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theadvantage

Autumn 2014

Autumn has arrived early this year and, with the end of daylight saving, the shorter, colder days are here for a while. Readers may have heard about Bitcoin, the subject of our first story. It's an interesting and relatively new form of currency. Next, we look at investment returns for the last ten years versus those for the last forty years. Finally, we've explored some issues to think about when planning to fund retirement or, for trustees, drawing down from a pool of investments.

Bitcoin

Bitcoin is a purely digital form of currency that allows for payments all over the world. Advocates claim transactions are faster, don't rely on any third party and have lower expenses than other systems. They'd like to see Bitcoin become a form of de-centralised, truly international and a-political money; lofty aspirations. Bitcoin has had a rather chequered career, to date.

Bitcoin is a "cryptocurrency", a "currency" that uses cryptography. Cryptography involves mathematics, computer science and electrical engineering to achieve security. ATM cards, computer passwords, and e-commerce use cryptography.

Bitcoin began around 2009 with volumes of trading becoming significant by 2011. Bitcoins (BTC) are the "currency". Every bitcoin can be divided down to eight decimal points where 0.00000001 BTC is the smallest. The denominations are being given names like centibitcoin and millibitcoin etc. The smallest is a Satoshi in honour of Satoshi Nakamoto, the pseudonym used by the inventor of Bitcoin. There's a lot of mystery about the identity of the founder. Just a few weeks ago, there was a news clip on TV showing an Asian man being confronted by a reporter asking if he was Nakamoto. He said he wasn't.

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Image courtesy of istockphoto.com

Bitcoin from front page

The value of bitcoins can be measured against any "normal" currency. You can even buy bitcoins with NZ dollars, the value being set for a number of minutes at any given time. Prices have fluctuated wildly and fortunes have been made and lost. In November last year, for example, bitcoins were trading on a Japanese exchange at US$900 and there was a trade in China at over RMB¥6780 (US$1100). By early February this year the price was down to US$400.

The Bitcoin community claims the value of bitcoins will rise over time because they will be scarce. There will only ever be twenty one million produced and the last will be "mined" around the year 2140. Mining is a highly technical process too difficult to explain here but you can read about it on the internet. There are new "blocks" of coins mined every ten minutes. The number being produced is being scaled back by half, geometrically. It started with 100% of the possible twenty one million. That number, 100%, was reduced by half to 50% then 25%, then 12.5% then 6.25%,3.125%,1.5625%,0.781250% and will go all the way down to eight decimal places where 0.00000001 will be halved to nothing.

Scandals about Bitcoin are all too common and regulators across the world are warning of the hazards. There's room for all kinds of glitches and money laundering is an ever-present risk. It is well-nigh impossible to check users, the source of their funds or their destination. The Canadian authorities have announced they will prosecute violations of their regulations that arise from use of bitcoins. The US Department of Homeland Security has been active shutting down a bitcoin exchange business and an on-line black market last year.

Bitcoin is struggling to gain legitimacy but a major hurdle was overcome in July 2011 when the US Department of Treasury added "other value that substitutes for currency" to its definition of money services businesses and they have also issued an interpretive guidance regarding "virtual" currencies.

Overseas, some large firms accept payment for goods in bitcoins. If you're flying Virgin Galactic, you can pay Richard Branson with your bitcoins but there's not a lot of scope, yet, for this new, novel and entirely electronic currency.

Recent vs long term investment returns

We've just received data from Finametrica (our risk tolerance software provider) for the period ending December 2013 and it's been interesting to see a recent trend that differs from the past. The data shows investment portfolio returns have been lower over the last ten years than for the thirty previous years. Not only have average recent returns been lower but the upper range of returns, above the average, is also down.

Using a balanced "portfolio" to illustrate the change, here are the numbers. (This is not an actual portfolio but a combination of index returns. No-one can invest in an index and index returns don't take into account any holding or trading costs.) In the table:

- All returns are annual, after inflation (real) and before tax.
- "Upper range" means better results than average with the one, very best result excluded.
- "Lower range" means worse results than average with the one, very worst result excluded.
- "Long term" means January 1973 to December 2013.

The upper range of recent returns is a whopping 3.3% lower than long term and the average return is also a significant 2.2% lower. This is important. If recent returns are considerably lower, long term return projections will need to be adjusted downwards. We can't blame high inflation as all data is after inflation.

Interestingly, despite all the events of the last ten years that have thrown investment markets into chaos, the lower range of returns for this period is the same as for the long term. That's understandable in the light of all the crises that dogged the last thirty years of the twentieth century such as the Gulf War, oil shocks, the 1987 crash and so forth.

Using lower return projections is especially sensible when planning for major life events such as retirement. In the next article, we discuss some of the other issues that need to be considered when planning for those years.

Balanced "Portfolio"	Long term return	Return over last 10 years
Upper range	10.5%	7.2%
Average	6.5%	4.3%
Lower range	1.7%	1.7%

Retirement, the risks

Being "retired" is a state that most people prepare for, both in a financial sense and at many other levels. It's a major life transition with many facets. Some manage it well whilst others dread its onset or, worse still, never get to enjoy. When trying to work out how well someone has prepared themselves for retirement there are lots of issues to consider.

Some risks involve factors where people have no control whilst others can and should be considered both before and during retirement.

Macro-economic issues

These are the big picture issues beyond anyone's individual control. They are associated with ***government policies (including taxation), interest rates, inflation and investment returns.***

- Superannuation has been a political "football" that every party has kicked around for years. The "game" is still on.

  The age of eligibility for New Zealand Superannuation has moved from sixty to sixty five with the likelihood of it moving further still in future. Plenty of warning is required but that may not happen for political reasons.

  The rate of employer subsidy on Kiwisaver has been adjusted downwards.
- The Reserve Bank's mandate to control inflation is executed in New Zealand by setting the Official Cash Rate (OCR). This affects all investments where price is influenced by interest rate movements. An OCR of 2.5% might have been helpful for getting the post-earthquake economy going in New Zealand but it made for slim pickings for retirees relying on bank interest.
- Inflation. It's the silent thief of spending power. At 3%, inflation will destroy more than half the value of money over 25 years. Retired people may experience higher inflation than the one measured by the CPI and, since they no longer have the opportunity to seek a higher-paying job, they are a very vulnerable group. Vulnerability increases with longevity. As medicine assists more people to stay healthy, out-living the money supply is a real danger.
- Investment returns are what they are. The overall level of return has a significant effect in determining how long money will last before it runs out but, more importantly, the sequence of return is critical. A downturn at the start of a payout period is much worse than one at the end.

Individual economic issues

These are things that could be influenced by individuals and action taken before and during retirement. They are about ***the dollars saved, the nature and extent of other assets, the age when retirement starts, health, family situation and spending choices.***

- The size of the nest egg at the start of retirement is one of the most critical factors in determining how much is available for spending. The earlier saving begins the better. Compound return is an amazing ally. Start as early as possible, save a set amount every pay day, never use long term funds for short term spending and be patient. The ups and downs of investment markets are a saver's friend in this phase of life.
- Regard the family home as a personal asset because it can't be used to help with spending in retirement unless sold. Down-sizing may not produce "change".
- The sale of a business may be difficult and the value less than envisaged. Financial and other assets that can be cashed up easily are required.
- If health and other circumstances allow, delaying the start of retirement is always an option. When debt has been repaid, higher earnings that accompany seniority allow for a period of saving which can be very important in establishing the pool of funds required to fund retirement spending.
- Sometimes, a smaller cheaper house is an option if a partner dies. Death of a person receiving an annuity like a Government Super Fund payout can adversely affect the amount coming into the household though some expenses may be a little lower.
- Spending choices have to be made. That's a highly personal area where some people want to spend up large whilst they can and others want to see it go to others when they're gone. Generally, there's a bit of both.

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At Accordia, we help clients to establish how much they need to support the spending they plan in their retirement years. We work out how long money will last under various scenarios – the current value of the portfolio, how much is being withdrawn and various indicative rates of return. Clients' Investment Policy Statements have this "sustainability" clause if they are making withdrawals. Our clients can see, in advance, how things may work out and that planning gives them a sound basis for better personal decisions. Those processes are also very helpful for trustees who need to make sure they're using a sound framework when making decisions about assisting beneficiaries.

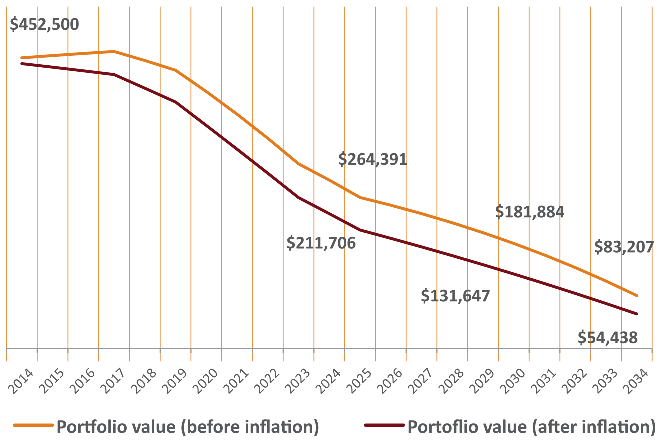
The table below is an example of a sustainability table for a 66 year old client with a portfolio of $452,500 who's making withdrawals of $1,500 per month. We've used a 20 year time horizon. The monthly withdrawals will move up with inflation (assumed to be 2%) every year. The indicative returns are after tax and costs. There are no deposits.

This client's portfolio will have reduced to $264,391 by 2024 if the return is 5% per annum. $264,391 in the nominal value but that amount will only buy $211,706 worth of goods and services if inflation averages 2%. In 15 years, the values will be $181,884 (nominal) and $131,647 (after inflation/real). When this client is 86 years of age, there'll still be some money left. It's a useful exercise meaning the client will be able to check how things are going every year and make decisions to keep their withdrawals the same or change them, according to their circumstances and needs.

We've based the first part of this article on a piece in Forbes Magazine by Wade Pfau.

(Mr Pfau is a Ph.D., Chartered Financial Analyst, Professor of Retirement Income in Pennsylvania and Chief Financial Planning Scientist for inStream Solutions. We have been authorised by Forbes Magazine to use the material.)

Drawdown of $452,500 @ $12,000 over 20 years (5% p.a. return)



Estimated Future Values							
Current Value	Indicative Return	Nominal Value	Inf. adj. value	Nominal Value	Inf. adj. value	Nominal Value	Inf. adj. value
		By 2024		By 2029		By 2034	
$452,500	4%	$210,124	$168,253	$104,749	$75,817	-$17,204	-$11,256
$452,500	5%	$264,391	$211,706	$181,884	$131,647	$83,207	$54,438
$452,500	6%	$311,764	$249,639	$255,592	$184,997	$188,717	$123,469

Accordia Freephone 0800 444 999
Accordia Email service@accordia.co.nz
Accordia Christchurch Unit 4B, 303 Blenheim Rd
Accordia Auckland Plaza Level, 41 Shortland St
Accordia Hamilton Suite 9, 9 Lynden Court

accordia
www.accordia.co.nz