MONOGRAM

NEWSLETTER

Making our wealth last a life time… and beyond…

October 2017

The Fund returned +0.5% in September, bringing the year-to-date return to +8.1%. Global Equity markets (ACWI) were up +1.6%, Developed ex-US Equity (EAFE) was up +2.2% and US Equity (S&P) up +1.7%. US Investment Grade Bonds lost -0.4%, US High Yield Debt gained +0.6% and Gold was down -3.0%.

Making our wealth last a lifetime

With private individuals increasingly having to take responsibility for their wealth accumulation during their working lives, and indeed their spending decisions in the decumulation i.e. retirement phase, the choice of which assets to hold at what time and in what proportions becomes intensely personal and important. Here we focus on the latter phase and ask if conventional recommendations from the financial advisory sector really offer sound advice?

Of course, the issues we address here apply equally to family wealth, trusts, endowments, etc. – any pool of wealth, which requires regular withdrawals.

As families or individuals approach the end of their savings or accumulation phase the advisory industry typically recommends that they start 'de-risking' their portfolios by increasing the allocation to less risky assets, i.e. bonds, especially government bonds. This approach is also referred to as 'target-date' or 'glidepath' investing.

Unfortunately, such 'target-date' portfolios fall short on two very important accounts:

i. Even most 'de-risked' portfolios still contain a fair amount of (equity) risk. In fact, in 2009 the three largest such target-date funds in the US lost nearly 30% of their value.

ii. There is increasing evidence, both in the US and abroad, that with many retirees living 25 years and longer in decumulation, there is a serious danger of missing out on the extra returns offered by equities through several cycles: historical simulations suggest that de-risking in retirement may lead to lower consumption than necessary.

The 4% rule

There is a well-known rule for both private retirees and endowments that 4% per annum of initial real wealth can be safely withdrawn for 30 years from a US portfolio of 50% equities/50% bonds. This rule is typically derived from historic domestic US returns since 1900 and is credited to Bengen (1994)[1]. In a more recent study using annual return data for 20 countries since 1900, Blanchett et al (2016)[2] suggest that the returns from US assets over the 20th century are actually pretty unusual by international comparison, and that most countries would not have generated returns sufficient to support the 4% drawdown rule: for example, the UK would only have managed 2.8% p.a. (see FTMoney, 4-Feb-2017).

This begs a number of important questions:

i. If we broaden the portfolio to include additional assets such as international equities, commodities, etc. can we improve on the 4% rule and not run out of money? After all, the only free lunch in finance is diversification, although the standard equity/bond split of 60/40 has proved remarkably robust in practical terms. Family offices and university endowments have therefore long favoured greater asset

[1] Bengen, W. P. (1994), Determining Withdrawal Rates Using Historical Data, Journal of Financial Planning, 7(1), 171-180.

[2] Blanchett, D., Buffenoir, M., Kemp, D. and Watt, S. (2016). Safe Withdrawal Rates for Retirees in the United Kingdom, Morningstar Research.

diversification, including illiquid assets. But is such diversification really worth the effort in terms of higher withdrawal potential?

ii. Is there another property of investment portfolios, which is, as yet, unsung in the finance world but which could offer the prospect of potentially higher rates of decumulation?

Diversification offers little protection

Surprisingly perhaps, the incremental diversification from additional asset classes as mentioned above, did not protect families and endowments around 2009, when portfolio values fell by around 30% in some large US endowments and led to the cancellation of building projects and hundreds of staff layoffs. To investors' horror, the return correlations of virtually all assets moved towards unity during the financial crisis and all these assets fell at the same time, ridiculing the key concept of asset class diversification.

Such dramatic reduction in wealth because of (i) a drop in markets in combination with (ii) an additional reduction of capital due to regular spending obligations is an example of Sequence Risk. As detailed in the current issue of the Financial Analysts' Journal (Clare et al, 2017)[3], the only meaningful protection against large portfolio drawdowns and Sequence Risk arises from 'smoothing' returns using techniques such as Dual Momentum or Time-Series Momentum, or similar. These are exactly the type of methods we employ in our portfolios.

The acid test question is how much could one reasonably withdraw from a portfolio, which does not suffer from Sequence Risk or which at least has a far smaller exposure to Sequence Risk?

The answer is a very healthy 5-6% per annum using similar assets and scenarios as Bengen above. In other-words, one could potentially give beneficiaries a 50% pay rise (!) over a standard 4% p.a. withdrawal by tweaking the investment strategy to reduce Sequence Risk.

Thus, simple diversification across asset classes is not actually the main route to enhancing withdrawals in the real world! Rather, it is avoiding the prosaic (but rarely discussed) Sequence Risk.

Positioning and outlook

For the month of October our indicators continue to favour Developed ex-US Equity, Emerging Market Equity, US High Yield, and USD Short and Ultrashort Investment Grade Bonds.

3 Clare, A., Seaton, J., Smith, P.N., and Thomas S., (2017). Reducing sequence risk using trend following investment strategies and the CAPE, Financial Analysts Journal, (forthcoming).

About MONOGRAM

MONOGRAM Capital Management is an investment boutique founded in 2014 and headquartered in London. We take an innovative empirical, evidence-based approach to investing and believe there are fundamental, identifiable, persistent, and exploitable sources of return; risk is the permanent impairment of capital (peak-to-trough drawdown) and not volatility in its various forms.

There are two options for investors to access MONOGRAM's investment strategy. Investors can invest in the Luxembourg Domiciled MONOGRAM Fund or in MONOGRAM's bespoke segregated managed account, provided the investors meet the minimum subscription requirements. Further details are available on request.

For further information on MONOGRAM or to invest, please contact Milena Ivanova on **milena.ivanova@monograminvest.com** or **+44 (0)7931 776206**