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Table Talk: Is SA equity a “safer” option than cash?

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Q: Would it be safer to move more of my retirement savings from equity to cash until things settle in the markets?

A: When investing for retirement, it’s important to be cognisant of your investment goals and the investment term you have available to achieve them. There is no one-size-fits-all asset allocation for a retirement portfolio -- your exposure to growth assets (i.e. those assets like equities and listed property that can deliver inflation-beating growth over the long term) should be based specifically on these factors.

Asset allocation decisions for your retirement portfolio should not necessarily be based on looking for ‘safety’, but rather which combination of assets will be best placed to help you achieve your retirement goals in the time you have left to save. Think of it this way: each asset class has its own risk/return profile, and your aim should be to put together a portfolio with a combination of asset classes that creates an overall risk/return profile aimed at meeting your goals over time. Typically, the riskier the asset, the higher the potential returns an investor can achieve over the long term. While cash appears to be a “safer” option by providing more stable returns over the shorter term, you may be foregoing the potential upside provided by equity in helping to achieve your retirement goals..

Fight fear with facts

Fighting fear with facts can be a way to find the solution that is suited to your retirement needs. This is backed by the theory in behavioural finance, which is a field of study that provides insight into how emotional biases and cognitive errors may influence individuals’ perceptions and investment decisions. The theory challenges the assumptions that investors access all the relevant information when making investment decisions, and are making rational decisions based on those facts. It instead suggests that investors’ own biases influence their decisions and may therefore act irrationally. The science behind behavioural finance applies at any time, but it is particularly evident during periods of market uncertainty and volatility, which lead to investors’ emotions interfering more with their rational decision-making.

The cost of de-risking

ASISA data for SA unit trust investment flows shows a consistent long-term pattern for investors moving to lower-risk funds including more cash-type assets, at the expense of higher-risk equity and high-equity funds, during periods of heightened uncertainty. When investors de-risk like this in an attempt to avoid losses, it is normally only after they have already incurred those drawdowns, consequently “locking in” the losses. The biggest subsequent challenge is then trying to determine when to switch back out of cash and into higher-risk funds. This ‘re-risking” typically happens only after the market has rebounded with good returns, which by definition means the investor has missed out on gains from the rebound – often among the best gains for the year. As a result, switching out of growth assets or disinvesting when the markets are (already) down will negatively affect the long-term return potential of an investment portfolio.

Historical data shows that remaining consistently invested in growth assets means benefiting from the best days in the market, which ultimately will smooth out returns over time. Taking the patient approach is particularly necessary for retirement investing when there is a longer investment term (generally 30-40 years or more in a working career) for returns to smooth short-term market volatility over time.

Even at the point of retirement, the effects of de-risking can affect retirement outcomes. Recent research by M&G Investments on the largest LISPs in SA revealed retirees commonly opt for a more conservative portfolio at retirement compared to their earlier investments by de-risking from balanced funds to less risky solutions. They structure their post-retirement portfolio for lower future expected returns, which significantly increases the probability of them experiencing a retirement shortfall. While this might not be harmful for the rare retiree with ample savings to meet all their needs over the expected 20-30 years of retirement, sadly, the vast majority of South Africans retire with a big gap in their savings and can ill-afford to assume less risk once in retirement.

De-risking reduces potential returns over time

To quantify the impact of de-risking, we analysed the historic returns since inception of pre- and post- retirement books (in other words the underlying investments according to ASISA categories of retirement annuities [RAs] and living annuities [LAs]) of a few of South Africa's largest LISPs. In RAs, just over half (approximately 54%) of the investments were in multi-asset high-equity portfolios, but at the point of retirement, the allocation to these balanced funds in LAs effectively halves to only around 27%, moving to lower-risk categories such as multi-asset medium- and low-equity funds. Based on this data, our calculation revealed a total expected real return for the pre-retirement RA book of approximately 4.85% p.a. versus 4.05% p.a. for the LA book, which is a 0.8% p.a. difference in returns. This means that investors de-risk their portfolios at retirement at the cost of foregoing some 0.8% p.a. in investment returns. On face value, 0.8% p.a. may not sound like much, but when it is compounded over time, the effect over the long term is highly detrimental: over time retirees will deplete their retirement capital around 28 months earlier than the scenario where they did not de-risk. So, retirees who are worried about outliving their retirement savings shouldn't be afraid to keep a reasonable allocation to equities in their portfolios, such as that of a balanced fund, at up to 75%.

Make sure your manager adds alpha

Alpha (above-market returns), or the lack thereof, will naturally have a substantial impact on the retirement outcomes investors are able to enjoy, so the performance of your portfolio manager is important. Looking at an investment of R1 million into the M&G Balanced Fund 20 years ago, an investor would now have R11,102,274, which is a return of more than 7% p.a. (after fees) above inflation. For the M&G Inflation Plus Fund, the same R1 million would now be worth R7,234,049, a return of more than 5% p.a. (after fees) above inflation. In addition, these returns were produced with less volatility than an SA equity portfolio (using the JSE All Share Index as a proxy).

While nobody can control the markets, try to focus on what is within your control, such as fund selection and asset allocation. Targeting inflation-beating returns at lower levels of volatility can help you improve your possible retirement outcomes.

An investment case for SA equity

South Africa is faced with many political and economic challenges and investors may be seeking seemingly "safer" offshore equity options over their local equivalents. However, it's important to note that the majority of earnings on the JSE are sourced from outside of South Africa, and for this reason, SA equities may provide return prospects not dependent on local economic conditions.

Also, in our view, now is a good time to invest in SA equities. Based on the comparative valuations of global and SA equities, local equities are still offering better prospective returns over the next three to five years for the risks involved, and most of the risks have already been fully priced in. The latter is not true of US equities, in our view. This means that our multi-asset portfolios like the M&G Balanced and Inflation Plus Funds are overweight South African equities, while we are neutral in global equities, although select global equities are also attractive. These offshore assets also play critical roles as diversifiers in our portfolios.

Local assets remain cheap on both a relative and historic basis, offering excellent potential returns for patient investors. At the same time, growth prospects are gradually improving given the approach of the end of the long interest rate hiking cycle and declining inflation. Investors who have been favouring cash in the past two years would do well to consider moving into diversified funds that have stronger prospects of earning higher returns as the environment evolves. Investors continue to benefit from solid, inflation-beating returns from all M&G funds, and in our view, they remain well-positioned to take advantage of improving market sentiment.

Against the backdrop of the current local conditions, we note that while investor sentiment may favour the seemingly "safer" global options we remain committed to our long-proven investment process which indicates that the "safest" way to deliver excellent returns is to remain overweight in cheaper, attractively valued assets. Currently that means South African equities and bonds, and to selectively pick global assets as diversifiers in our portfolios. These views are reflected in the positioning of the M&G Balanced and Inflation Plus Funds, which have a strong track record of outperforming their benchmark and objective respectively over 20 years to end August 2023.

While we cannot control the markets, we can help manage investor behaviour when it comes to their investments by fighting fear with facts. Market fluctuations are a natural part of investing, and trying to avoid short-term losses by switching in and out of funds may affect your ability to reach your long-term investment objectives. A more prudent approach would be to remain invested in funds that offer consistent long-term returns.

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