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Long-term view delivers the most efficient returns

David O'Shea, director, Quintas Wealth Management, explains why longer-dated bonds can deliver the best pension results

Gary Owens, CEO of corporate pensions specialist IFG Ireland, with Noel Creedon, MD of Quintas Wealth Management. The two companies have launched a strategic partnership offering a full suite of financial services to corporate clients in Munster.

ONE of the most costly mistakes investors make over their lifetime is mismanagement of their pension contributions and investment strategy.

For the majority of people the provision of a pension is the single biggest investment decision that they will make after a purchase of their home. Yet the attention given to pensions is scant at best.

We can readily divide a discussion of pensions into those controllable variables and those that can be unpredictable. In fact, former US Secretary of Defence Donald Rumsfeld's quote of there being "known knowns... (and) unknown knowns" makes an unlikely but relevant framework for a discussion of efficient pension management.

WHAT WE KNOW

In life when we know an event will take place at some time in the future which has an associated cost then we make provision for this event now.

Pension investment is no different. We know that at 66 (current retirement age) we will likely stop working and income will need to be generated from savings and pensions. What we also implicitly know, or can at least estimate, is how much income will be needed.

The replacement ratio is the ratio of post-retirement income that is needed to provide for a suitable income stream to fully or partially match pre-retirement income.

So, for example, an individual currently on a net salary of €2,500 per month may need to replace say 75% of this income, or €1,875, in retirement. If we can estimate that the state pension will be €920 per month, this leaves us with a shortfall of €955 to make up.

In order to do this over, say, a 25-year period in retirement we would need to start with a fund on retirement of approximately €200,000. By growing this fund conservatively at 3.5%, and taking into account annual inflation of 1%, we can plan for a regular pension withdrawal and match the cash need of post-retirement.

In order to generate a fund of €200,000 that investor would need to save approximately €250 per month for 30 years and grow it by 5% per annum. It all sounds simple, but all we are doing is dealing with those variables we know and creating a plan around it.

WHAT WE DON'T KNOW

But what about those "unknown knowns"? Finance and financial modelling is littered with assumptions and we've made a very large assumption above in dealing with our "known knowns" — that we will grow our funds by 5% pre-retirement and by 3.5% post-retirement.

This is a rather large assumption on the ability of the individual or their advisor to achieve such investment profits. The actual returns, however, are unknown and open to many risks. Investors are painfully aware that assumptions made about the growth of their pension assets have been significantly off the mark and they have suffered a funding shortfall as a consequence.

So let's go back to Mr Rumsfeld's quote and let's consider what we do know. What we do know is that there are a number of asset classes. In the Irish market they are predominantly equities and property. But what do we know about their likely profitability and return?

We do know that actuaries in insurance companies will make certain assumptions about the likely return which form the basis of suggested contributions. Yet the assumptions are based primarily on historical data.

Unfortunately, at the moment we find ourselves in one of the most challenging financial cycles seen in 40 years and we should question whether many of the assumptions that underpin those forecasts are relevant.

The most recent market turmoil should alert pension investors to the scenario of potentially lower returns on offer in the foreseeable future from a number of asset classes.

Equities have been the worst performing asset class in the current market turmoil.

Companies are under significant pressure and dividend payments have been reduced or stopped.

Despite some assumptions of 7%-9% annual growth figures for equities it is difficult to see those levels of returns being broad based in the coming years.

The unfortunate issue with equity investing is that many 'buy and hold' strategies which were being used in pensions had simply become 'buy and ignore' strategies instead.

Bonds are one of the most appropriate methods to provide for pension funding. Investing in longer-dated bonds can help match pension investment portfolios to the retirement need in the future. Currently in bond markets we are experiencing 'flat yield curves', meaning that even if you invest in longer-dated bonds the returns on offer are extremely low. Flat yield curves are a significant problem for all providers of pensions, whether it is insurance companies or the state in the provision of state benefits. Corporate and convertible bonds as well as emerging market bonds are more interesting and relevant bond investments given this environment.

Commodities are perhaps the most interesting asset class to be considered for pension investors. Given their value they are a natural hedge against downturn in financial cycles. But investors should avoid broad-based commodity indices and funds and concentrate on individual commodities.

CONCLUSION

Pension investors should identify and deal in what they know.

While forecasting markets can be difficult, pension liability funding is not — identify your desired replacement ratio and create a suitable savings plan to achieve your goal.

When it comes to an investment strategy consider alternative investments. A pension investment is a perfect opportunity to purchase cheap or undervalued assets as you have considerable time to see them return to profitability.

You don't need to be an active manager to hold an efficient pension portfolio, but you do need to be attentive.

Understand what you can control and pay particularly attention to that which you can't.

And always ensure that your pension is relevant — a pension portfolio created a number of years ago by you or your financial adviser is unlikely to be a relevant portfolio today.