Professional Capital

Advising Professionals Every Step of the Way

Charting your Financial Future

The importance of getting good investment performance on your savings

"Compound interest is the Man's greatest invention. He who understands it, ***earns it*** … he who doesn't … ***pays it." AE***

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Introduction

If you have monies in a pension or are looking to invest further sums in a pension you WILL be subject to a **future rate of return**.

Whatever you do, there will be a return on your money. This could be a good return, a poor return, it could even be a negative return.

What do we mean by 'a return?'

This is a description of the **rate of interest** you will get if the money is held in cash or the **annual investment return** if your money is invested.

Most people use risk investments in their pensions and these will generate a return.

You cannot receive income from the investments so the return you get from the money invested, within your pension, will be capital growth combined (if relevant) with a roll up of any income.

If your invested money performs badly this return could be ***negative***, implying a ***capital loss*** not capital growth.

This research guide aims to show you how important this factor is – we will outline some basic illustrations of how much future returns can affect the eventual outcome, how much returns have varied from commonly used pension funds and what you can do to give yourself the best chance of getting the best returns possible from whatever strategy you pursue.

Part 1.

Future Investment Returns

How big a difference do investment returns make?

So just how much difference do future investment returns make?

One aspect of a pension is – more often than not – it represents *a long term* investment.

More so than just about any other investment most people will make. This is a very good thing, because it means there is plenty of time to (a) deal with the ups and downs in prices and values that inevitably occur with higher risk asset areas (which tend to perform best in the longer term) and (b) to ***magnify*** the impact of extra annual returns.

The effect of compounding returns is real and dynamic. Aiming to achieve the best compounding return you can get is a highly desirable objective for any pension investor.

Taking this second point (point b above) on board, this impact can easily be illustrated.

Let us take two 40 Year Old's who have pension funds of exactly the same value today - **£40,000**. They both have a fresh start with their investment approach starting today.

Investor 1 (Getting 3% Per Year)
Pension Fund = £40,000

Investor 2 (Getting 6% Per Year)
Pension Fund = £40,000

One invests using a strategy which ultimately produces 3% per year, the other adopts a different strategy and this produces 6% per year. How does this grow their £40,000 fund?

By age 50:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £53,756

Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £71,633

Now let's look at the difference at 60:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £72,244

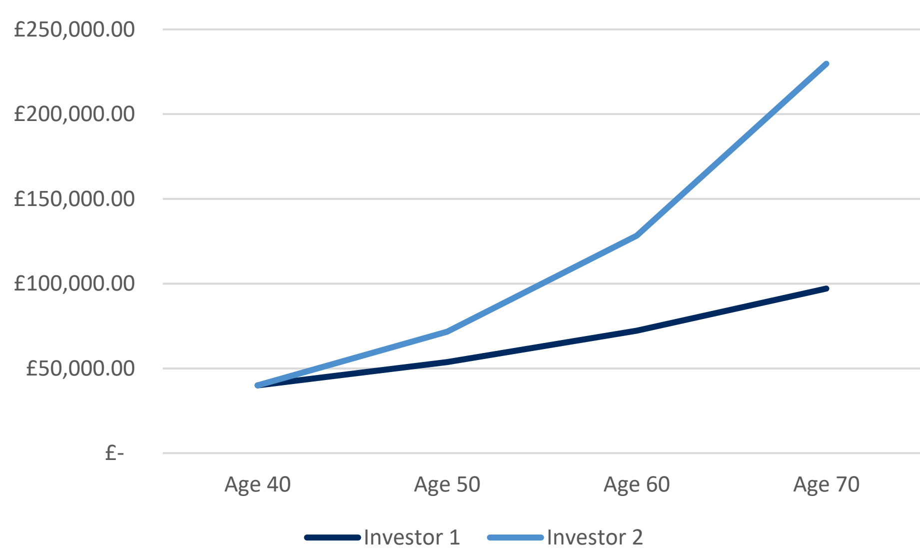
Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £128,285

And at age 70:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £97,090

Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £229,739

Perhaps the most impressive way of illustrating this effect is to show it on a graph:



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You will note that the longer time period stretches the difference quite markedly, emphasising the long-term value of the higher return.

We can play with these types of comparison at will. The extra return ***always*** produces an ***ever escalating*** gap between the two investors' future positions.

Have we illustrated wildly optimistic future returns? No, we have shown the difference between 3% and 6%, both levels which should be considered realistic.

To highlight the trend here even further let us look at the position for a 24 year old saving £100 per month, who will retire at age 67.

> At 3% per year their projected future fund will have grown to **£89,700**

> At 6% per year their projected future will be **£113,000**

Again the difference is stark.

This is all simple mathematics, a demonstration of the differences that can be achieved by obtaining higher rates of growth.

Remember in the real world these differences represent a difference to the future value of a fund of money that is YOURS. The prize for getting better returns is a big prize, **one that has direct consequences on the amount of money you will have available in the future.**

Part 2.

Time or Extra Return

What makes the biggest difference?

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What makes the biggest difference – time or extra return?

It is interesting to view just how much difference is made in generating returns if we view both time and returns in a separate fashion.

To start with let us look again at 3 investors with £40,000 in their pension funds who have a 10 year time horizon; one of whom gets 3% per year, one gets 6% per year, one gets 9% per year.

Their future pension pot sizes after 10 years:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £53,756

Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £71,634

Investor 3 (Getting 9% Per Year)
Their Pension Fund Grows To £94,694

Even over a short period the extra return starts to escalate and compound, however it is time which makes the astonishing differences.

Look at the same investors getting 3% and 6% OVER 30 YEARS:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £97,090

Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £229,739

And OVER 40 YEARS:

Investor 1 (Getting 3% Per Year)
Their Pension Fund Grows To £130,481

Investor 2 (Getting 6% Per Year)
Their Pension Fund Grows To £411,428

The compounding effect is amazing over time and accentuates the final figures.

Many pension investors will say something along the lines "but I'm 50 and I don't have 30/40 years to invest". This is a fair point, however even a 10 year period delivers a sizeable difference if better returns can be found. PLUS, many pension investors will continue to have their pension pots managed and invested well into their retirement years. The recent changes to how private pensions may be drawn at retirement (the "pension freedoms") mean that many investors will draw on their pension pot slowly, in stages, through retirement, leaving the undrawn part invested. This means a 50 year old may still have an investment approach in place for another 20 years+.

Part 3.

The Real World Position

How have Pension funds performed in the past?

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How have pension funds performed in the past and what sort of differences in performance have occurred?

Can you make a difference?

We can now show you a snapshot picture of how pension funds have performed in different sectors over an historic 10 year period to demonstrate the wild fluctuations that occur and why **if you can find good funds with good performance it will make a big difference:**

ALL FIGURES ARE BASED ON BID-BID PRICES AND WERE ASSESSSED ON 1st NOVEMBER 2016.

WE THEN SHOW YOU HOW MUCH DIFFERENCE THIS WOULD MAKE TO A STARTING SUM OF £40,000 TEN YEARS AGO; INVESTOR ONE ACHIEVES TOP QUARTILE RETURNS, INVESTOR TWO BOTTOM QUARTILE RETURNS.

The conclusions are completely consistent with the exact same comparisons made in 2014 and 2015, plus were re-evaluated in 2018 with the same degree of fluctuation appearing.

This shows a pattern which clearly evidences that there are big differences between the top performing funds and the bottom performing funds.

It should be noted that not all funds, even within the same sector, have the same level of risk, an important balancing factor.

However, adjusting for risk metrics does not change the dynamic, fluctuations in performance are rife, even where the risk rating is considered.

The following figures from November 2016 are used to illustrate the sort of differentials that can exist and were taken from Trustnet.

Sector: UK Smaller Companies

This is a sector which contains funds, where the fund manager invests into smaller companies in the UK.

There are 44 Funds we have tracked with an established ten year performance.

- The 10 year average return was 111.4%.

- This is 7.6% per year.

However, the average of the top quartile (i.e. the best 25%) was 10.3% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 4.5% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 5.8% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £106,614

- Bottom Quartile Investor £62,119

On a £40,000 notional starting fund this is around £44,500 more simply for choosing a better fund or funds.

Sector: UK Index Linked Gilts

This is a sector which contains funds, where the fund manager invests into UK government index linked gilts.

There are 57 Funds we have tracked with an established ten year performance.

- The 10 year average return was 120%.

- This is just around 8.2% per year.

However the average of the top quartile (i.e. the best 25%) was 9.3% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 6.8% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 2.5% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £97,333

- Bottom Quartile Investor £77,228

On a £40,000 notional starting fund this is approx. £20,000 more simply for choosing a better fund or funds.

Sector: Flexible Investment/Managed

This is a sector which contains funds, where the fund manager invests into predominately equities, but with a split to include other assets (e.g. cash and gilts); this is the traditional 'manged fund' that many pension investors use.

There are 77 Funds we have tracked with an established ten year performance.

- The 10 year average return was 84.0%.

- This is 6.2% per year approx.

However, the average of the top quartile (i.e. the best 25%) was 7.6% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 4.3% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 3.3% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £83,211

- Bottom Quartile Investor £60,940

On a £40,000 notional starting fund this is just over £22,000 more simply for choosing a better fund or funds.

Sector: Europe excluding UK

This is a sector which contains funds, where the fund manager invests into companies across Europe but excludes any companies in the UK.

There are 99 Funds we have tracked with an established ten year performance.

- The 10 year average return was 83.3%.

- This is 6.1% per year.

However, the average of the top quartile (i.e. the best 25%) was 7.75% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 4.54% per year approx.

You can see that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained 3.21% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £84,379

- Bottom Quartile Investor £62,357

On a £40,000 notional starting fund this is about £22,000 more simply for choosing a better fund or funds.

Sector: UK All Companies

This is a sector which contains funds, where the fund manager invests into companies of any size or type in the UK.

There are 135 Funds we have tracked with an established ten year performance.

- The 10 year average return was 65.3%.

- This is 5.1% per year.

However, the average of the top quartile (i.e. the best 25%) was 6.78% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 3.70% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 3.08% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £77,083

- Bottom Quartile Investor £57,524

On a £40,000 notional starting fund this is about £19,500 more simply for choosing a better fund or funds.

Sector: UK Direct Property

This is a sector which contains funds, where the fund manager invests into property in the UK.

There are 73 Funds we have tracked with an established ten year performance.

- The 10 year average return was 15.0%.

- This is around 1.3% per year.

However, the average of the top quartile (i.e. the best 25%) was 3.11% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was **negative** 0.75% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 3.96% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £54,334

- Bottom Quartile Investor £37,099

On a £40,000 notional starting fund this is over £17,200 more simply for choosing a better fund or funds.

Sector: Asia Pacific incl. Japan

This is a sector which contains funds, where the fund manager invests into companies across Asia, including Japan.

There are 69 Funds we have tracked with an established ten year performance.

- The 10 year average return was 166.6%.

- This is 10.4% per year.

However the average of the top quartile (i.e. the best 25%) was 12.9% per year approx.

The average of the bottom quartile (i.e. the worst 25%) was 8.3% per year approx.

You can see therefore that over a relatively short period (10 years) an investor who was in the average of the best funds would have gained around 4.6% more per year than an investor in the average of the worst funds.

- Top Quartile Investor £134,585

- Bottom Quartile Investor £88,786

On a £40,000 notional starting fund this is around £45,800 more simply for choosing a better fund or funds.

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Part 4.

Conclusion

Conclusion

These examples, a sample from the fund market demonstrate that even within sectors there are relatively large variations in performance from the top to the bottom; as described in our opening segment these variations will create sizeable differences in "pot value" over time. An investor who can get the better returns will have a far bigger pot at retirement than investor who gets the lower returns.

Today this is truly significant; because the recent changes in pension rules for private pensions, mean that from April 2015 onwards pensions can be drawn in full (subject to tax) at retirement, they do not have to be turned into an annuity.

Someone arriving at retirement with a pot of £100,000 because they have managed to get a better return than someone else, who has a pot of £70,000, as an example, can enjoy this extra £30,000 as a cash sum (less tax where appropriate).

We have established therefore that returns compound quickly and that even relatively small extra amounts soon start to add up; that differences in returns exist within the fund market – which leads to…

How do we try to ensure we get the best returns?

The importance of seeking help and advice

Government changes introduced in April 2015 provide greater freedom for pension investors with a private or personal style pension plan at the point they retire. In brief these changes will allow pensions to be drawn without restriction, at a rate and pace of income to suit that person's requirements.

This is an important change which invigorates pensions, making them incredibly flexible at their most important stage: the stage where they are needed to produce income.

However, this change should not mask what is most important to anyone saving into a pension and looking forward to their retirement: the amount of money that is in the pension will always be the ***most*** important factor.

In this respect, this guide has been produced by us to highlight how much difference pension investors can make to their eventual retirement pot and income by focusing on the importance of the return generated year by year.

There is a real, meaningful and discernible "prize" to be gained from concentrating on performance. Most modern pensions are keenly charged – in other words they can be accessed with low or competitive charges – leaving the ***variation in performance*** as the likeliest biggest differentiator in how much money will be available in retirement.

Just how does a pension investor get better performance?

The issue that remains therefore is this: it is clear that performance makes a big difference; that there are variations in performance in the fund market and that two investors using similar strategies can and possibly will get very different results.

How can you set out to get the better performance?

Clearly no-one knows what future returns will be from any sector or fund in the market. Likewise there is no guarantee that a good past performance (including out-performance) will be maintained.

This suggests therefore that there is an element of chance around pursuing any mix of fund selection.

This is true, but only to a point. There are ways to focus on better performance and there are steps to improving the prospects of getting superior future returns, naturally these are not guaranteed, but these steps can be employed by anyone. They include:

1. Ensuring that your asset allocation approach is based on your risk profile and tolerance.
2. Using detailed analysis of funds which extends beyond a simple past performance assessment.
3. Ensuring that the funds you use are non-correlated and are diversified.
4. Undertaking a process of regular reviews to monitor and, where appropriate, change any non-performing funds and to keep your approach current to changing fortunes.
5. Having a disciplined and structured approach, and a plan of action which is focused on continually searching out the best funds.
6. Working with appropriate, qualified and quality professionals who will have experience in the selection of funds.

The summary of this is a simple one: improving performance or getting good performance is worth pursuing. It is unlikely to involve any significant increase in costs or charges, however it will inevitably require more time and focus. The outcome if you can achieve this ***is a higher pension for you to enjoy in your retirement***.

THE IMPORTANCE OF GETTING A GOOD INVESTMENT PERFORMANCE ON YOUR SAVINGS GUIDE

Please note all figures, fund data and information contained within this document were assessed as of 1/11/2016. The fund performance data was taken from Morningstar. THE FIGURES REFER TO PAST PERFORMANCE.

PAST PERFORMANCE IS NOT A RELIABLE INDICATOR OF FUTURE PERFORMANCE.

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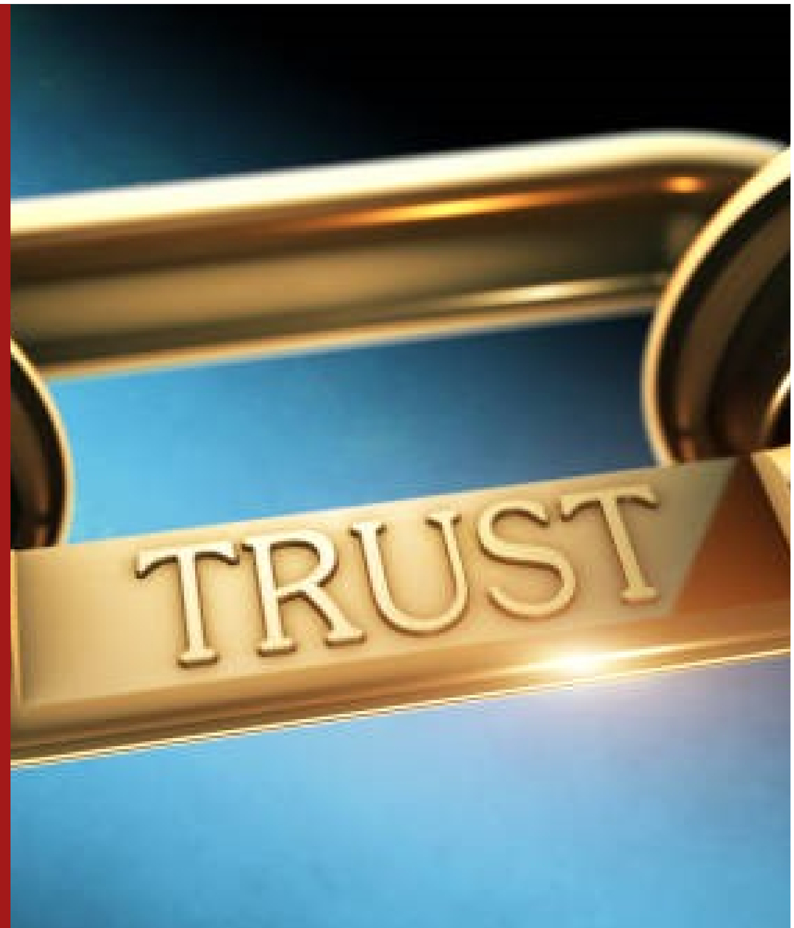

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