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Thought leaders in decumulation

Article 1.

Accumulation vs. Decumulation investment portfolios

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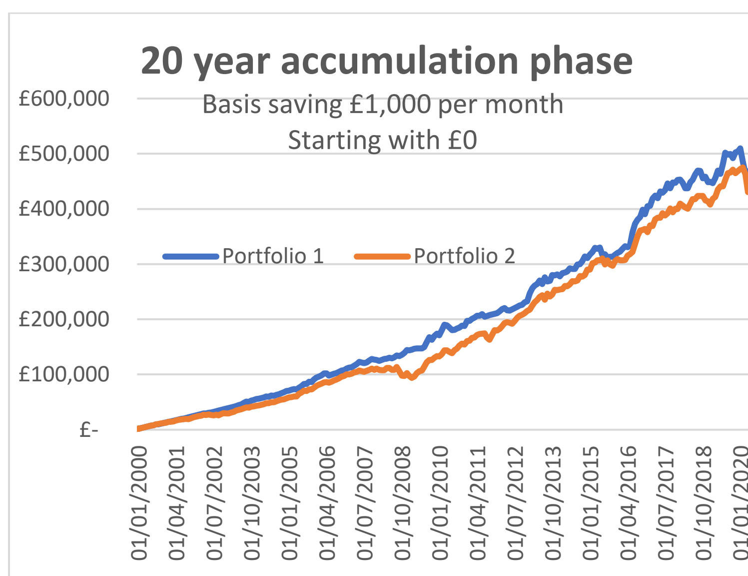
Accumulation vs. Decumulation Investment Portfolios

"Decumulation strategies are still in their infancy. There is a danger that accumulation carries on into decumulation. I am not sure there has been enough thought put into a wide enough range of decumulation solutions." Sam Liddle, Church House Investment Management. October 2020.

To illustrate the problem, consider the following example of two independently constructed, mixed asset growth portfolios. Both are widely available in the market today.

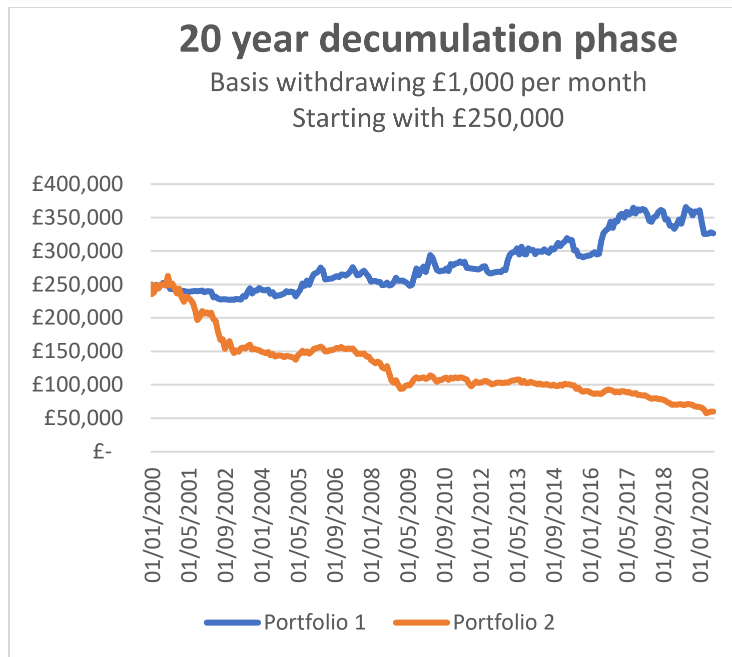
In the accumulation phase, £1,000 a month was invested into both portfolios for 20 years, starting on 1st January 2000 and ending 20 years later.



Source: Whole Money Ltd

The investment outcome, when realised in 2020, was almost identical from both investments.

In the decumulation phase, £1,000 a month was withdrawn from the same two portfolios over the same period, but the outcomes were very different.



Source: Whole Money Ltd

Sequence risk, the risk of suffering a series of poor annual returns while in decumulation, is the culprit.

Portfolio 2 suffered from the equity market losses associated with the dot-com bubble in 2001 and again from the great financial crisis of 2008. Due to capital depletion and the crystallisation of losses (from the need to withdraw funds annually) Portfolio 2 was never able to recover.

Portfolio 1 had a similar asset allocation but additionally included a strategy designed to mitigate sequence risk.

New developments

Renowned management thinker Peter Drucker is often quoted as saying that "you can't manage what you can't measure."

Fortunately, academics recently developed a way to scientifically measure the sequence risk associated with any given asset allocation. Armed with this new metric, existing portfolios can be rated by the likelihood of their suffering from sequence risk and new and better decumulation products can be developed.

Professors at Cass Business School have extensively researched the impact of sequence risk in decumulation and how it may be mitigated.

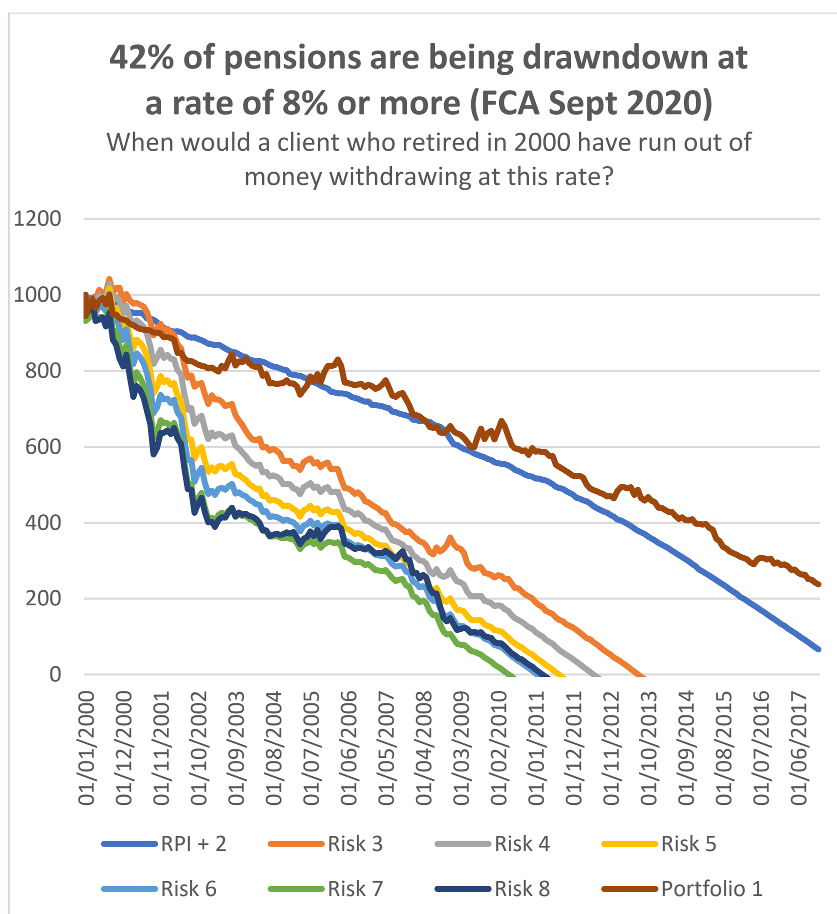
They have analysed target date funds, cash 'buckets', buying put option protection and varying allocations to stocks and bonds.

Their definitive conclusion after studying over 100 years of equity, fixed income and commodity price return data is that by switching systematically between equity exposure and cash, the worst instances of sequence can may be mitigated, as employed by Portfolio 2.

Risk in decumulation

The requirement to 'risk profile' clients for their attitude to risk and their capacity for loss results in accumulation strategies being offered based on portfolio volatility. This approach has been naturally extended into decumulation, but volatility is only incidentally related to risk when in decumulation.

As shown below, the exhaustion date of various volatility risk rated portfolios were not significantly different when drawn down at a rate of 8% starting in 2000. Only Portfolio 1 was still viable seventeen years later.



Source: Whole Money Ltd

The primary risk in decumulation is the risk of having to reduce withdrawals in the future to avoid exhausting a pension pot. This risk is directly related to the likelihood of, and the damage caused by, suffering large losses.

Let us consider how some promoted decumulation products have fared.

Lifestyle or Target Date Funds (TDFs)

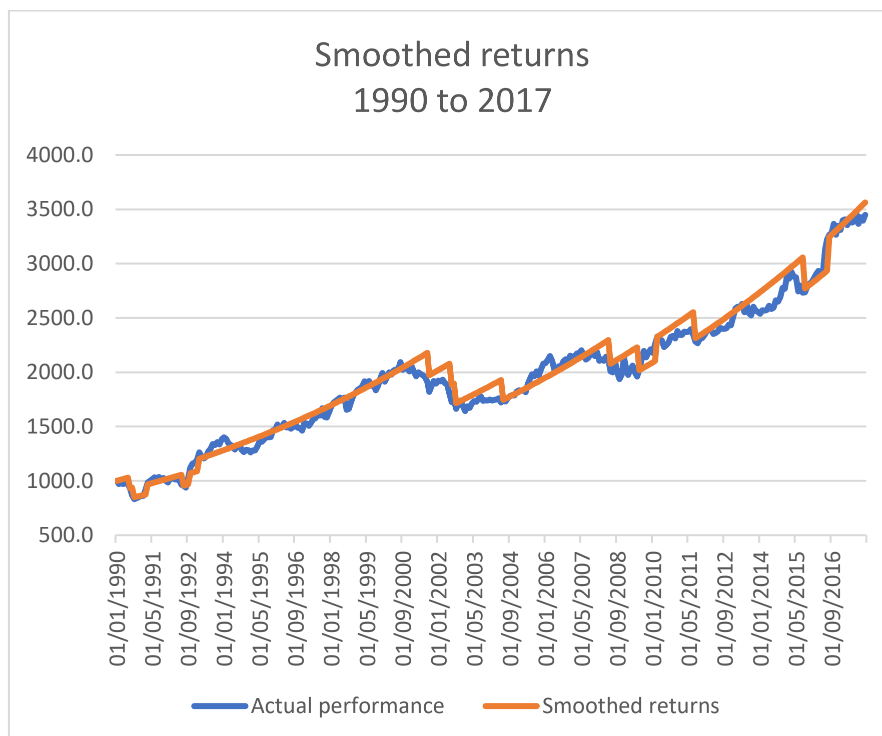
A particularly unfortunate and highly publicised example of sequence risk in action occurred in October 2009 when the three biggest TDFs in the United States lost around 30% of their value one year prior to the 2010 target date. So serious was the impact, Congressional and SEC hearings were held.

Clearly, this was not supposed to happen given the funds' de-risking approach. However, around the target date, these strategies still have around 50% exposure to equities, which once every 10 years or so can experience severe drawdowns of 40%–50%.

Smoothed equity returns

A popular drawdown investment has been into funds which 'smooth' returns, providing a published constant return, but only when they don't - and then have to reduce the value of a client's portfolio by 10% or so, to realign the published returns to the performance of the portfolio in reality.

Actual fund data is not publicly available prior to 2008, however a robust simulation of performance since 1990 shows periods in 2001 and 2008 particularly, when a series of 10% downward adjustments would have had to have been applied. This would be to the significant detriment of retirees just nearing or entering drawdown when the value of their pension pots was greatest.



Source: Whole Money Ltd

Each adviser will bring expert knowledge to help their clients navigate drawdown over what might be a 20 or 30-year planning horizon and diversification is, as always, an important consideration.

Sequence risk can now be measured, and new and innovative portfolios specifically designed to mitigate sequence risk are now available. These will provide more options for advisers with which to construct a suitable drawdown portfolio and so improve retirement outcomes for their clients.

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