M&G Insights

M&G Investments

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Planning for different financial scenarios

Looking at different potential investment scenarios for you and your family is a great example of how thinking about the future can help you plan in the present.

Scenario planning requires you to look at different possible outcomes, test your assumptions, and prepare for potential adversities that could impact your financial goals. It is essentially making sure that you have a backup plan to achieve your investment outcomes in the event of unexpected changes to the investment climate.

In recognition of Money Smart Week South Africa, an initiative of the National Consumer Education Committee, we're focusing on three different types of financial scenarios for you to consider and possibly discuss with your financial adviser.

What is scenario planning?

Scenario planning is a thinking tool that makes it possible to identify and examine possible future scenarios or outcomes. It became part of the political and economic discourse in South Africa in the early 1990s, when it was used to debate different pathways to the country's future and where those might lead. One of the best-known examples of scenario planning was the Mont Fleur Scenarios exercise that took place in 1991-1992, a time of deep conflict and uncertainty in the country.

How it relates to your investments

Once again, the world, and South Africa, are in a period of deep uncertainty. Globally, concerns over rising inflation, increased interest rates and a slowdown in global economic growth have placed downward pressure on financial markets, sparking a plethora of possible knock-on effects. This makes planning and investing for your financial future even more challenging, given the broad range of possible outcomes. How do you invest now for an unknown future?
Just as the participants in the Mont Fleur Scenarios had to make certain assumptions when developing their scenarios, so your financial adviser will need to use certain assumptions when creating your financial plan. The primary factors concern the behaviour of interest rates, inflation and economic growth, all of which help determine investment returns across different asset classes.
Let's say your desired outcome is to have a financially secure retirement. Your adviser will most likely begin by asking you your current age and at what age you plan to retire (your investment horizon), and how much money you think you'll need in retirement as a proportion of your current salary (your income replacement ratio). He'll also ask you how much capital you already have saved, and how much you're able to add to this on a regular basis. Then he (or she) will create a forecast using the above assumptions, and others, and present it to you.

The problem is that these are simply assumptions that can change over time. Given the volatile nature of investment markets, and the amount of political, economic, and social uncertainty the world is experiencing, it's difficult to get these assumptions right. All of which makes it increasingly important to have a working plan for a range of possible scenarios.

The value of different scenarios

Looking at different future scenarios enables you to adjust your investment plan in the present. For example, let's say that you and your financial adviser look at three different scenarios – an aggressive scenario, a moderate scenario, and a conservative scenario. You can even give them catchy names! The Mont Fleur team developed four scenarios and named them *The Ostrich, The Lame Duck, Icarus, and Flight of the Flamingos.*

The aggressive scenario

In this scenario, you might plan for higher-than-average returns on your investment portfolio, driven in part by higher-than-expected growth in the economy (which can boost company earnings and dividends), higher interest rates (on your fixed income investments) or lower inflation. This, in turn, would enable you to invest less to reach your retirement capital goal and thus have more spending power in the present.

This scenario would be very favourable and mean that you either reach your investment goals quicker, you exceed them, or both. As it's a bullish scenario, it would also be appropriate to have a higher exposure to equities, such as the M&G Equity Fund, which invests in both local and global equities.

The moderate scenario
In this option you might simply stick to the average performance of different asset classes over the long term, and project that these same performances continue into the future. You would do the same for economic growth, inflation and interest rates. This is obviously a 'safer' scenario than the aggressive one in that it may be more likely to play out as you project it will. In this scenario, you might have less exposure to equities than in the aggressive scenario. As such, the M&G Balanced Fund could be a good choice to include in your portfolio.

The conservative scenario
Taking a conservative approach to your future investment scenario would mean forecasting lower-than-average investment returns and economic growth, and/or higher-than-expected inflation, known as "stagflation". The impact of these more bearish conditions on your financial plan would be that you either have to invest more than you currently are or invest for longer (increase your investment horizon) in order to reach your retirement income goals, which could mean retiring later, for example.

Giving you different investment pathways

This diversity of scenarios gives you a range of possible investment strategies for a given longer-term goal, from an indicative minimum monthly contribution amount under the most bullish scenario to a maximum contribution using the most bearish scenario. You can then feel more comfortable knowing how your investments are measuring up to the changing investment environment over time.

It's in the process

Often, the real value of scenario planning is the process itself, as it makes investors realise the future impact of their investment decisions today. For example, you can see what a difference investing just another R100 a month can make in reaching your investment outcomes, or the impact that small changes in the performance of your investments can make. In this way, scenario planning can help to overcome existing biases or preconceptions about investing and help direct your choices going forward.

Another real benefit is that investors can see the importance of having a financial plan. That's not to say that once you've structured a financial plan with your financial adviser, that you shouldn't revisit it from time to time. As your investment objectives change, so should your investment plan to reach those objectives. And even if there aren't any changes to your long-term goals, over time market movement could see your prescribed asset allocation needing to be rebalanced to bring it back to within your optimal allocation. Either way, reviewing your financial plan (or plans) from time to time is an important aspect of long-term investing. That way, you can always see if you're on track to meeting your investment goals, or if you need to make any adjustments.

For more information on investing with M&G Investments, please contact our Client Services Team on 0860 105 775 or email us at info@mandg.co.za.