Volatility, friend or foe?

David Hutchins explains how best to harness volatility to improve returns in defined contribution funds

It is no coincidence that, following the roller-coaster ride experienced by investors over the last decade, reducing the volatility of asset values has become a hot topic not just for defined benefit (DB) pension schemes but also their defined contribution (DC) equivalents. After all, auto enrolment is set to introduce millions of new savers to DC and, by extension, to the ups and downs of investing in the stock market.

Many recent strategies have set out, as their investment objective, to provide similar returns to equities but with lower volatility. But does this always result in a better outcome? We believe the answer depends critically on cashflows, which are typically very different for a new DC investor than for a more mature DB scheme.

To illustrate this we looked at two possible investments, UK equities and a typical cash fund, between 1st January 2001 and 31st December 2010. This period neatly captures two market cycles, covering both the dot-com crash and the credit crunch.

Clearly, as Fig. 1 illustrates, an investor investing £12,000 at the beginning of the period and making no withdrawals or investments in the interim would have done no better investing in an equity portfolio than investing in cash. Indeed, they would have been worse off to the tune of some £200, whilst being subject to a somewhat unsettling journey. In round terms, the average return on the money invested over the period was 3.7% per annum in either portfolio. This is not dissimilar to what an investor in a mature DB scheme might have experienced.

As Fig. 2 illustrates, the experience of an investor who started with nothing and invested £12,000 over the period in equal monthly instalments of £100 per month (similar to that of a young DC investor) would have been somewhat different. In this scenario the equity investor would have ended up some 25% better off, or around £3,400 – equivalent to nearly three years' worth of additional contributions.

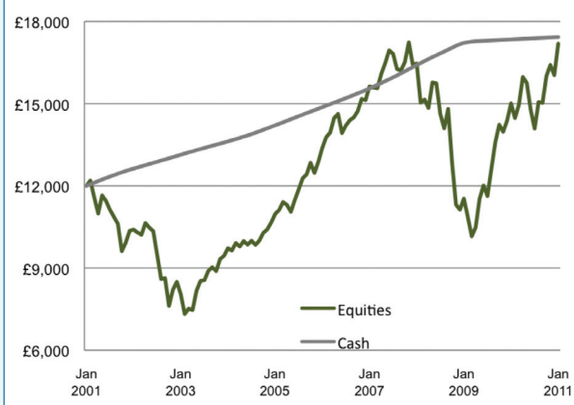
Thus, for our young DC investor, the average return on the money invested would have been 3.2% per annum for cash or 7.5% per annum for equities, a premium for the latter in excess of 4% per annum. Whilst the journey would not have been without its downs, the investor would have clearly benefited from good old-fashioned pound-cost averaging.

Unfortunately, the losses that equity investors experienced in 2002 and 2008 might have led to many pension savers bailing out of such a volatile equity strategy before benefiting from the subsequent recoveries. Clearly, if this is a possibility, action should be taken to manage such volatility. Management could take a number of forms: member communications explaining the benefits of volatility; the pursuit of a deliberately less risky, lower-returning, strategy; or the appointment of someone with the skill to actively manage volatility.

Whatever the case, as our two simple examples illustrate, volatility affects investors with different cashflow profiles very differently. As a result, investors with divergent cashflow profiles will not have the same needs when it comes to volatility management. Indeed, a perfectly-executed piece of volatility management, which might be ideal for more mature DB schemes where cash contributions broadly equal payments, could be quite detrimental to the outcome when applied to a young DC investor.

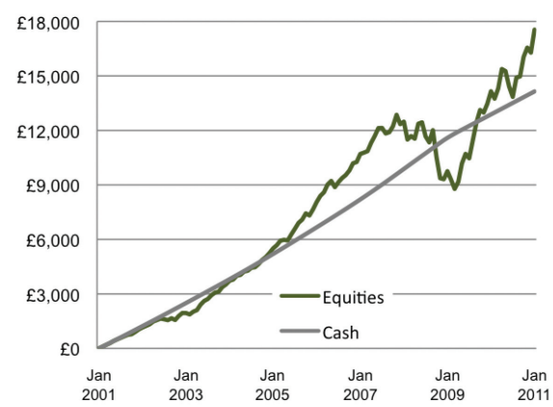
We think all this argues not only for the continued judicious use of riskier investments (such as equities) in pension saving, but also for an intelligent approach to volatility management. In other words, volatility in itself is not to be feared when harnessed effectively. ■

Fig.1: Investor investing £12,000 lump sum



As of 31 December, 2010. Source: AllianceBernstein. Historical information provided for illustrative purposes

Fig.2: Investor investing £100 per month



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