



Your investment strategy is often the most important decision you will make as an investor. Having made it, it is also important to keep it under review and to change it as your investment needs change. In most cases, as you get closer to when you will spend your money you should think about reducing the volatility and minimising the chance of a negative return. A low or negative return in the years immediately prior to when you will spend money can have a significant impact on the money available to spend.

Over the last 30 years, NZ shares performed better than bonds after-tax. About 1% a year better, on average. The average returns from NZ bonds and NZ shares were:

| | 30-year average ¹ (after-tax) |
|-----------|---|
| NZ bonds | 7.1% p.a. |
| NZ shares | 8.1% p.a. |

Therefore, if you had saved \$1,000 each year for the last 30 years (i.e. \$30,000 in total) and you earned the average return each year (i.e. 7.1%/8.1%), your accumulated balances would have been:

| | Accumulated balance |
|-----------|---------------------|
| NZ bonds | \$100,409 |
| NZ shares | \$121,167 |

The 1% a year higher return from shares was worth about \$20,000 or 20%. However, these are not the balances an investor would have received. This is because an actual investor earns the individual year-by-year returns.

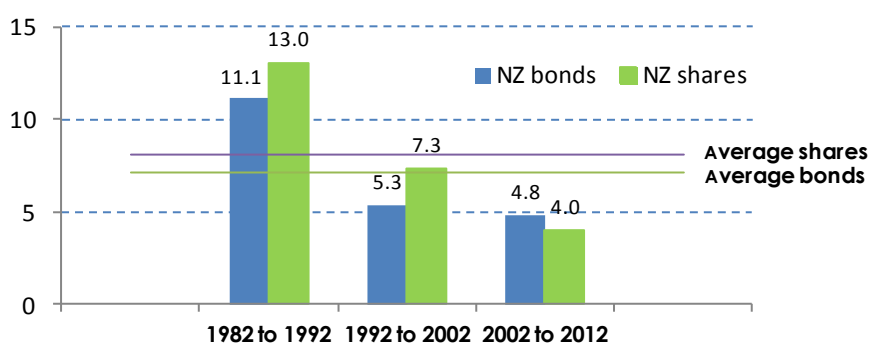
Using the actual individual year-by-year returns and not just the average return, the position was:

| | Accumulated balance |
|-----------|---------------------|
| NZ bonds | \$83,098 |
| NZ shares | \$75,381 |

The reality for an investor was that, shares underperformed bonds and both underperformed what was expected on average. Therefore, understanding the pattern of the returns and what different patterns can do to your savings is important.

When the bonds and share returns are looked at over shorter periods (e.g. over ten years), we see that shares were higher than bonds at the start of the period and lower than bonds at the end. In fact, shares outperformed bonds in the first 20 years (by about 2% a year) but underperformed bonds in the last 10 years (by about 1% a year).

Chart 1



The actual balances for an investor were less than the balances expected because, relative to the average returns (of 7.1%/8.1%), the actual returns were significantly higher at the start of the 30 years and lower at the end of the 30 years (see Chart 1). Where the returns were higher, less of the \$30,000 was invested. When the returns were lower, most of the \$30,000 was invested. This highlights that the returns over the last ten years are important and can have a big impact on the total savings. In this case it was a negative impact.

To further illustrate the importance of the pattern of returns, assume that the returns over the last 30 years had occurred in the reverse order. Assume, the return earned in 1982 was earned in 2011 and vice versa. The return earned in 1983 was earned in 2010 etc. The average is still the same, but now the low returns would have been at the start and the higher returns at the end. In this case the accumulated balances are:

| | Accumulated balance |
|-----------|---------------------|
| NZ bonds | \$117,178 |
| NZ shares | \$190,556 |

Your retirement would look a lot different if you had \$190,556 to spend as opposed to \$75,381. Same investment (\$30,000), same period (1982 to 2011), same returns, but a different pattern of returns.

This reinforces the concept that the returns in the 10 years before retirement typically dominate the final result (whether good or bad), as these returns apply when most of the money (i.e. the \$30,000) has been invested. Avoiding low returns matters most, when you are near to spending your money. As you approach the time when you will spend your savings, it is often better to be in a less volatile investment.

It is unusual for shares to return less in dollars than bonds after such a long period of time but it can and does happen. It happens, not because the bonds outperformed shares on average (they did not in the last 30 years), but because bonds outperformed shares in the years immediately prior to the end of the period. During the last ten years it also did not help that share returns were also negative. As we never know what the future returns will be from bonds and shares, we need to make the investment strategy decisions between bonds and shares based on principles and the nature of the risks we are happy to be exposed to.

The last 30 years' experience reinforces the message that when you are saving, the returns that matter most are often the returns in the most recent years, i.e. immediately prior to when you will spend your money. As you approach this period it is important to review your investment strategy. It also highlights the principles of the need to have discipline to sell investments based on need for increased certainty and not hold on to them in the hope of a higher return. It is better to buy low and sell high and accept that the future return could be lower.

Buy low sell high

Reducing risk is particularly important when the recent returns have been above average. But this is the time when it is harder for many investors to do, as it means that you are selling assets that have been doing well and buying assets that have not done so well.

Reducing risk also reduces the expected return

It should also be remembered that by reducing the chance of a low or negative return, you also reduce the opportunity to earn a higher return. Reducing risk increases the certainty that you will get a positive return. However, we think it is better to set the mix of cash, bonds, property and shares based on your need for the level of certainty in your returns (and when you will spend money) and not based on recent returns, or the hope for high returns.

Savings versus ultimate benefit

Using the last 30 years' returns and investing \$1,000 a year, Chart 2 shows the split of your ultimate savings (i.e. 100%) at different points between what has been saved (past savings) and what will be saved (future savings). Early in the period, most of your wealth comes from your future savings. In the early years, a negative return has a small impact on your ultimate savings and if it occurs, there is time to recover. In the latter years, most of your wealth comes from your existing savings. A negative return has a large impact and there is no time to recover. As your ultimate wealth becomes more influenced by your accumulated wealth, the exposure to volatile assets should probably reduce. This should probably happen when your current savings represent more than 80% to 90% of the expected total.

Chart 2



Conclusions

When we look at the investment experience over the last 30 years, there are some valuable lessons:

- if high returns occur early in your saving period, it feels good and gives confidence for the future, but the impact is small, as you have saved very little;
- if low returns occur early in the period, the negative impact is also small and there is plenty of time to recover. We therefore need to learn to resist the temptation to panic;
- if low or negative returns occur in the period just before you will spend your savings, the impact can be significant as the low returns apply to most of your savings and there is no time for recovery. Most investors cannot afford to take this risk. It highlights that you should only be invested in shares if you can wait 10 to 12 years before you will spend the money, should the markets go down.

As we approach retirement therefore, we should consider the need to reduce the exposure to shares and increase bonds. For some investors, this is best done automatically (as otherwise, it will not happen) and should be done gradually over time. For others, it is best to make a judgement call as to timing each year, recognising that no one knows what will happen in the next 10 years.

¹ The analysis in this Update uses data for the last 30 years (1 January 1982 to 1 January 2012). We have adjusted the gross returns for tax at a flat rate of 33% to reflect the "average" tax rate over the period. The data is used to illustrate the differences that arise from ignoring tax and ignoring the cash flows.

The legal stuff

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