A LONG-TERM VIEW FOR RETIREMENT FUND INVESTORS

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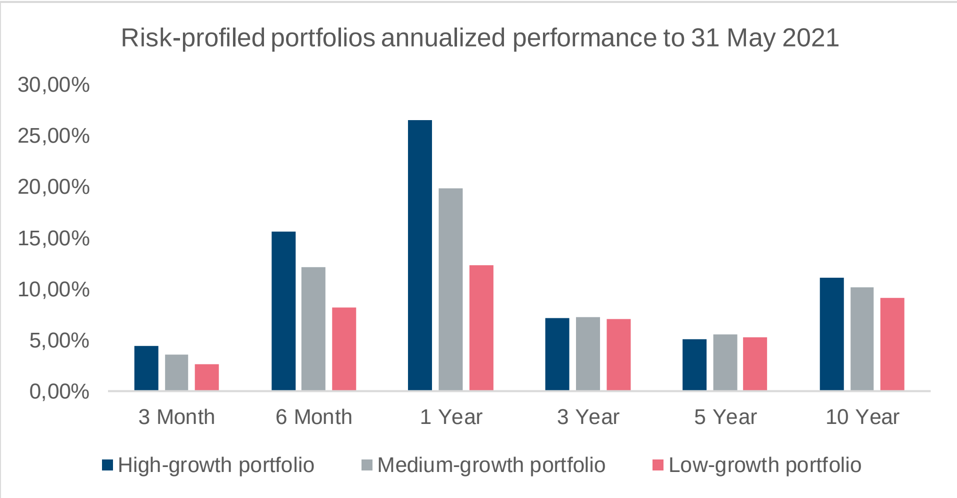
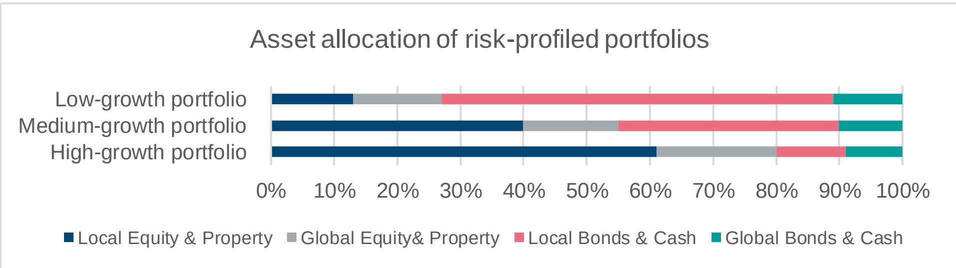
MENTENOVA

INTRODUCTION

With most JSE indices delivering returns of more than 30% over the past year, the short-term performance of high-growth portfolios, i.e. those portfolios with a high allocation to risk assets, has been welcomed by local investors. This past year has shown that those investors willing to maintain exposure to growth assets have the potential to be handsomely rewarded in certain market environments, with the strong performance of local and global equity markets adding significant value.

However, the 3-5 year, annualized performance of these high-growth portfolios has been less inspiring, with many of these producing similar returns to lower-growth portfolios. This is demonstrated in the charts to the right, leading investors to conclude that there has been little difference in the returns of portfolios across the risk spectrum over a 3- and 5-year period, and only a small difference over 10 years.

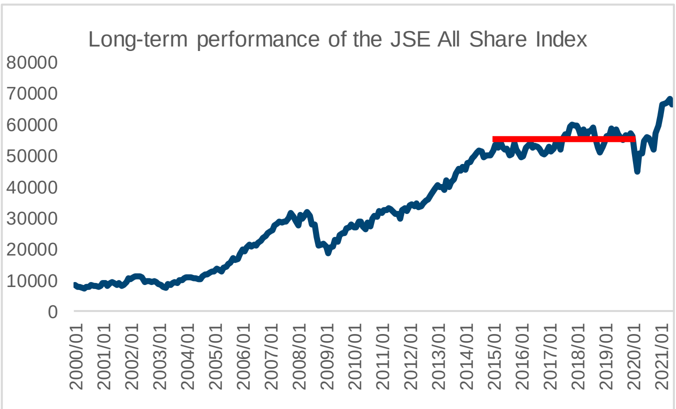




This begs the question: Do investors need to endure the volatility associated with investing in the equity markets and other risky assets to achieve their investment goals in retirement?

PERIOD OF POOR LOCAL EQUITY RETURNS DISTORTS LONG-TERM ANNUALIZED PERFORMANCE

While recent months have seen the JSE index climb to record highs, supported by flush global liquidity conditions and low valuations coming out of the COVID-19 market crash, an extended period of poor performance from local equities preceded this. In fact, between the start of 2015 and the start of 2020, the JSE All Share Index experienced little to no real growth (growth above inflation), with South Africa stuck in a business down cycle as the country's GDP growth rate averaged less than 1% over this period. While global equities fared better over this period, local institutional investors would have had a home bias in their portfolios, with the exposure to offshore equities limited by Regulation 28 guidelines.

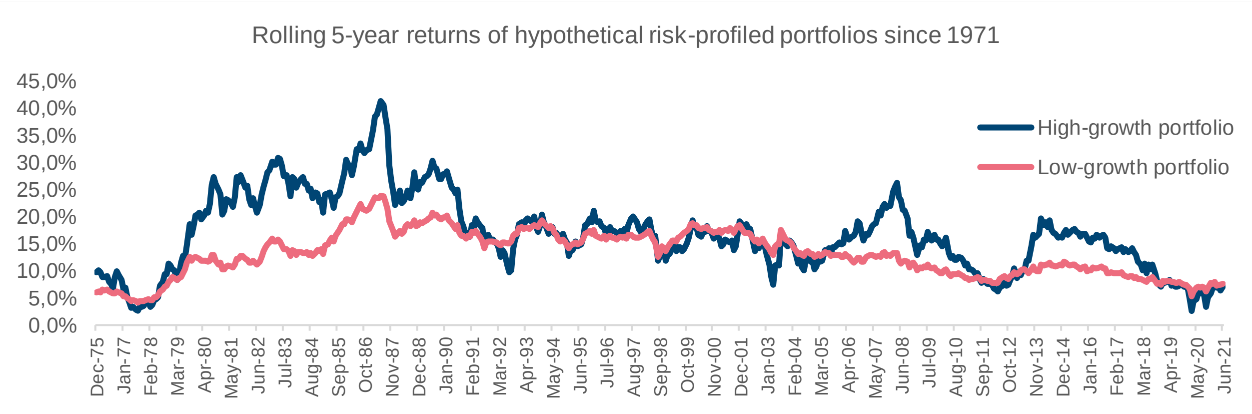


Source: Bloomberg

On the other hand, local bonds and cash produced returns between 7-8% over the 5 years between 2015 and 2020. It is against this backdrop that the returns of portfolios across the risk spectrum show little value add from additional exposure to equities over the 3- and 5-year annualized periods, and only a small value-add over the 10-year annualized period.

A LONG-TERM PERSPECTIVE

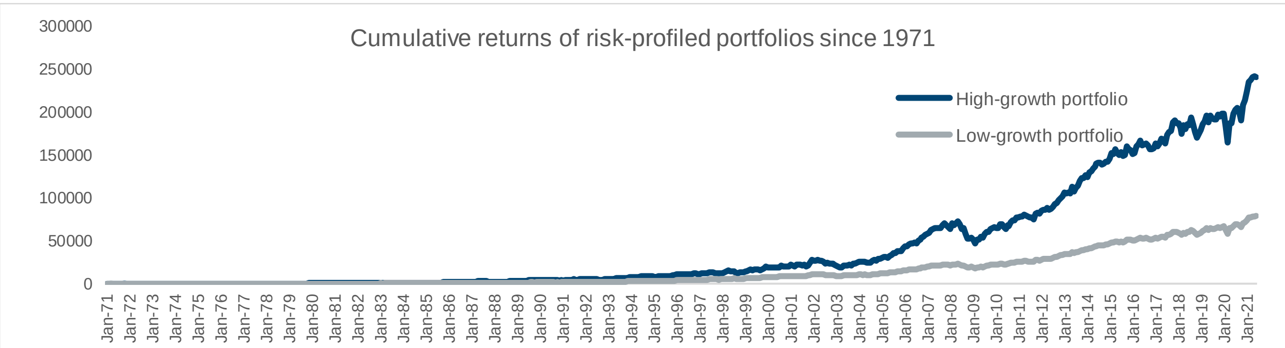
Stepping back in time gives us a better perspective of long-term asset class returns and allows us to answer the question of whether investors do in fact need exposure to growth assets to build their wealth. Investors expect to be consistently rewarded for taking on exposure to these assets; however, data going back to 1971 shows that the performance of risk-assets and, by extension, high-growth portfolios are non-linear. This is represented by the rolling 5-year returns of a hypothetical high-growth portfolio vs a low-growth portfolio over this period.



Source: Bloomberg, Mentenova

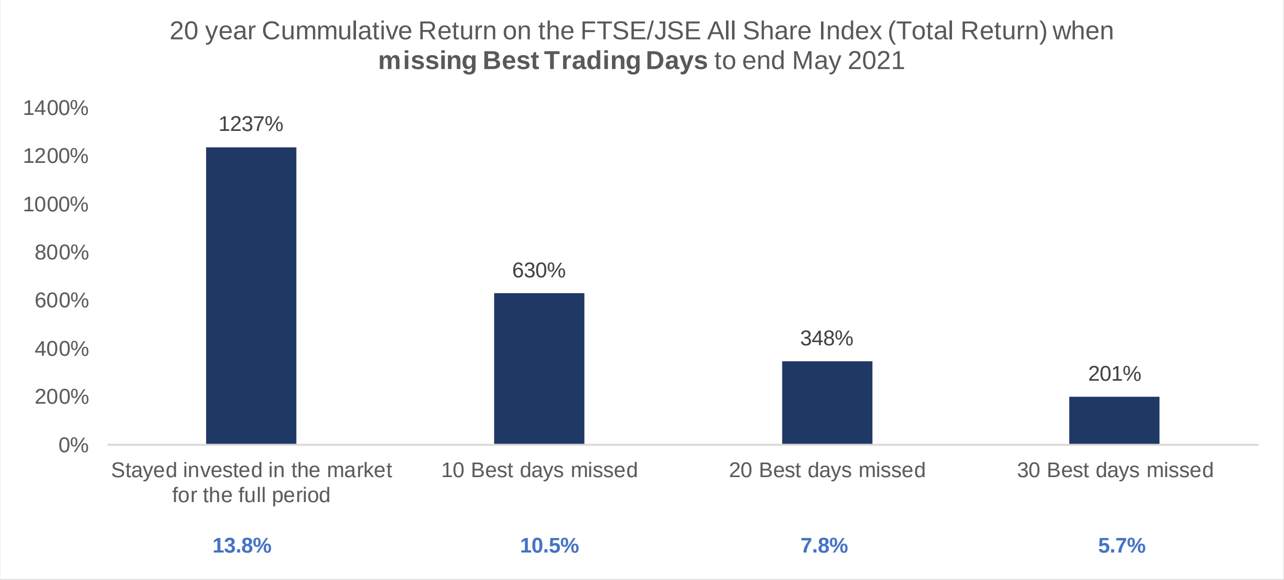
This clearly shows that growth from portfolios across the risk spectrum does not occur in a straight line, and can be prone to significant bouts of volatility along the way. This performance is closely correlated with the business and interest rate cycle. In other words, there are times in history when high-growth portfolios have underperformed low-growth portfolios, and vice versa, highlighting that the outperformance of risky assets tends to be rather bulky.

However, the compounding effect of the periods when high-growth portfolios do outperform has a significant impact on wealth generation, demonstrated by the cumulative returns of high vs. low-growth portfolios over time. In this example, R100 invested in the high-growth portfolio in 1971 would have grown to almost R240k today, compared to R80k in the low-growth portfolio. Staying the course and sticking to your diversified investment strategy over the long term, therefore, remains the best way to reach your goals.



Source: Bloomberg, Mentenova

While investing in growth assets means that investors need to accept a certain level of volatility in the short term, trying to time market movements can be very costly. This is especially true as history shows that the majority of the best days on the domestic stock market have occurred after bad news or during uncertain times. Missing out on just 10 of the best days on the stock market over the past 20 years would mean an investor would have earned a total return of 10.5% p.a. (or 630% in total) instead of 13.8% p.a. (or 1237% in total) had the investor just remained invested. Similar comparisons are shown below for missing out on a greater portion of the best days:



Source: Bloomberg, Mentenova

CONCLUSION

For a protracted period preceding 2020, local equities underperformed more defensive assets like local bonds, leading to convergent performance of multi-asset portfolios across the risk spectrum over the past 3-5 years. Although the strong performance of local and global equities over the past year has helped somewhat to close this gap, many investors are asking themselves whether it is necessary to have exposure to the equity markets and other risk assets when even the 10-year annualized performance of risk-profiled portfolios looks as similar as it does at this point in time.

Looking through a historical lens, the performance of asset classes through several business cycles gives us a good indication of the type of long-term returns we can expect from the various asset classes and drives home the importance of having sufficient exposure to risk assets over time. While providing the comfort of more stable returns, a too-conservative investment approach will result in your missing out on meaningful long-term growth. Sticking to your long-term investment strategy and remaining invested in a well-diversified portfolio continues to be the best way to achieve your goals in retirement.

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