Sequencing of Risk Return

Video transcript - featuring Vince Smith-Hughes, Head of Business Development, Prudential

00:00:01:20	Sequencing of return risk.
00:00:03:22	The main risk of investment is generally well-known. Investing for long term growth means investing in real assets. Which of course brings with it market volatility and potentially losing value at any given point.
00:00:17:07	One that's not so immediately obvious though is *sequencing of return risk* - as the FCA and others have called it.
00:00:25:22	Well, what is this?
00:00:27:09	It's effectively, that when income is being taken the order returns are delivered in, can significantly impact the future value of the fund. Even if the returns are identical but delivered in a different order.
00:00:40:18	This might happen where units have been en-cashed to provide an income as potentially is the case for income drawdown or an investment bond paying income.
00:00:50:16	Let's look an example to prove the point.
	Here, £275,000 is invested over six years and the returns from Portfolio A, B and C are as follows:-
00:01:02:10	What you'll note from the table is that the percentage returns of the three portfolios A, B and C, are the same numbers albeit arranged differently.
00:01:10:21	Here's the results if no income is taken: The colors of red amber and green represent the worst, medium and best result over a given period. As no income is being taken after six years, the values are the same despite fluctuations over the six year period.
00:01:28:04	But when we introduced 'income taken' it's a different story. The values continue to fluctuate but the end result is vastly different. Here's that same investment but with £1,500 per month income.
00:01:42:08	Well why is this?
00:01:44:01	Let's look at portfolio B as an example.
00:01:46:21	This highlights the risk that with poor performance in the first
three years,	
	losses via income being taken are effectively being crystallised and are thus never recovered over the time period.

00:01:57:19	By contrast portfolio A has the best start and therefore gains rather than losses have been crystallised, so the end number is much better.
00:02:04:22	Portfolio C sits in the middle.
00:02:07:13	So what methods can an adviser adopt to counteract this risk?
00:02:10:22	Well, there are several strategies. Let's look at the first example.
00:02:15:14	It might be that our adviser uses the cash fund to pay income in the short term. Typically these funds don't fall in value. And so there is no sequencing of return risk.
00:02:24:21	However, one problem here is that deposit rates are very low at the moment and in some cases almost non-existent. This means that though there is no fall in value for money earmarked for withdrawals sitting in cash, there is no growth either.
00:02:38:15	Let's look at another example.
00:02:40:12	The second method here is what has become known as the *bucket approach*.
00:02:44:15	The premise of this is that the fund is divided into a series of buckets invested according to when the client may need the income. So, used in conjunction with the first method you may have cash in the short term bucket and then perhaps two or three more buckets intended to provide income at points in the future.
00:03:01:21	The general principle is that the longer until income is needed to be drawn from the individual bucket, the more aggressive and thus more potential for growth there is.
00:03:10:13	This can work well but still has a problem of low returns on the cash element and also of course there is no guarantee of the other buckets providing the right performance for the ear marked time period.
00:03:22:09	A variation on this theme though could be that a longer term bucket is promoted to pay income earlier than expected. If it has performed well. Let's look at another example.
00:03:33:05	Another method is taking natural income. This involves bond dividend or rental income generated by a portfolio, becoming the client's income.

	This enables the investor to avoid drawing on their capital or selling fund units, thus avoiding sequencing risk. However, this approach is also not without drawbacks. Even if the yield is stable in percentage terms. When applied to the capital value, it is likely to fluctuate. This means that the investors income will fluctuate from year to year.
00:04:05:00	*Are your clients comfortable with a volatile income*?
00:04:08:11	This may not work, if for example a retiree needing to budget around a particular income requirement. This can often make this particular strategy unattractive in isolation for all but the relatively wealthy.
00:04:21:12	Of course, the investor could top up their income by cashing in units, but then your back to the main problem that this is trying to avoid of cashing in units at the wrong time.
00:04:32:14	Let's look at another example.
00:04:34:10	The final method is the one of a multi asset smooth fund.
00:04:38:16	The Fund can be invested in a wide range of different assets. This in itself providing an element of consistency of return. A smoothing mechanism is also applied to the fund, meaning that the unit price is only adjusted if the underlying value goes outside of set parameters.
00:04:55:08	Otherwise, the fund will grow by an expected growth rate which can also help give investors an idea of their expected outcome.
00:05:02:00	Typically these funds remove some of the day to day volatility that an investor in real assets would normally expect to see. These however also have drawbacks. For example the fund could perform poorly over time, or it may be that there is an adjustment to the value relatively soon after the investment because of a market correction.
00:05:23:01	Finally, one important point to mention is that none of these strategies are mutually exclusive.
00:05:28:16	It might be, that two or more are used for the same client in order to give them the level of certainty they need and ensure their capacity for loss is not breached.
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