Investing over the life-cycle – building wealth

Introduction:

Many investors are currently confused as to how best to approach the construction of an appropriate portfolio of investments, in order to build wealth over their lifetime. We have moved on from the traditional approach of relying on cash for short term liquidity needs, bonds for income, equity investments for longer term capital growth and perhaps gold as an inflation hedge. New asset classes have emerged, new investment techniques are available and portfolio construction has become more complex. Investors are, understandably, often confused as to how best to look after their medium and longer-term financial interests and how to build capital for the future.

Lifecycle theory of investing:

The traditional theory of Lifecycle investing, documented by Modigliani and Miller, is that each individual will go through various lifecycle stages, in which the investment needs are different. First, when younger, there is the' accumulation phase' (age 20'2 and 30's), when the individual is able to invest in higher risk assets and follow an aggressive investment strategy, designed to achieve maximum longer term growth. Second, comes the 'consolidation phase', in mid-life (age 40's and 50's), in which the individual is in mid-career, has accumulated assets to cover the important needs of housing and living expenses and is now looking for opportunities to increase wealth generation. In this phase, the individual would have more resources to devote to investment, but might want to take a less risky approach. The third phase is the 'decumulation phase', (age 60's and 70's) during which the individual is no longer working and is living on the income and capital accumulated in the first two phases. Finally, there is the 'gifting' phase, (age 80's and 90's) in which individuals who have accumulated far more wealth than they will need for their own lifetimes, decide to pass some of their assets on to others – perhaps as an inheritance, or charitable donations. The theory suggests that, as individuals move through these lifecycle phases, their investment needs and objectives change significantly and, while being able to hold mostly risk bearing assets when young (the theory relies on holding mostly equities, to maximise long term growth), the individual needs to eliminate most investment risk as they grow old.

Traditional asset allocation approaches:

Attitudes to asset allocation often vary from country to country and the typical 'Anglo-Saxon' approach is exemplified by many UK investors. Until recently, they used a simple rule of thumb – when younger, invest heavily in equities to build wealth for the long term, since you can then benefit from the extra returns over time. Thus, UK pension funds often held 80% of their assets in equities. In Continental Europe, however, there has traditionally been a much higher weighting in bonds at all stages of the lifecycle, in order to provide more security of income and capital protection, with the high UK equity weightings being perceived as far 'too risky'. Both these approaches - relying too much on equities, even at younger ages, or too much on bonds - can be questioned today. The Lifecycle theory of investing is, in the modern investment world, too simplistic.

Moving on from the traditional, simplistic approach

Financial markets and products have developed significantly in the past two decades, since the Lifecycle theories first gained popularity and, in my view, it is now important for investors of all ages to consider their investment options in a more balanced manner. . Sophisticated risk-management systems are commonly used by large corporations, however such modern techniques have yet to be widely used to help individual investors plan their portfolios over the life-cycle. Relying only on equities at younger ages, exposes younger individuals to more risk than necessary. A diversified portfolio, including inflation linked assets, hedge funds, venture capital, property, commodities and bonds, as well as straight equities, should be constructed, with derivative products used as a tool for managing downside risk. At older ages, relying too much on bonds will still expose investors to risk, but will also sacrifice significant potential returns. Again, a more balanced portfolio, still including hedge funds, venture capital, real estate and commodities, as well as inflation linked assets and bonds, would be expected to deliver superior returns over time. Downside protection using derivative products can still be applied. The important element is that the mix of investments will change over the lifecycle, with more emphasis on less volatile assets at older ages, but this should be a subtle shift, rather than a complete reversal of emphasis

<u>Bonds can be risky too:</u>

After the severe losses suffered by many investors, who relied heavily on equity investments to build wealth over time, it has become clearer that equity investments are risky over the long term as well as the short term. Some of the instinctive reactions of private investors and their advisers in the UK has been to suggest that they should switch out of equities and hold more bonds in their portfolios. In particular, there is much interest in increasing holdings of corporate bonds, both among private investors and especially among pension funds. These are thought to be safer than equities, while offering a higher yield than Government bonds. This is, again, too simplistic. It is important to understand that holding corporate bonds is not necessarily a 'low-risk' long term investment strategy.

Corporate bonds do yield more than Government bonds, but they also have default risk. If the company fails, bondholders could still lose much of their capital, so switching from equities into corporate bonds retains some of the risk of holding equities, but may sacrifice the longer-term superior return potential of equities.

<u>More modern thinking on asset allocation – diversification, broader asset mix:</u>

Portfolio construction can benefit from a diversified range of assets to build wealth over time. Inflation-linked bonds can offer inflation protection, index funds can be used to capture the market movements of equities, while hedge funds or funds of hedge funds can provide the benefit of absolute returns, which are not highly correlated (or may be uncorrelated) with other assets. Property and commodities can provide further opportunities for diversification, as can venture capital. It is also now relatively easy to use derivatives (options, swaps or futures) and currency hedging to help protect one's wealth against losses from market or currency movements. Investors wishing to optimise their investment returns and build wealth over their lifetime, should consider holding a well-diversified portfolio of assets, which can benefit from low correlation of returns, to achieve longer term growth and risk control of the portfolio. Using the latest multiperiod hedging techniques will allow better management of market risks over time, rather than simply relying on 'time diversification'.

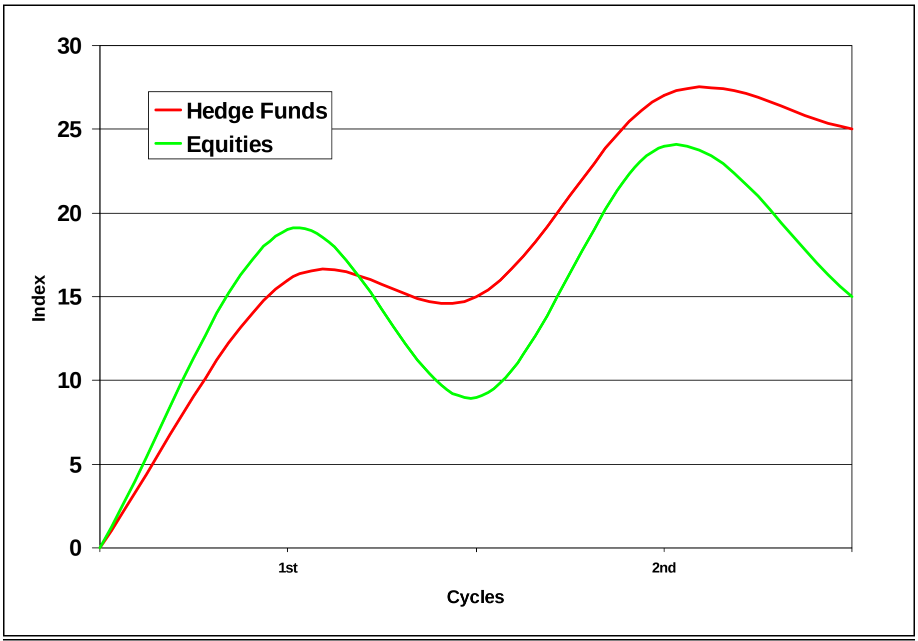
<u>Including alternative assets, such as hedge funds:</u>

Since 2000, UK investors learned the hard way that over-reliance on equities can seriously damage your wealth and that investment risk works two ways.

However, many investors benefited from strong returns from hedge funds and are now considering hedge funds as a core part of their long term investments. It is important to understand the implications of doing this. Hedge funds, or funds of hedge funds, are an alternative method of enhancing potential asset returns, while lowering portfolio risk. They do not necessarily increase portfolio risk, as is often thought. Hedge funds aim to provide absolute returns and capital protection, with strategies which are uncorrelated or lowly correlated with equities and bonds. They allow managers more freedom and flexibility to make money in all market conditions, either by profiting from falling markets by going short, or by profiting from the successful exploitation of relative value anomalies between different assets. As with all investment products, the skill of the managers is crucial in determining performance, but this is particularly the case with hedge funds. In addition, fees are high and there is limited liquidity and transparency.

...the 80/20 world of hedge funds

From the point of view of capital accumulation, however, the flexibility of investment management offered by hedge funds has much merit. Just relying on a portfolio of equities, with performance measured against the index benchmark, gives almost no protection against falling markets. So, if the equity market falls by 50% (as happened to many sectors around 2000) the portfolio would then need to double from that level just to get back to where it started. However, if the investments fall by ,say, only 10%, the year on year returns in future do not need to be spectacular to provide outperformance over the long term. This is sometimes described as the ‘80/20’ scenario, whereby hedge funds may only suffer 20% of the downside when markets fall, and then perform less strongly than the markets during a bull phase, perhaps capturing about 80% of the upside. However this means they outperform strongly on a compound basis over time. The diagram illustrates this.



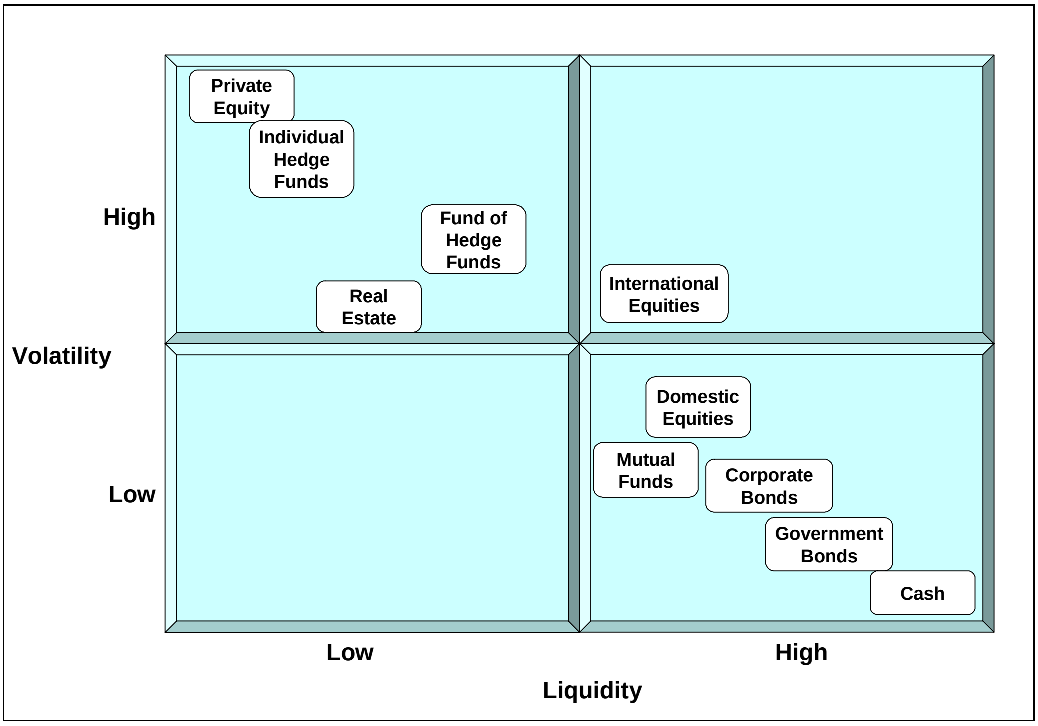
Consideration of investment goals over the life-cycle:

Different stages of the life-cycle can entail different investment allocations, but a standard ‘one size fits all’ approach is not optimal. Investors with extra capital to set aside for the future should consider a full range of assets in which to invest at all ages.

Rather than switching into bonds, over the life-cycle, investors can consider investing in a range of assets, including funds of hedge funds, even as they approach retirement. Using modern risk management techniques should help to achieve superior, risk-adjusted long term returns and enable investors to build wealth over time, with reduced volatility of returns. Instead of using standard ‘mean-variance’ optimisers, it is now possible to include multiperiod hedging techniques, which encompass a broad range of assets and time periods. Individual’s portfolios can also take advantage of derivatives at all stages of the life-cycle, to provide some downside protection. This will allow them to benefit from developments in the investment banking and fund management industries, using more sophisticated products for longer term wealth creation, but with better risk control.

Diversification, regular monitoring, rebalancing:

The different types of investment can be classified in terms of their volatility and their liquidity. There is no guarantee that more volatile assets will generate higher returns, but they would normally be expected to do so, in order to compensate investors for the ‘risk’ of volatile performance. However, this risk can be on the downside, as well as the upside, which can cause problems for investors who rely too much on any one asset class. If focussing on only low volatility and highly liquid assets, the investor may be sacrificing long term returns and therefore will have less potential to build wealth. However, relying only on high volatility and less liquid assets could mean that accumulated wealth will be vulnerable, at particular points in time, if these more volatile assets are experiencing a period of negative returns. The chart below gives an indication of where the different types of assets might be thought to fall on the volatility and liquidity spectrum (this is just an indication). More cautious investors and those who may need to draw on their wealth, should hold more assets from the bottom right hand corner, but should not ignore the other assets, whereas investors who are interested in maximising their wealth potential over time will probably have higher weightings in assets from the top left of the diagram, but should still hold less volatile assets too.


Private Equity
Individual Hedge Funds
High
Fund of Hedge Funds
Real Estate
International Equities
Volatility
Domestic Equities
Mutual Funds
Corporate Bonds
Low
Government Bonds
Cash
Low
High
Liquidity

Conclusion:

The traditional approach to life-cycle investing is too simplistic. Developments in financial markets and products now allow individuals to benefit from modern techniques which use multi-period hedging, swaps and options, to identify more optimal portfolios to deliver consistent returns and build wealth more reliably over the life-cycle. Investors have learned that relying on equities, even when young, entails too much volatility and a broader spread of assets is required at all phases of the life-cycle. Diversification, together with regular monitoring and rebalancing are key to long term investment success for most investors. A broad spread of holdings and a variety of assets – including equities, fixed income, property and alternative assets such as hedge funds and private equity – is usually best at all stages of the lifecycle. As particular assets appreciate in price, portfolios should be monitored and rebalanced, so that profits are locked in and assets which are out of favour can be bought more cheaply. This, combined perhaps with derivative products for downside protection, represents a superior approach to building wealth, rather than reliance on traditional portfolios. Investors in their 30's and 40's are now able to use sophisticated techniques to construct portfolios which will be expected to generate capital growth over time, with less volatility than the standard traditional approaches of relying on equities when young and then moving to fixed income assets in later life.