understand why the solutions look the way they do, and how that can be integrated into an advanced financial advice
framework. Without this understanding, it is easy to criticise the solutions as simplistic, and advisers should be aware of this, so that they can defend the methodology and approach to their clients.

I have taken care to articulate these complexities and discuss appropriate ways of addressing them before presenting a solid foundation for the methodology and recommendations made. I would urge all stakeholders to put sufficient emphasis on this understanding, before embarking on this methodology of investing to meet goals. I think that clients want to see consistent and integrated thinking and advice, and goal-based investing is well positioned to provide it, but requires a deep understanding of the complexity and the time to get the client to a good level of understanding.

The time invested upfront will be worth it as the adviser meets with clients annually along the journey, comparing how the investments are tracking relative to the goals. This presents a wonderful opportunity to stop the “short-termism” prevalent in the industry as investors chase the best past performers according to some survey or peer group ranking tables, in the belief that past performance may in fact be a good guide to future performance, despite all the “health” hazards communicated around this.

It is important to recognise what goal-based investing aims to achieve, and the idealised solutions that would theoretically be employed to meet them. It is equally important to understand the practical considerations that are needed when arriving at real world solutions, and the limitations and compromises that have been made to arrive at these.
Goal-based portfolio construction

By Malcolm Holmes, Head of Portfolio Management, STANLIB Multi-Manager

“This is often the question I ask the new portfolio managers in the team as a way of opening their minds to various possibilities. It is indeed a tricky question, because there is no one right way, but rather there are several construction methodologies that could be used, each with their own pro’s and con’s, but they all generally follow the same principle – get your client invested in an optimal combination of different asset classes that over time have the greatest probability of achieving your objective.

This creates a potentially big issue for investors who happen to be experiencing a particularly bad patch of capital market returns, especially when this persists for longer periods of time as they are less likely to achieve the CPI+5% p.a. objective. At the other extreme, you will have an investor who is fortunate enough to have invested before a patch of significantly higher returns and therefore achieves more than the CPI+5% p.a. objective.

Construction considerations

Unfortunately, there are no asset classes in South Africa, or indeed globally, that will deliver guaranteed real returns of CPI+5% p.a. for extended periods. Even inflation-linked bonds have return uncertainty over shorter periods, and could have return uncertainty to maturity if they paid coupons (due to reinvestment risk). With South African cash producing around CPI+1% p.a. over the long-term, achieving CPI+5% for the total portfolio requires exposure to growth assets, like equity and property that can produce much higher returns over the long-term.

One should try to use as many asset classes as possible to maximize diversification. For collective investment schemes we certainly use all of the traditional asset classes and could use alternatives in a regulatory environment that allows for this.

Investor understanding

Financial advisers and their clients need to understand that this does not imply CPI+5% p.a. every year. Some years will be better than others depending on the level of inflation and the returns from various capital markets, but a well-constructed portfolio should produce CPI+5% p.a. on average over the long-term. It is critical to understand that this is not merely wishful thinking, but fundamental to how assets are priced and hence how returns are derived. The reason that returns don not progress neatly from day to day, month to month, and year to year, is that many factors will influence their price over the short to medium term (and even over the longer-term).
real return each asset class can provide on a forward looking, long-term basis, we can model the optimal exposure to each asset class to achieve CPI+5% over a six year term (the modelling and outcome of this is covered in other articles in this edition – suffice to say this is an important step in the process of building such a goal-based solution).

With this strategic asset allocation (SAA) as a guideline, you can either build the solution using a specialist approach or a balanced approach to portfolio construction.

In a specialist approach, individual asset classes are given to specialist asset managers, and each of these specialist building blocks is then combined at the portfolio level. In this way, skilled equity managers manage the equity component and skilled bond managers manage the bond component and so on. Importantly, under this approach, the solution provider (us as a multi-manager for example) can tilt the exposure to each asset class portfolio depending on the current investment environment and our shorter-term outlook for each asset class (this is referred to as tactical asset allocation - TAA).

In the balanced approach, asset managers are given a multi-asset class mandate and are responsible for both the asset allocation and security selection within asset classes. In this way, the balanced manager can optimize stock selection within his/her equity component for example, giving consideration to the exact instruments and resulting duration of the bond component. These multi-asset (balanced) managers can take much bigger asset allocation positions based on their valuations, and tend to be more concerned with downside protection. This creates challenges for the solution provider creating a range of portfolios to meet various real return objectives.

In building a range of say five goal-based portfolios along the risk/return spectrum, our preference would be to use the specialist approach because this gives us more granular control over how the portfolios will perform as a range. We must also remember that asset allocation is the most important factor in determining the differences in returns observed from funds/portfolios.

It will be instructive to consider whether the portfolio should change over time to reflect past performance i.e. if you have achieved CPI+10% p.a. over the past three years, do you de-risk the portfolio on the basis that you will achieve your objective over the ensuing three years? There are a number of complications with this which are worth exploring in greater detail.

The first, is that the portfolio is aiming to achieve the objective continuously for many generations of investors, and many generations of their investments. Someone first investing in the portfolio after the three years of CPI+10% p.a. would not have enjoyed this return, and would now be invested in a lower risk portfolio expected to produce a lower return than the objective. The second is more caustic. If the portfolio had instead only achieved CPI+0% p.a. over the previous three years, do you increase the risk in the portfolio to try to make up for the shortfall, exposing investors to much more risk than had been initially assumed? Clearly this would have dire consequences if the risks materialized in large losses.

The above approach lends itself to considering both active and passive investing paradigms within portfolio construction, or a combination as required given other priorities (like costs).

**Measuring performance**

Once the portfolio has been designed and constructed to deliver the investment objectives, and is being managed to do this, it is important to reflect on how it is performing against the initial specification. There are several ways to do this and one needs to be careful with instinctive reactions of failure when the portfolio doesn’t deliver CPI+5% p.a. in the first complete six year period. If the initial discussions were well understood and documented, the discussion could be easier. This is where initial collateral and time exploring expected portfolio behaviour (not just the single dimension of expected long-term return) will be very well rewarded.
This also provides great insight into what makes CPI+x% such a bad benchmark i.e. the fact that it is not investable. This is why we would not give this objective to asset managers as a benchmark, and would never evaluate their performance against such. We would try to understand the performance of the portfolio in the context of the performance from the underlying asset classes, and appropriate peers. These solutions should therefore be evaluated on the same basis, and this is in fact how we negotiate the portfolio performance evaluation with our clients.

Any or all of these tools could be used in the short or long-term to provide insight into the likely probability of achieving your goal. Some are more effective than others for the client to measure your skill in building a portfolio.

**Conclusion**

Ultimately there are several ways to build a goal-based portfolio and hopefully which ever you choose is effective in meeting the investor’s goal. It is worth investing time upfront ensuring that both advisers and their clients understand the uncertainty in capital markets and how these uncertainties remain within portfolios even when they are very well designed and constructed around very specific investment objectives.

A portfolio’s performance can deviate significantly from an inflation objective in the very short-term, but this tends to converge over the longer term and the solution provider can monitor progress relative to this. We find that a good measurement tool is to compare the return of the portfolio on a short-term basis relative to the return of the optimal strategic asset allocation that we determined upfront in the design process. Using this, we can attribute the key drivers of out or underperformance into the component parts of manager selection and tactical asset allocation. In some circumstances, it may also be appropriate to compare the return of your portfolio to that of a representative list of peers aiming to achieve the same goal.
STANLIB Multi-Manager is the largest Collective Investment Scheme in South Africa
Embracing a new financial planning landscape

By Albert Louw, Head of Business Development, STANLIB Multi-Manager

The financial advisory landscape has changed remarkably over the past decade.

Increased regulation

The financial advisory landscape has changed remarkably over the past decade. The start of this new “era” came in 2002 with the publication of the FAIS Act which set minimum standards of qualifications and professionalism for financial advisers.

The Retail Distribution Review (RDR) discussion paper released in South Africa in November 2014 and the planned change to a “Twin Peaks” model of financial sector regulation further aim to enhance professionalism and improve investor outcomes. The “Twin Peaks” model of financial sector regulation will see the creation of a prudential regulator – the Prudential Authority – housed in the South African Reserve Bank (SARB), while the Financial Services Board (FSB) will be transformed into a dedicated market conduct regulator known as the Financial Sector Conduct Authority.

The financial advisory landscape looks significantly different now than it did even five years ago. Financial advisers looking to build a successful business for the future should aim to find opportunities among this ever-changing regulatory landscape.

Too much regulation or not – Embrace the opportunity

The South African financial planning industry is one of the most established in the world. Highly skilled financial advisers have spent decades building successful businesses based on robust investment advice, processes, trust and reputation. For these advisers increasing regulation has required minimal changes to their business models.

Over the past 10 years, there has been a natural tightening of standards across the broader advice fraternity. This has resulted in more comprehensive financial planning and improved advice to investors. However, the final outcome of the RDR proposals is still expected to have a profound impact, specifically on financial advisers who have yet to make the paradigm shift in how they execute their advice models and reposition their businesses for this new era.

There is a lot to consider when RDR is finally implemented. Will there be a big drop in adviser numbers? Will clients be reluctant to embrace the concept of advice fees? How can clients be persuaded to pay for advice? How will financial advisers build a profitable business? Will there be an increasing gap between clients able to pay for advice, and those who aren’t able to?

Despite the uncertainty and challenges, one thing is certain, financial advisers with strong relationships and the willingness to adapt and improve will remain relevant to clients.

Opportunities – The need for financial advice is greater than ever

There remain several primary challenges to clients’ financial security in the context of today’s economic and demographic environment. These reinforce the importance of the role of the financial adviser and the need for suitable financial planning.

The key challenges that clients are facing include but are not limited to:

Increasing longevity – Average life expectancy has increased significantly since most retirement systems
were first established. Today, life expectancy in South Africa is close to 70, and more than one in three South Africans who are 65 today will live past 80 years old. Meanwhile, only 6% of South Africans save enough for retirement, according to the World Bank.

**High debt levels at retirement** – In South Africa only 33% of retirees are debt-free once they stop working. The country’s national savings makes up just 15.5% of GDP. The fact that people are not saving enough is highlighted in the latest Momentum/Unisa Household Liabilities index that shows the real value of household assets continue to fall because of lower contributions towards savings and a lack of investment growth on savings.

**Lack of preservation** – In addition to South Africans not saving for retirement at all, there are many who aren’t saving enough or who don’t preserve their retirement benefits between jobs. Many South Africans have been tempted to access their retirement savings when changing jobs so they go back to a zero base in terms of retirement savings and, significantly, wipe out the years of compound interest they had previously earned.

**Lack of engagement and financial literacy** – At a time when the need for financial advice is so great for so many, levels of engagement with financial advisers are disappointingly low. According to BlackRock’s September 2016 Viewpoint, only 17% of individuals in the United Kingdom (UK) and Germany, and only 14% in the Netherlands, use the services of a financial adviser. The levels of adviser engagement in South Africa is expected to be even lower due to our high unemployment rate and lower levels of financial literacy.

If anything, the above highlights the significant opportunity for financial advisers, as many people need professional financial advice. However, some of the new challenges facing financial advisers include:

- The arrival of a **new competitor** - the digital wealth manager
- Clients questioning the **quality of advice** as they struggle to link the value of advice given with their needs and outcomes.

### The arrival of the digital wealth manager

Financial advisers are competing against the newest player in the market, the robo-adviser. The term robo-adviser implies that an element of advice is included in the process. However, it is provided without the intervention of a traditional (human) financial adviser.

Two factors are likely to drive consumer use of robo-advisers. Regulatory changes will be too onerous for some financial advisers to continue in business, leading to a likely contraction in the number of financial advisers operating in the sector. Quality advice comes at a price, one that the South African investor is not used to paying for. A large portion of customers could be priced out of the market due to a reluctance to pay for advice.

Since 2008, nearly 140 digital advisory firms have been founded in the US, with over 80 of those started in the past two years alone. A robo-adviser, in its uncontaminated form, provides a certain degree of advice, although on a more limited basis. Younger generation Y and millennial customers are likely to be attracted to the new digital wealth manager because of the anytime, anywhere opportunity to transact. This poses a further challenge to financial advisers who are trying to diversify their client base beyond its current predominantly aging customer profile.

According to the Investor Pulse Survey clients are contemplating robo-advice for convenience (42%), the appearance of simplicity (33%) and because there is no deliberate product push (31%).

Although the model may simplify the investing process, clients overestimate the effectiveness of robo-advisers in replacing the holistic advice given by traditional financial advisers. Non-comprehensive financial needs analyses and single-needs selling can result in detrimental financial planning shortfalls, which a client may only discover many years later.

Many clients in the 2015 Accenture report indicated their preference for continued access to traditional advisers. Despite this, financial advisers need to consider new ways of reaching, engaging, and connecting with clients through digital technology.
A hybrid business model that combines digital-user interfaces and client-relevant digital content (i.e. knowledge sharing), with face-to-face financial adviser interactions provides a far more compelling offering and a way to remain relevant to clients’ needs.

Quality of advice centred on holistic financial planning

Many financial advisers have adopted a “wait-and-see” approach to the new RDR legislation. Based on changes in the post-RDR UK market, there is likely to be a move away from investment planning (i.e. product pushing) to a more clearly defined focus on financial planning.

In the post-RDR era of increased scrutiny and higher professional requirements, financial advisers cannot afford to provide investment advice without rigorous and up-to-date investment research and analysis. The costs of setting up and maintaining a quality in-house research team are simply too high for many advisory businesses. In addition, advisers will want to mitigate the risks involved in defending, explaining and taking responsibility for all investment decisions. As a result, outsourcing investment research and portfolio construction to an independent provider has become an increasingly attractive solution for adviser businesses that want to focus on providing high-level financial planning and demonstrate value-add through quality advice.

Robust financial advice (i.e. a well-designed strategy) is based on an individual or family’s clearly defined financial and life goals. These could include education funding, buying a larger home, starting a business, providing for retirement or creating a legacy. The power of a goal-based approach to financial planning lies in its ability to highlight how realistic a goal is relative to a client’s risk preferences and the investment opportunities available.

As the ethos of goal-based investing gains traction with financial advisers and clients, it makes the principle of investing more tangible and relatable. It also helps to prevent rash investment decisions by providing a clear process for identifying goals and choosing investment strategies to match those goals.

Financial advisers looking to enhance and differentiate their value proposition as well as better equip themselves to deal with sometimes irrational and counter-productive investor behaviour will do well to adopt a goal-based approach. Key to the approach is shifting the focus from generating the highest possible portfolio return or beating the market, to investing with the objective of attaining specific life goals. Measuring investment performance is important, but measuring up to the goals set by a client as part of their financial plan is a more effective measure of financial success.

Conclusion

More stringent regulation, together with the outcome of RDR, will change the face of the financial adviser in what is seen as “a new era”. Financial advisers have an opportunity to embrace the changes despite current uncertainty. The need for financial advice is greater than ever but increased competition from robo-advisers along with increased scrutiny of the quality of advice, presents many challenges for financial advisers.

To succeed will require a focus on the real needs of clients to help them achieve their life goals. Helping clients invest according to their unique needs, objectives and time horizons encourages them not to view risk as something to fear and avoid, but rather as a barrier not to fully achieve their goals. By remaining highly relevant to clients’ investment and financial planning needs, financial advisers can truly differentiate themselves and strengthen client trust at the same time - There is no substitute for the trusted financial adviser.
Investing for a retirement goal

By Richo Venter, Head of Research and Development, STANLIB Multi-Manager

Introduction

The most important objective in saving for retirement for the average individual would be to live comfortably in retirement and not to outlive one’s money. A secondary objective may be to leave an inheritance for children or grandchildren. One of the biggest problems faced by pensioners is the fact that people on average live longer today than ever before in human history. South Korean women are now the first sub-population group to have breached a life expectancy at birth of 90 years.

Before the 19th century the average life expectancy at birth fluctuated between 30 and 40 years old. Life expectancy at birth (in developed countries) has improved by an average of three months per annum over the last 150 years, increasing life expectancy by more than 37 years. Some scientists even predict that children born today could easily live a healthy lifestyle beyond 100, given the exponential growth in technological advances. Some even believe that the first person to reach 150 years old could already be older than 40 today.

The result of this higher life expectancy is that we need to provide for income for far longer and either need to work until later in life, or save more while we work. While longevity risk cover can be bought from life assurance companies in the form of life annuities or pensions, these too will become increasingly expensive as people live longer.

The focus of this article will be on the longevity of an investor’s savings, once he or she retires. However, holistic financial planning is crucial for any investor and other aspects of financial planning should also be considered like car and house insurance, medical insurance, life insurance, disability cover, dread disease, funeral cover, estate and tax planning, etc.

Modelling income

The longevity of an investor’s retirement savings is driven by a few important factors:

- The aggregate amount of savings;
- The amount required to live on each month;
- How the savings are invested, and the resultant investment returns; and
- Inflation, which erodes the purchasing power of those savings.

For illustration purposes in this article, I will use a value of aggregate savings at retirement of R3 million. This is not meant to be representative of the average South African, but all monetary values can be scaled in this article to match your financial situation. So, for example, if you are fortunate enough to have savings of R12 million at retirement, just multiply the monetary values mentioned below by a factor of four. If your savings are R1 million, divide the values by a factor of three. For simplicity I have ignored tax, a very important consideration for individuals with higher savings and income requirements. However, tax implications on the R3 million investment amount should be minimal for reasons that will become apparent later when we consider the level of income (in South Africa, from 1 March 2017, the tax threshold for people between 65 and 75 years old is R117 300).
Depending on an investor’s risk profile, he or she could choose to either invest this R3 million conservatively, aggressively, or anywhere in between these extremes (at this point, we are ignoring the translation of these loosely defined terms into more concrete investment strategies, but we will consider this more precisely below). This decision will be driven by multiple factors, and one industry view is to consider the investor’s trio of risk factors, namely risk tolerance, risk capacity, and risk required.

Finding the correct asset allocation is critical, too high an allocation to cash is typically not appropriate regardless of age (except in exceptional circumstances), as cash will not give you a significant real return to withdraw from (around 1% in the long-run above inflation) while maintaining the real value of the capital over the long term. An exception to this could be if you have a very large investment with little requirement for income and very low risk tolerance. However, I must reiterate that every individual’s situation is different and should be discussed with a financial adviser.

For our exercise, we will assume that the investor invests in a fund that is expected to yield a 4% real return over the long run. It is important to realize that assets that guarantee this level of real return don’t exist and that the actual return can therefore be very different to this on an annual basis (and even over much longer periods of time).

In Chart one to the top right, we used a randomly selected (but representative) unit trust fund from the ASISA SA Multi-Asset Low Equity Category to show how volatile the returns have been over time. The chart shows rolling returns relative to an inflation plus 4% p.a. (CPI+4%) objective over various rolling periods since June 2001. Note how, over a 12-month period, the fund underperformed the CPI+4% objective significantly in 2003 (end of the bear market), between 2008 and 2010 (GFC) and again in 2016. At other times it outperformed this objective by quite a large percentage.

The rolling five-year return line shows more consistency, but still highlights five-year (60-month) periods where the objective was not met. In fact, the annualisation of returns somewhat masks the extent of this under-performance, which was as high as 18% for the five years to the end of April 2012 on a non-annualised basis. Over rolling 10 year (120-months) periods it is evident that this fund met the CPI+4% target over all historic periods - however, this is not a guarantee that it will continue to do so in future, even if longer periods are considered (in fact, we can calculate the probability of this happening under certain assumptions as being 4% or odds of one in 25).

Selecting the correct investment vehicle managed by a reputable multi-manager with the appropriate risk profile is still critical in meeting financial needs.

Simplistically, if we assume she can achieve a 4% p.a. real return from the R3 million investment and only draw this 4% each year from the capital invested (R120 000 p.a. assuming the R3 million), theoretically her money should grow with inflation every year and her purchasing power will be maintained, suggesting her capital should last indefinitely. If she withdraws more than the 4% every year, her purchasing power will gradually decrease as she starts “eating” into her capital, and if she withdraws less than 4% every year, her capital is expected to grow faster than inflation.

Unfortunately, as shown in Chart one above, the market does not deliver returns so neatly, something
generally referred to as “market risk”. If she happened to retire just before the global financial crisis and her portfolio lost say 20% of its value through the crisis (something that the above fund didn’t do), they would now only have R2.6 million. The dilemma is that such an investor could start depleting her capital at a much faster rate, as she now needs to withdraw more than 4% of her portfolio to maintain her standard of living.

Unlike many other examples in the media showing how an investment would have done when back-tested over history, I thought I would do something slightly different. I ran 10 000 simulations of returns of a fictional CPI+4% portfolio, assuming volatility of the real returns of 5.7% p.a. This volatility is consistent with the historical volatility of moderately conservative investment portfolios. The rational for this is that 10 000 simulated portfolio returns will provide us with additional insights into how a portfolio could perform going forward (parameterized using historical returns). This is essentially 10 000 different possible “versions” of the future, calibrated by history.

Chart two: 10 000 simulations over 30 years, using R3 million initial capital, 4% p.a. real return and initial income of 4%

The blue shaded area represents the simulated range of outcomes. I also assume he or she will withdraw an annual income of 4% of the initial saving, equating to R120 000 per annum or R10 000 per month, in real terms (all calculations are done in real terms). To clarify, R3 million invested at the start of the period is equivalent to R3 million after 30 years after adjusting for inflation.

The same applies to the withdrawal amount. We assume a R120 000 annual withdrawal in real terms. The actual rand amount withdrawn in future will be much higher than this, due to inflation, but we assume the purchasing power remains the same. It is critical to make the assumption that a similar withdrawal will be made in real terms as this is the amount he or she would require to maintain his or her standard of living.

The middle black line is the average of all the simulations at each point in time. Our initial investment is R3 million and the average investor’s real capital value should stay at R3 million as the annual real return of 4% p.a. is the same as the annual real withdrawal amount of 4%, so she is only consuming the return in excess of inflation.

The red line represents zero capital, meaning she runs out of money and therefore income. Simulations above the upward sloping blue line represents the 5% best results, at each point in time. Simulations below the downward sloping blue line represent the 5% worst results, which means that 95% of simulations lie above the downward sloping black line. As can be seen on the chart, the downward sloping line does not breach the purple zero capital line, which means that for more than 95% of all simulations, capital is not expected to be depleted (or that the probability of depleting capital is less than 5%).

Also note how some of the simulations start breaching the red line just after the 23 year (280-months) mark. This is important because it highlights that low probability events happen all the time, and this unfortunate event is a real (even though unlikely) event. Given this risk of being invested in such an unfortunate period or simulation, there are a few measures commonly recommended to investors to
improve chances of outliving capital. We will explore three options.

**Option one: Begin with a bigger lump sum**

Ensure the investor has enough capital at the start to allow him or her to withdraw a smaller percentage. For example, if the investor has R4 million at the start of the investment period, he or she would only need to withdraw 3% p.a. to still get an income of R120 000 p.a., if we maintain the capital invested to yield 4% p.a. real. The median capital value is now expected to grow in real terms indefinitely, and expected to reach approximately R6 million (in real terms) in 30 years.

In fact, none of the simulations ran out of capital over 30 years, although this should not be misunderstood to mean that this couldn’t happen. All else being equal, the lower the withdrawal percentage, the longer capital will last on average. Although this may not be an option at retirement, it is nevertheless a good concept to understand as it can be factored into retirement planning i.e. set the goal/objective higher long before retirement and invest more aggressively when you have a very long time horizon to increase the chances of having a higher lump sum at retirement.

**Chart three: 10000 simulations over 30 years, using R4 million initial capital, 4% p.a. real return, and initial income of 3%**

**Option two: Lower your income requirement**

Alternatively, an investor could reduce the income required in retirement, by making certain adjustments to living standards i.e. by spending less on “luxury” goods and focusing more on necessities. For example, withdrawing 3% instead of 4% of the R3 million equates to R90 000 p.a. or R7 500 per month. Given these parameters, in all simulations the capital comfortably lasts the full 30-year period, while the expected capital value goes over R4 million after 30 years.

**Chart four: 10 000 simulations over 30 years, using R3 million initial capital, 4% p.a. real return, and initial income of 3%**

**Option three: Invest more in growth assets i.e. more aggressively**

The final alternative we will consider, is for the investor to invest in a portfolio with a higher expected return i.e. a portfolio with a higher allocation to growth assets like listed property and equities. However, these portfolios will on average have higher volatility of returns, which means that their returns from day to day, week to week, month to month, are more uncertain. They therefore have a higher chance of yielding negative returns, and these negative returns can be larger. This also means that the expected range of outcomes, positive and negative, becomes wider. Investors should therefore understand this risk really well to establish whether they have the tolerance and capacity for it.
Below we explore this option, now assuming an expected real return of 5% per annum and a corresponding real volatility of 8% per annum. From the graph it is evident that the chances of outliving capital for the 5% worst simulations did not improve over our original example. It in fact became even worse, with some simulations depleting capital after just 21 years, which clearly demonstrates the risk discussed above. We do however find that the expected capital value after 30 years is now higher at approximately R5 million.

**Chart five: 10 000 simulations over 30 years, using R3 million initial capital, 5% p.a. real return, and initial income of 4%**

**Range of outcomes**

The above examples used very specific assumptions for the simulations. I thought it would be useful to demonstrate the period an investor’s capital is expected to last (the middle black line in the previous examples), given various real return and initial withdrawal rates. The results from these simulations are captured in the table opposite. For example, if an investor invested in a moderately aggressive portfolio, expected to provide a real return over the long term of 6% per annum (last row) and withdrew an initial income of 10% of the capital invested (last column), she could expect that the average outcome would see her capital last less than 15 years. These are the results that were derived from 10 000 simulations, but the investor would only experience one of these (or technically, none of these but rather some other random variant). It is therefore important to understand these scenarios in probabilistic terms.

**Table one: Period over which capital is depleted in 50% of simulations**

<table>
<thead>
<tr>
<th>Real return on investment %</th>
<th>Initial withdrawal %</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2.5%</td>
</tr>
<tr>
<td>2%</td>
<td>80 yrs</td>
</tr>
<tr>
<td>3%</td>
<td>Never</td>
</tr>
<tr>
<td>4%</td>
<td>Never</td>
</tr>
<tr>
<td>5%</td>
<td>Never</td>
</tr>
<tr>
<td>6%</td>
<td>Never</td>
</tr>
</tbody>
</table>

**Conclusion**

Theoretically, if an investment is expected to return 4% in real terms p.a. and the initial withdrawal from such an investment is also set at 4%, an investor’s initial investment should last indefinitely. However, investment markets are risky and investment outcomes are not always as expected, as markets tend to be volatile or uncertain. This uncertainty poses a dilemma for pensioners at retirement, specifically given that life expectancy is continuously increasing. In my analysis I considered a 30-year time horizon post retirement, to illustrate what could happen over this period under different assumptions.

Using thousands of simulations, I showed how an unfortunate investor could deplete her capital if markets suffered significant drawdowns (negative returns) during the period of investing.
I then explored various options to counter this potential capital shortfall, suggesting that an investor either saves more during her career to increase her capital investment at retirement, or reduces her standard of living once in retirement. The key here is that the withdrawal amount in real terms should be less than the expected real return, allowing for a “buffer” which will combat market uncertainty. I also illustrated how a retiree could increase the riskiness of her portfolio, without increasing the risk of depleting capital by much. This option does come with additional risk, especially if the investment horizon is short.

This article contains many simplifying assumptions that won’t necessarily apply to every individual. Saving enough for retirement is critical and an investor should be comfortable that she will have enough capital to invest to allow a withdrawal of income, without depleting capital. As previously mentioned, we did not cover other important aspects of financial planning which most investors should talk to a professional financial adviser about.

The result of higher life expectancy is that we need to provide for income for far longer and either need to work until later in life, or save more while we work.
Diversification beyond asset classes with STANLIB Multi-Manager