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Keep Calm and Carry On Investing: Lessons Through COVID-19 for Retirement Portfolios

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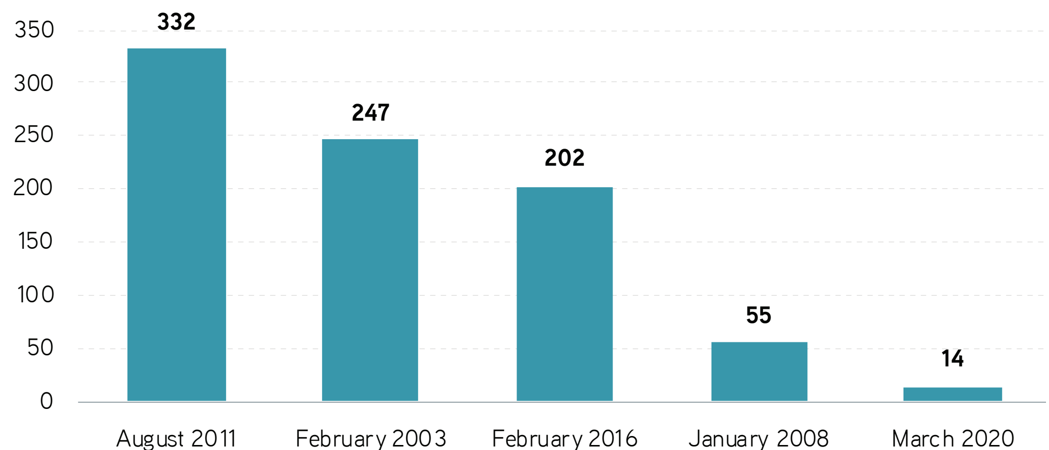
A year can feel like a long time in volatile equity markets. Imagine a super fund predicting this time last year that the S&P/ASX 200 would turn from 'bull' to 'bear' in a mere 14 days[1]. Yet, that's exactly what happened, and (as we show below) it created history when it did.

Figure 1: Days to reach bear market status in the S&P ASX 200® Index



Source: Bloomberg, Parametric. Past performance is not a reliable indicator of future results.

The timing was particularly poor for super funds working on the design of their retirement solutions in the lead up to mandated 'CIPR' rules[2] - another year on, perhaps more would have had the equity component of their solutions in place to manage the COVID-19 investment journey of this growing member cohort. But in another sense, the COVID-19-induced volatility[3] was timely in reminding funds just how harsh equity markets can be (and scary for their members), and why retirement equity portfolios need to be designed around the distinct needs of pension members.

Let's test this idea by examining what last year's journey through the onset of COVID-19 (January-April 2020) would have looked like for a specifically designed (hypothetical) retirement equity solution instead an accumulation-style passive exposure to a portfolio of S&P/ASX 200 stocks; our *Keep Calm & Carry On Investing* portfolio. What are the main characteristics of our Keep Calm portfolio?

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[1] We define a bear market as a 20% decline in equities value from peak to trough.

[2] Super funds must have Comprehensive Income Products for Retirement (CIPRs) in place by 1 July 2022.

[3] The S&P ASX 200 VIX exceeded the 50 point level in March 2020 for the first time since the GFC in 2008. Source: S&P, Parametric, as at 31 March 2020.

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1. Moving from market-cap exposure to a 'smart beta' (rules-based 'factor investing') portfolio favouring stocks with low volatility and downside protection characteristics. We intend this to smooth the journey for members and cushion their retirement 'nest egg' against downturns.
2. Adding to our optimised portfolio construction a preference for stocks with good yield characteristics. This recognises the important work the portfolio needs to do to replace salary for retired members.
3. Using listed index options, writing (out of the money) calls over the equity portfolio. We are prepared to give up some returns in strong bull markets to receive, instead, a steady, smoothing income stream through flat and down markets from the call premium income. This, too, focuses on what matters to retired members and helps us shift from a relative (to market cap index) return to an absolute return focus.

Figure 2 below shows our Keep Calm portfolio outperforming its accumulation-style S&P/ASX 200 counterpart by 80bps (pre-fees) over the intense period January 1 through April 30, 2020[4].

Figure 2: Keep Calm retirement portfolio hypothetical performance Jan 1 - April 30, 2020 with attribution

Arithmetic Total Return		Keep Calm & Carry On Investing - Excess Return Contributions			
Keep Calm	S&P/ASX 200	Options Writing	Low Volatility Equity Factor Tilt	Dividend Equity Factor Tilt	Total
-13.32%	-14.12%	2.00%	4.68%	-5.88%	0.80%

Source: S&P, MSCI, Parametric. Performance is hypothetical, does not reflect the actual returns of any investor & may not be relied upon for investment decisions. Actual client returns may vary. Hypothetical strategy returns exclude fees and transaction costs which, if included, would reduce the hypothetical returns shown. Past performance is not indicative of future results. All investments are subject to loss. Indexes cannot be invested into directly.

Here, the tilt towards low volatility stocks worked to cushion the bear market blow, with the portfolio falling by 4.68% less than a passive accumulation portfolio. We also see the options writing premiums adding 2% to Keep Calm's excess return over this challenging period.

Our attribution tells us that dividend stocks, sadly, were a drag on performance over this period (detracting 5.88% from Keep Calm's excess return). But this is a retirement portfolio, so there is a more important question: did we continue to deliver salary-replacement income through the COVID-19 onset by targeting these higher-yield stocks? Figure 3 over the page tells us 'yes'.

[4] Results are shown using arithmetic returns in order to conduct an attribution

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Figure 3: Keep Calm retirement portfolio hypothetical dividend + franking yield v S&P/ASX 200

Date	S&P/ASX 200 Dividend + Franking Yield	Keep Calm Dividend + Franking Yield	Excess Dividend Yield
1/31/2020	0.00%	0.00%	0.00%
2/28/2020	0.72%	0.74%	0.02%
3/31/2020	0.81%	1.03%	0.22%
4/30/2020	0.01%	0.02%	0.01%
Total	**1.54%**	**1.79%**	**0.25%**

Source: S&P, MSCI, Parametric. Performance is hypothetical, does not reflect the actual returns of any investor & may not be relied upon for investment decisions. Actual client returns may vary. Returns exclude fees and transaction costs which, if included, would reduce the hypothetical returns shown. Past performance is not indicative of future results. All investments are subject to loss. Indexes cannot be invested into directly.

Note here our inclusion of franking credits in all our yield measures. If we are serious about having income objectives in our retirement portfolio, we shouldn't ignore this useful source of yield.

We see, overall, how the various components of our *Keep Calm & Carry On Investing* retirement equities solution would have operated to give a better experience to a super fund's pension members than an index-tracking accumulation portfolio through the tumultuous onset of COVID-19 this time last year. It should remind super funds, as they design and build out their pension solutions, that equity objectives need to align with the unique problems faced by this member cohort.

A final implementation-focused caution about a thoughtfully designed solution like this: factor portfolios need to be carefully optimised to address a common problem found in many smart beta strategies - unintended risk biases[5]. To ensure super funds are getting what they think they're getting, we recommend keeping track of how much a strategy's active risk is actually being consumed by the fund's intended factor bets, without unintended sector or factor bets creeping in[6]. We carefully controlled for such unpleasant surprises in Keep Calm's portfolio, but imagine if, in pursuit of income, our portfolio had inadvertently loaded up on shopping centre or travel stocks. These were (and remain) some of the worst-hit stocks during COVID-19 – hardly a recipe for retirees to remain calm during a crisis.

[5] For example, value factor portfolios can often have an unintended short profitability bias. This is due to the value and profitability factors exhibiting particularly strong relationships and a portfolio seeking high value exposure may inadvertently tilt towards fundamentally cheap but unprofitable companies.

[6] We discuss this metric in detail in Raewyn Williams, Vassilii Nemtchinov, Mahesh Pritamani and Paul Bouchey, 'Factor Investing: A New Paradigm for Superannuation Funds and Investment Managers', September 2016 (available on request).

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