Momentum Investments

Why deliberate outcome-based portfolio construction makes sense

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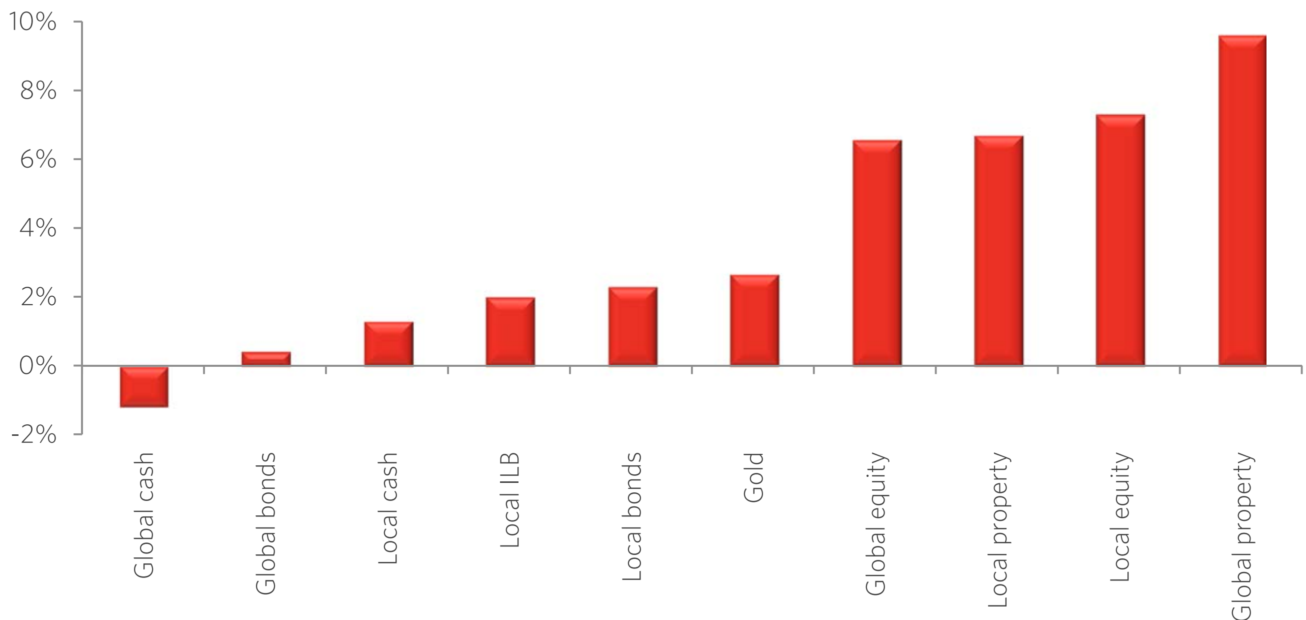
Since the Global Financial Crises, investors have been fortunate enough to experience an upward trending market in equities in the past 10 years. The average return of the South African equity market delivered more than 12% per year, which translated into a return of 7.3% per year above inflation in the last 10 years.

This resulted in a large growth in purchasing power of capital, had you been invested in the equity market during that time. Most asset classes, including global asset classes in South African rand terms, yielded positive real returns in the last 10 years, even taking into account the rather dismal 2018.

10-year asset class real returns



Investment markets are inherently volatile and, therefore, past returns cannot be expected to be a sure indicator of future returns. 2018 has been one of the four calendar years in the past 20 years to deliver a negative return from the local equity market. Irrespective of the negative return experienced in 2018, the asset class still managed to deliver an exceptional return above inflation over a 10-year period.

As a result of shorter-term fluctuations in returns from asset classes, the focus of an outcome-based investing philosophy is on striving to increase the likelihood of achieving goals given the market outlook over the relevant investment horizon. This reinforces the basic fundamental lesson in investment management to not put all your eggs into one basket.

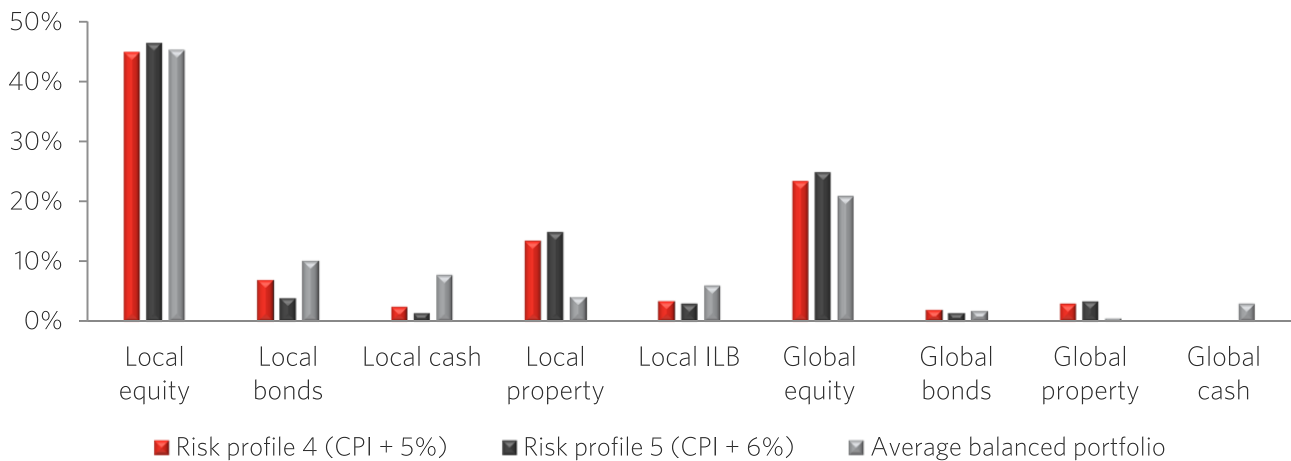
Even though diversification is one of the most important aspects of investing for efficient risk management, it is important to have the correct mix of asset classes and appropriate weightings to the asset classes. This will not only ensure risk diversification, but also ensure delivery on the predefined objectives with the highest possible likelihood.

The only way to effectively solve for the correct weightings to the various different asset classes is to construct the solution with the end in mind. What proportion of asset classes will ensure the delivery on the objective with the highest likelihood?

This might sound trivial, but does have a large effect on the journey towards delivering on the outcome and the likelihood of delivering on the goal with a high degree of success.

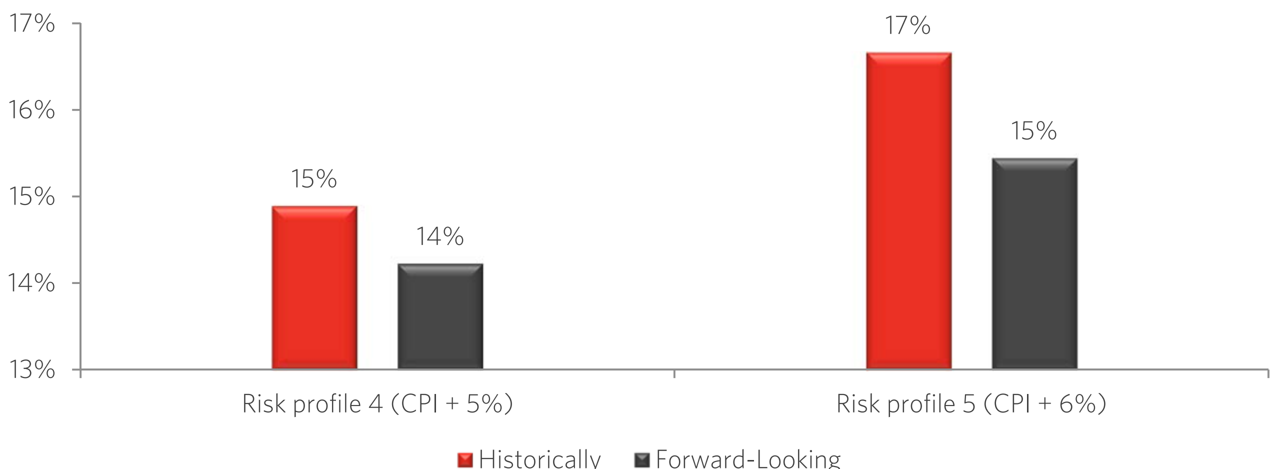
A small difference in allocations to asset classes can translate to a large difference over time. To prove this, Momentum Investments has compared portfolios that were purposefully constructed to deliver on an inflation objective against the average balanced portfolio in the market. The graph below indicates the different allocations to the asset classes for these portfolios.

Asset allocation



It is clear from the graph that the difference in the asset allocation relative to the average balanced portfolio is marginal. The difference in the likelihood of delivering on the outcome, however, is quite large.

The likelihood of achieving CPI + 6% over seven years relative to the average balanced portfolio



The graph displays two outcomes, namely what has occurred and what is most likely to occur. Historically, the two outcome-based solutions have increased the likelihood of achieving the objective by 15% and 17% more than the average balanced portfolio.
The forward-looking likelihood has decreased from historical values due to the lower yields expected from asset classes. Nonetheless, a significant higher likelihood of delivering on the outcomes relative to portfolios not purposefully built for a similar outcome is observed.

Solutions constructed with the objective in mind, does give the benefit of an increased likelihood of delivering on the objective. An important aspect to keep in mind in an ever-evolving market dynamic is to remain focused on the outcome, stay invested and use every possible means to reduce risks and increase the chances of achieving your goals.

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