Hedging against Sequence Risk and Volatility

We are often reminded about the old adage, “it's not about timing the market, but about time in the market”. In reality, timing is key - especially in retirement. Early market declines, particularly if paired with rising inflation, can have a significant impact on how long one’s post retirement savings can be sustained.

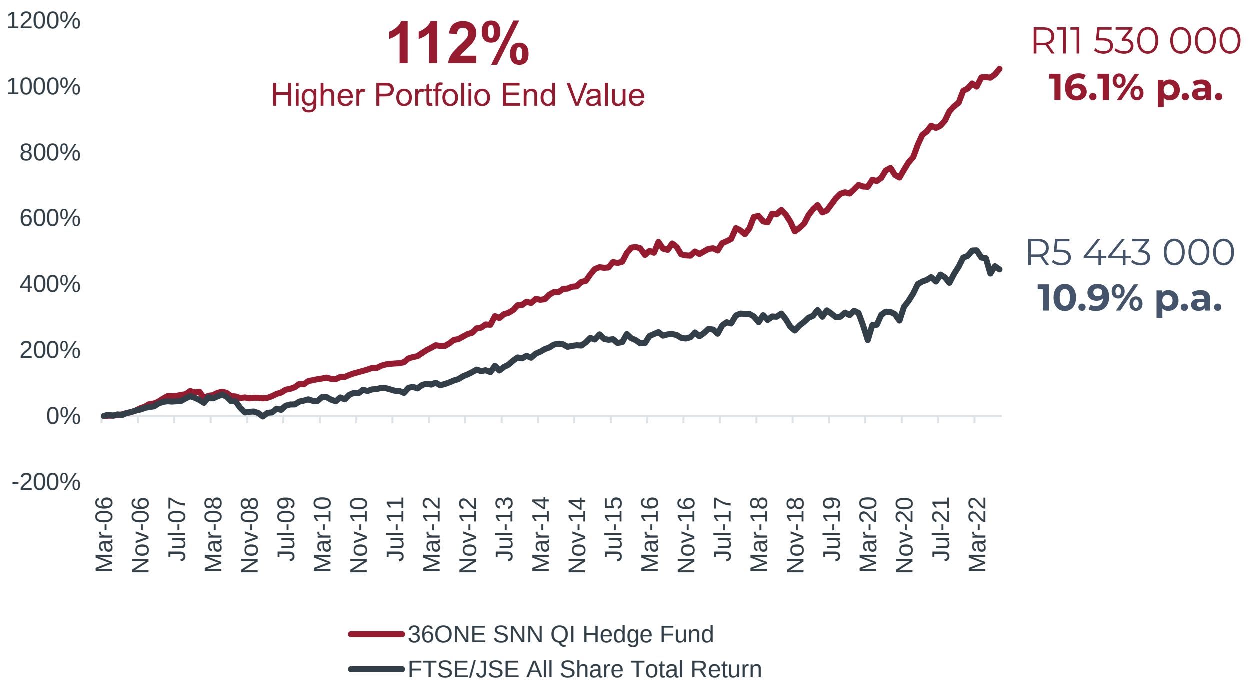
The risk involved in withdrawing from a volatile portfolio – termed sequence-of-return-risk – is less when portfolio volatility is lower. Put simply, if the value of one’s retirement savings declines near the outset of drawing an income, the amount withdrawn will represent a bigger portion of the investment, than if you had experienced growth over the same period. The effect of this is that the capital base continues to decline with each additional income withdrawal, leaving less capital to grow. This could result in retirement savings depleting sooner than if the portfolio experienced positive returns at the start of the withdrawal period.

To better understand the above and how the 36ONE Hedge Funds can help minimize sequence of returns risk and volatility, let’s examine two scenarios.

Scenario 1: Lump Sum Scenario

Consider a hypothetical portfolio valued at R1 000 000. We start investing in April 2006 (launch date of the 36ONE SNN QI Hedge Fund – ‘36ONE Hedge Fund’) with a single lump sum investment and neither add to it nor withdraw from it.

The chart below summarises what the portfolio would be worth in nominal terms:

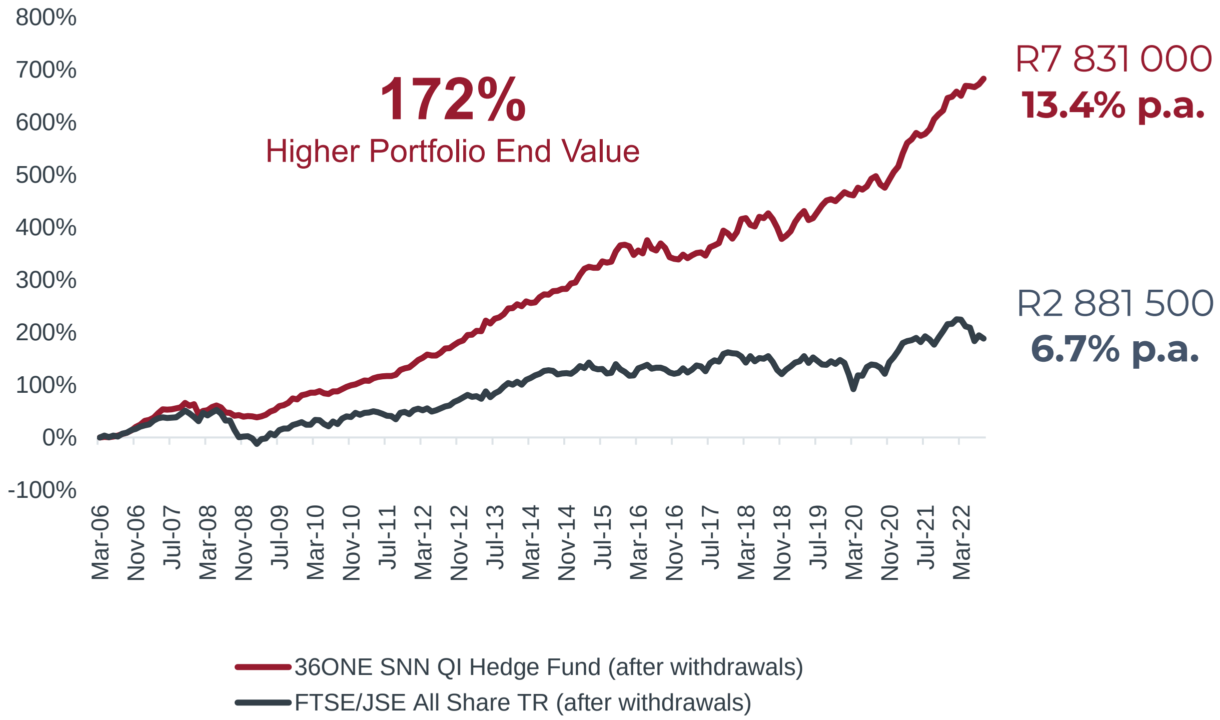


The investor would have been much better off if they had invested the full amount in the 36ONE Hedge Fund. Not surprising as the hedge fund has outperformed the FTSE/JSE All Share Index (‘ALSI’) by 5.2% p.a. (after fees) over the period.

However, the outcomes look very different if you include regular withdrawals.

Scenario 2: Income Producing Portfolio

In the second scenario below, we observe a hypothetical portfolio valued at R1 000 000 and assume an income of 4.5% p.a. (withdrawn monthly), escalating at 6% p.a.
The chart below summarises what the portfolio would be worth in nominal terms, after withdrawals:



When we compare the end values of the income producing portfolio (scenario 2), the 36ONE Hedge Fund outperformed the ALSI by 6.7% p.a. The end portfolio value is **172%** higher when investing in our hedge fund, in comparison to the ALSI. This is substantially higher than the lump sum scenario (scenario 1), where the resulting portfolio end value was 112% higher.

A sizeable gap in outcomes. The difference is the very essence of sequence of return risk. An important element in the above examples is the impact of volatility.

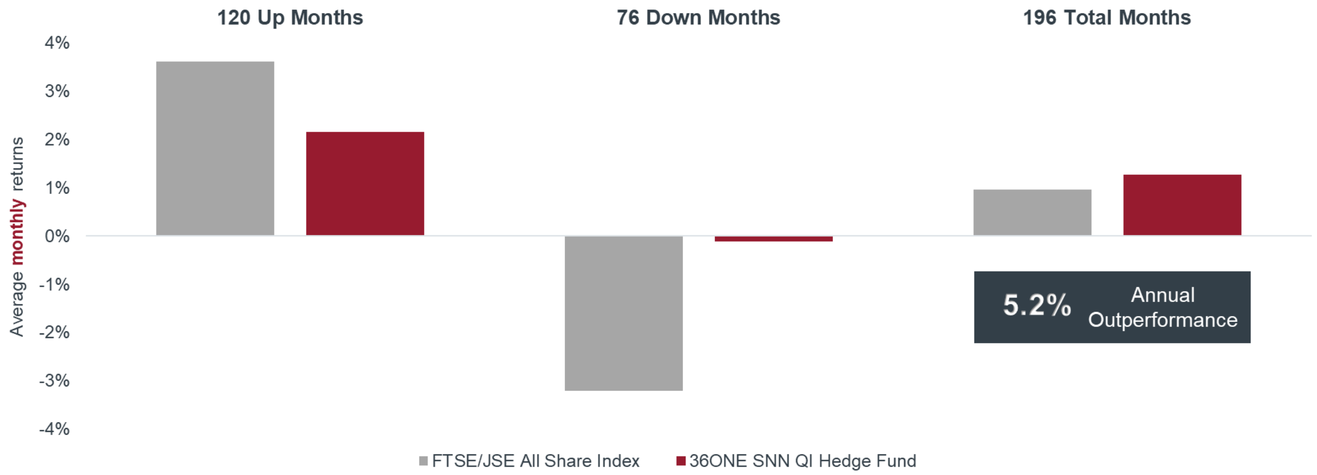
Over the ~16 year period, the volatility of the 36ONE Hedge Fund was substantially lower than that of the ALSI, with much lower drawdowns. The return profile of the 36ONE Hedge Fund was more stable than the market over the period, which resulted in a much better outcome for the portfolio invested in the 36ONE Hedge Fund**:**

	Volatility p.a.	**Max Drawdown Since Inception**
36ONE Hedge Fund	8.4%	-12.59%
ALSI	16.1%	-40.44%

Above scenarios don't include tax and other related costs

Withdrawing assets in a down market during the early years of retirement is one of the biggest risks to portfolio longevity.

We believe the 36ONE hedge funds are an appropriate solution to combat sequence risk. By virtue of the broad toolkit and instruments that we utilise, we can participate not only in up markets, but also protect capital during down markets. The below chart shows how our 36ONE Hedge Fund has performed since inception during ALSI up and down months. Over time we have outperformed the ALSI by 5.2% p.a but with a fraction of the volatility.



In conclusion, our hedge funds can play an integral part in a portfolio.

We have the ability to provide investors with returns that are similar to the market, but with much lower levels of volatility and drawdowns. Therefore, the client is not compromising on long term growth and receives better risk-adjusted returns.

The 36ONE SNN Retail Hedge Fund is now available on most major LISP platforms. If you aren't already considering the benefits of this strategy within your clients' portfolios, we suggest you get in touch.

Disclaimer:
The information presented here is not intended to be relied upon for investment advice. Various assumptions were made. See our [full disclaimer here.]
Source: Bloomberg, 36ONE Research; Data and performance to 31 August 2022.