Compounding
Why a low-volatility approach is so important

StatePlus

Formerly State Super Financial Services

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When you're approaching or entering retirement, you have different needs. StatePlus is a leading specialist in retirement investing. Our investing approach is tailored to meet your unique needs at this stage in your life.

Key points

- In retirement investors still need to take some investment risk. Otherwise, returns over the medium and longer term are unlikely to keep up with inflation.
- When investing for people in retirement, it makes sense to adopt a lower-risk approach to investing in shares.
- By reducing the impact of down-markets, investors are much more likely to achieve a better outcome over the medium and longer term. This effect demonstrates the benefit of compounding returns.

When you retire, you're likely to have many years of retirement ahead of you. So it's vital that your savings continue to grow in retirement. At StatePlus, we use a combination of shares and other types of assets in the 'growth' assets part of portfolios. The reason for this is to provide good returns above inflation over the medium and longer term.

But one characteristic of shares is their volatility, and the possibility that negative markets (drawdowns) can occur. For this reason, we target exposures to shares that are less volatile than the average.

By using this approach, we expect the investment outcomes to be smoother over time and this should reduce the impact of negative markets. What this means is, if you don't lose as much during a down-market, your portfolio will have less to make up when markets recover. This highly-beneficial effect is known as **compounding**.

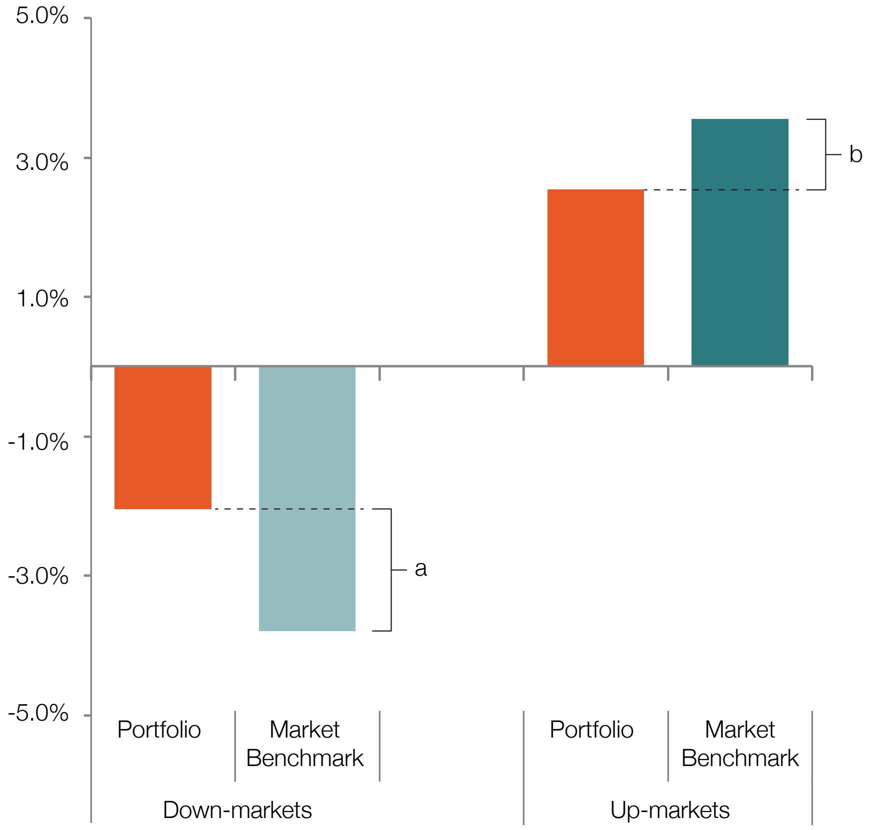
The examples on the following pages show how compounding works.

The power of compounding

Compounding – why a low-volatility approach is so important

Example 1 – Performance in rising and falling markets

This shows actual summarised data for one of our investment managers. This manager follows a low-volatility approach. The chart shows the actual monthly down-markets and up-markets of the international share market over the last 10 years. It compares how the market and the portfolio have performed on average in each of the rising and falling markets.



Source: StatePlus

Key points

- In down-markets, the portfolio tends to fall less than the market, that is, it outperforms the market (a).
- In rising markets, the portfolio will often lag the market slightly because of its more conservative approach (b).
- Importantly the extent of the outperformance in falling markets (a) is **greater** than the underperformance in up-markets (b). This effect has a powerful impact over time, leading to better compounding returns.

How managing volatility
can lead to better returns

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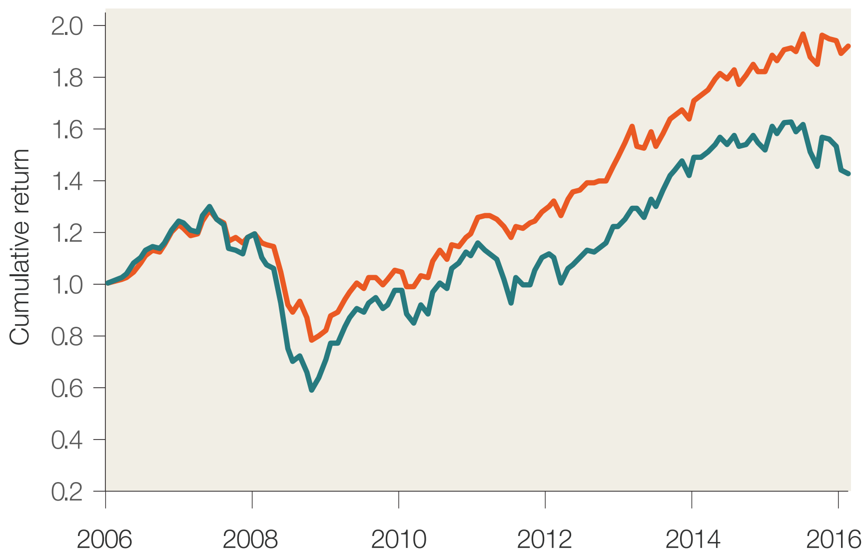
Example 2 – Cumulative compounded return

This example uses the same data from Example 1 and compares the cumulative investment return (i.e. the return over the whole period) of the same investment manager's portfolio with the overall market over the same period. It shows that over time, this portfolio reduced volatility by over 30% and improved compounded return by more than 30%.

This chart shows that over the 10-year period from 2006 to 2016, the manager's portfolio had a cumulative return of 90.4%, compared to the cumulative market (benchmark) return of 42.2%.



Source: StatePlus

Key points

- When markets are falling, the portfolio has performed better than the market average, even though both are negative.
- Over time the portfolio achieves superior growth.
- Over the 10 years (of actual data), this investment manager has **reduced monthly risk, or volatility, by over 30%.**
- It has **improved the actual compounded return by over 30%.**
- This clearly shows why using a low-volatility approach for managing shares should deliver an overall better outcome for your portfolio.

A smoother ride
over time

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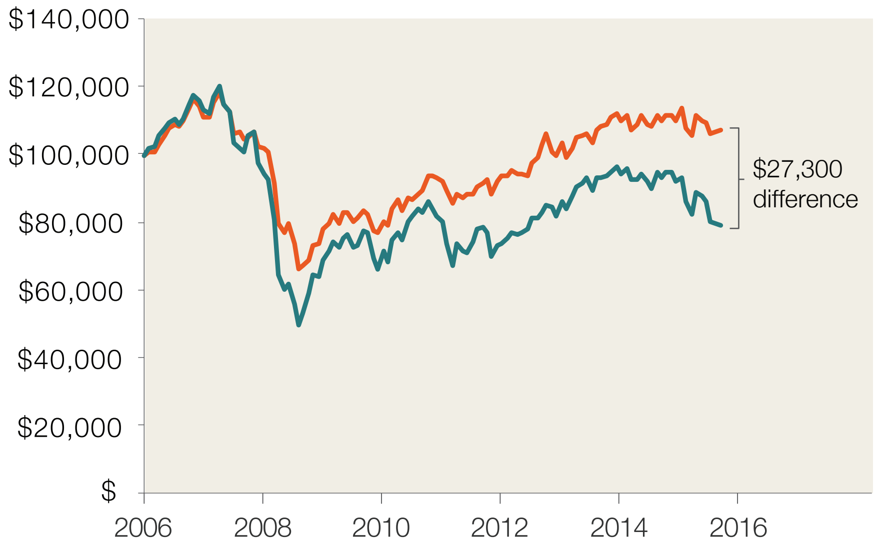
Example 3 – The value of Henry's $100,000 over time

Henry is a retiree who started with a sum of $100,000. He draws a constant 6% each year on a monthly basis, which works out at $6,000 in the first year. If Henry's assets had been invested with the same investment manager as shown above, he would have received a much better financial outcome with around $27,000 more at the end of the 10-year period than if he had been invested in the broader market.

The chart below shows that with a more stable investment, over time Henry benefits significantly from the reduced impact of drawing income during down markets. How is this so?

Henry's portfolio delivers a smoother return overall which benefits from a better compounding return over time. And over the medium and longer term, this results in a better financial outcome.



Source: StatePlus

Manager
Benchmark

For more information and to book an appointment contact StatePlus

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