Ninety One

Previously Investec Asset Management

The importance of active management for living annuity investors

Jaco Van Tonder
Advisor Services Director

This article is the fourth in our series[1] on how to manage a living annuity to provide an inflation-proof income over a period of 30 years.

We quantify the extent to which an active fund manager can add value to a living annuity portfolio, specifically by managing the portfolio in a way that improves the probability of that annuity delivering a 30-year inflation-proof income. This article builds on the key learnings from the first three articles in our series, exploring the relationship between a reduction in portfolio volatility and an increase in the sustainable income from a living annuity.

From our research, using index return data going back to 1900,[2] we make a key conclusion: While real returns matter to living annuity investors (as they would to any investor), most living annuity investors underestimate the extent to which lower volatility portfolios make a meaningful difference to the long-term health of their living annuity.

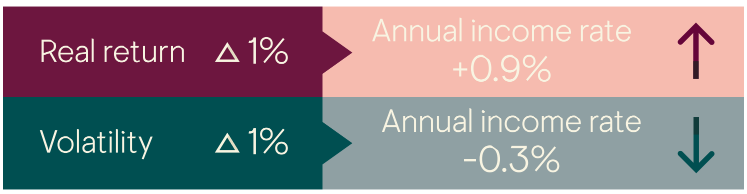
Volatility is an important driver of living annuity success.

Reviewing the impact of real return and volatility on sustainable incomes

In our first article[1] we established the following relationships between a living annuity's maximum sustainable income rate and the real return and volatility of the underlying investment portfolio:

If the long-term real return in the portfolio changes by 1% p.a., the sustainable annual income rate for the living annuity changes by 0.9% p.a.

If the long-term volatility[2] of the portfolio increases by 1%, the sustainable annual income rate for the living annuity reduces by 0.3% p.a.



1. Managing retirement income.
2. Defined as the standard deviation of the annual real returns.

These results concluded that volatility was an important driver of living annuity success, because high volatility magnifies the impact of sequence of return risk on a pensioner (i.e. the impact of retiring in a bear market as opposed to a bull market).

We then briefly highlighted how investments that beat their benchmarks on both performance as well as volatility improves the chances of success of a living annuity strategy, using the performance histories of some ASISA category[1] averages and the Opportunity Fund. Let's take a closer look at the power of this return-volatility combination.

Table 1 reflects results from our living annuity modelling engine.[3] The table sets out the maximum sustainable initial income rate for a living annuity (subject to a 10% probability of failure and an investment term of 30 years) for portfolios comprising different combinations of real return and volatility.

Table 1: Maximum sustainable initial annuity income rates for different combinations of portfolio real return and volatility

Volatility of real returns p.a.	Portfolio return					
	CPI + 4%	CPI + 5%	CPI + 6%	CPI + 7%	CPI + 8%	CPI + 9%
8%	3.6%	4.5%	5.4%	6.3%	7.2%	8.1%
9%	3.3%	4.2%	5.1%	6.0%	6.9%	7.8%
10%	3.1%	4.0%	4.9%	5.8%	6.8%	7.5%
11%	2.8%	3.7%	4.6%	5.6%	6.5%	7.2%
12%	2.5%	3.4%	4.4%	5.3%	6.2%	6.9%
13%	2.2%	3.1%	4.1%	5.0%	5.9%	6.6%
14%	1.9%	2.8%	3.8%	4.7%	5.6%	6.3%

Source: Ninety One, in-house model.

The table highlights how a living annuity investor can benefit from a combination of:

A high real return

A low volatility

Applying the return-volatility table to actual examples

In our first article we investigated the impact of volatility using the Opportunity Fund, a number of other funds and industry sector averages. Analysing the performance and volatility data of these investments over the 20 years from 1 January 1999 to 31 December 2018[4] we obtain the following results:

— The Median Multi-Asset High Equity unit trust fund delivered a return of CPI + 7.2% p.a., at an annualised volatility of 10.9%, over this period.

— The Opportunity Fund delivered a return of CPI + 8.4% p.a. with an annualised volatility of 9% over this period.

— One of the poorer performing funds in the Multi-Asset High Equity sector (Fund Z) delivered a return of CPI + 6.7% p.a. and an annualised volatility of 11% over this period.

3. See Appendix at www.ninetyone.com for a brief description of the model and its assumptions.

Plugging the performance and volatility numbers of these three investment options into Table 1, gives us maximum starting incomes which these different investment portfolios would have been able to support over a thirty-year period, as shown in Table 2.

Table 2: Combined impact of volatility and real return on income rates

Portfolio	Real return	Annualised volatility	Max sustainable starting income
Fund Z	6.7%	11%	5.1%
MA High Equity Median	7.2%	10.9%	5.6%
Opportunity Fund	8.4%	9%	7.3%

Source: Morningstar and Ninety One, as at 31.12.18.[5]

Table 2 highlights how incredibly sensitive a living annuity's sustainable income rates are to the quality of the investment portfolio. If a pensioner invested for 20 years with an underperforming manager, their sustainable income would be 10% lower than if they had invested with an average manager. A poor performing manager poses a bigger risk for living annuity investors than other investors, because managers who underperform over long periods of time often also exhibit higher volatility signatures. This represents a double blow to living annuity investors, as Table 2 shows.

Conclusion

Living annuities present a unique challenge to financial advisors. Due to the combined impact of volatility and real return on a living annuity's prospects of success, financial advisors need to pay close attention to the likely 'volatility alpha' of their active managers, in addition to the expected 'return alpha'.

Financial advisors should seek out active managers who can deliver on both 'return alpha' as well as 'volatility alpha'. Identifying such fund managers arguably represents the biggest potential improvement to a living annuity's maximum sustainable income rate.

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4. Source: Morningstar
5. Monthly returns are used as input into our in-house living annuity modelling tool to calculate the maximum sustainable starting income. Performance figures are based on lump sum investments, NAV based, inclusive of all management fees, but excluding any initial charges, gross income reinvested. Investment performance is for illustrative purposes only to show the volatility and real return impact. The returns for the Opportunity Fund are based on the combination of class A and R performance which were the most expensive classes over the period. R class inception date: 02.05.97 and A class inception date: 02.04.00. CPI inflation lags by one month. TER of the Opportunity Fund (A) class is 1.50%, and highest and lowest 12-month rolling returns since inception is 43.8% (31.07.05) and -15.7% (28.02.09), respectively.

Important information

Contact Information

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Alternatively, please contact your Ninety One investment consultant.

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