Using wealth, not returns, to set objectives and measure success

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Views expressed here are those of the author, who is solely responsible for any errors and omissions.

Content:

Introduction

For asset owners that have liabilities to meet, whether they be pension or endowment funds, or a saver planning for retirement, one of the key questions they must answer is how much wealth they need to generate in order to at least meet those cash-flow requirements.

Traditionally, investment objectives and our success in achieving those objectives has been predominantly measured by looking at total returns – the general level of return averaged across the life of the fund in question. For example, a pension fund would need to achieve X% return over its expected life to have sufficient assets to meet its expected liabilities. For an individual saver, what level of assets is enough to ensure they have sufficient funds to live on once they retire?

It is becoming increasingly clear, however, that focussing on total returns is not sufficient. These questions may be better answered by looking in greater depth at the level of absolute wealth as a target consistent with a desired objective, and the impact of different paths of return on the likely level of that wealth during the accumulation and spending phases of a fund.

1. Wealth matters

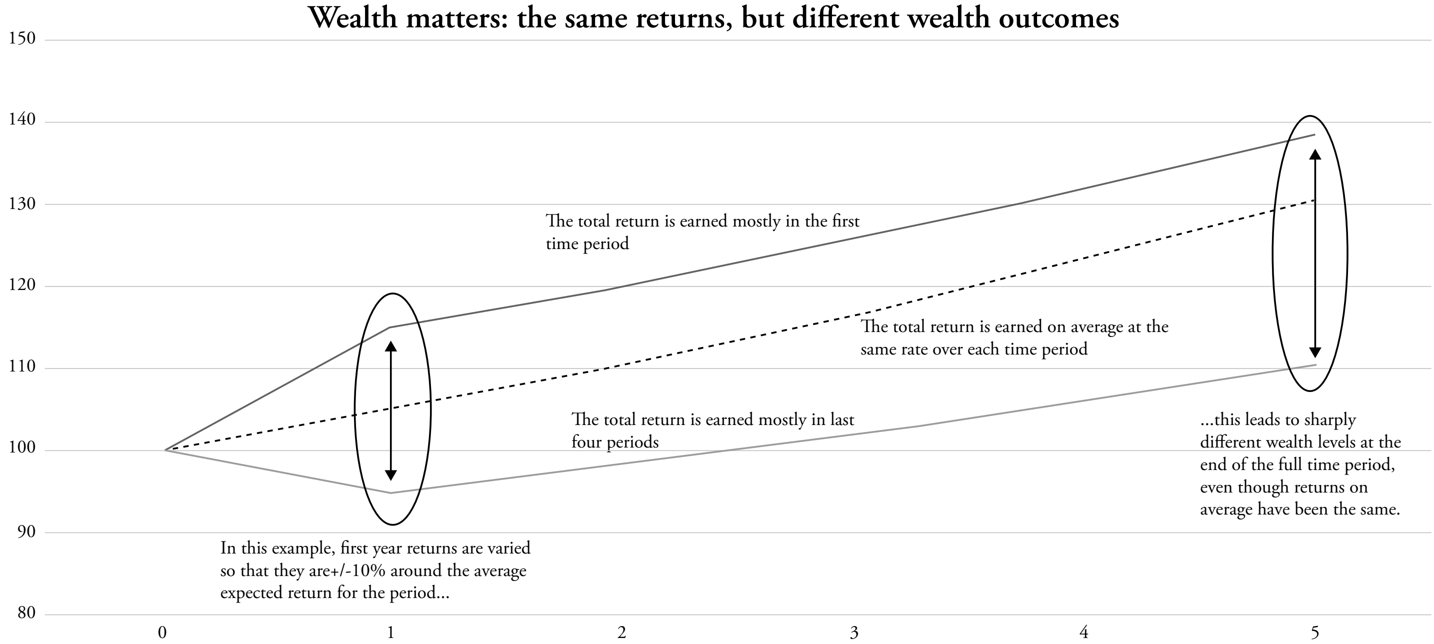
Although pension funds, sovereign wealth funds, endowments and individual savers are all very different in nature, they all share a common feature: their level of wealth will determine how well they achieve their objective. While that level of wealth is dependent on investment returns, focussing too much on those returns may lead to objectives not being achieved. The path those returns take is also a key consideration.

Consider, for example, a sovereign wealth fund that wishes to grow its assets in line with inflation to keep its real spending power stable over the next 10 years in order to pay for an expected project in the future. For simplicity, let's assume that this is a £1 billion fund with no expected inflows or outflows over the next decade and inflation will be 2% per annum over that period. The target wealth level is therefore £1.22 billion.

Now assume the fund is confident it can achieve a real 2% return over the 10-year term on average, but the pattern of those investment returns cannot actually be forecasted. There is a multitude of different paths those returns can take to achieve that real average return of 2%. Yet, those paths can result in very different outcomes for the fund.

For example, one path might be that returns are poor to begin with. On another returns are strong to be begin with. Although the average returns are the same across both scenarios, the total wealth they each generate is quite different because of the effects of compounding. A scenario where returns are poor to begin with will have less assets to grow once a period of strong returns arrives. The compounding effect is therefore less powerful than it would be for a fund that enjoys strong returns at the start of the period. See figure 1.

Figure 1



Now consider a closed defined benefit pension fund with assets of £1 billion that needs to pay its expected pensions over the next 10 years. It needs an average real required rate of return of 2% a year to do so. Assuming the fund has the same annual outflow over the next 10 years, there will be exactly the right amount of money to meet all its payments. Poor performance early on may result in the fund not being able to make the pension payments towards the end of its expected life as the strong performance years will be working on a smaller pot of assets. Strong returns early on may, by contrast, result in the fund having more money than it needed.

The message from these examples is that total returns are insufficient for the purposes of achieving the right objective and measuring how we meet that final objective. Overall wealth is a key metric for success, not just the amount of returns.

2. When do returns matter?

Returns do matter of course. They are what will deliver the required levels of wealth. So while they are not necessarily the right measure of success, they are important because they are used to judge the extent of the risk being taken in achieving an objective. Investment returns provide valuable information, but they do need to be seen within the context of a wider framework.

Judging investment returns needs to be done in the context of what we could reasonably expect those returns to be, which is a function of valuations and economic scenarios. Assessing how required returns may evolve across scenarios is an important risk control for achieving a wealth target. However, in assessing expected returns across scenarios and using them as a risk metric in this way, we should also ask ourselves, are we measuring the returns the right way?

3. Time-weighted and money-weighted returns

Typically, we measure investment returns across time, i.e. returns over given periods. We compare returns across time periods as well, such as the last 12 months versus the 12 months before that. This is useful, especially when analysing market trends.

However, when considering the impact of the market trends on the likelihood of achieving our objectives, we should also consider adding money-weighted returns to our list of measures. When we have explicit wealth targets and if we acknowledge that the path of returns may be important in considering how we achieve that target, weighting returns by the amount of wealth we have at the time may be a more useful measure of success.

For instance, consider a simple example of wanting to build a pot of assets over a five-year period, putting in £10 for each period and having this invested in the equity market. If we were told that we could have a guaranteed total return for sure, e.g. 8.5% annualised, but we were given the option of having that return in two patterns: one that had no returns until year five when we had a 50% return; and another that had 50% returns in year one, but no other returns thereafter, which would we opt for? The answer, given the fund is in an accumulation phase, should be the first, because this gives us more wealth as the large uplift at the end of the investment period is on a larger pot of assets.

This tells an important story for investors who are either accumulating or drawing down assets. For those in accumulation mode, higher returns are better at the end of the investment period. For those wanting to draw down assets, the reverse is true. This means that money-weighted returns matter more as an indicator of how much wealth is being created, or used up, through time.

4. Conclusion

Asset owners, whether pension funds or endowments, insurers, sovereign wealth funds or individual savers, rightly worry about expected future returns. They should also be aware of the paths of those returns when they face a net outflow of assets. Stating their objectives in terms of total wealth and measuring both the time- and money-weighted returns in achieving that wealth level, and using expected returns as a risk metric as well as a metric of success, is likely to lead to a better understanding of how to achieve their objectives and the risks involved.

The views and opinions expressed in this paper are those of Stefan Dunatov, Chief Investment Officer, Coal Pension Trustees Investment Limited.

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Current economic and investment trends will change the investing landscape over the next two decades and we are at a crisis point which presents huge risks to investors, according to the 300 Club. Moreover, the 300 Club believes that current financial and investment theory and practice run the risk of failing investors at their time of greatest need.

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