Oakwood
FINANCIAL ADVISORS

Strategic Alternatives to Deposits

In our January note to clients (see link **Reasons for Optimism**) we struck a positive note for markets in 2021. This was related mainly to an efficient vaccine rollout and increased consumer spending from the buildup in savings deposits. While Ireland has had its issues, the surprising success in the UK and the US shows that, when enough vaccines are available, much can be achieved.

One paradox of the coronavirus pandemic is that even as some business and jobs disappear, a significant number of households have reduced personal debt levels. On average, more money has been saved, as a result of lower spending. The majority of these funds are held in bank deposits.

Cash Buffer

Every investor needs a cash buffer in case of emergencies, but too much cash can negatively impact on returns. A good rule of thumb is to save six months of your salary in cash. Then invest in a spread of different assets that can deliver a long-term return for your specific goals.

Purchasing Power Over Time

It is common for some people to hold large cash balances, especially in times of market uncertainty. But historically cash is not a good store of value for individuals due to the corrosive nature of inflation eating into its purchasing power over time.

You might choose to invest because you are looking to achieve potentially higher returns on your money than holding cash. Moreover, you are comfortable with the idea of setting your money aside for the long term (at least five years or more).

Impact of Inflation

Inflation typically runs at about 2% on average each year. A basket of goods bought in Ireland in 1981 for €100 would now cost €326 in 2021. That equates to a 226% increase in prices over 40 years. (Source – Central Statistics Office).

If we look over a 10-year period and translate a 2% inflation rate to the value of cash deposits, this means €100,000 today would be worth €81,707 in real money terms in 2031.

Negative Deposit Rates

This is particularly relevant in the current environment where deposit rates on cash are low and, in some cases, negative. If you have excess cash balances you should consider how to protect and grow your capital to achieve your specific needs.

Tax Efficiency

It's important to save in the most tax-efficient way, by making sure you fully utilize any available tax reliefs. Maximising your pension contributions is still the most the most tax efficient way when available on earned income. For those with Capital Losses carried forward, investments can be structured to offset any gains against these losses.

Diversified Investment Portfolio

Investing does, of course, carry its own risks. However, a well-structured and well-diversified portfolio, can be tailored to an individual's requirements. Managed correctly, it can protect capital from inflation and the decline in purchasing power over time. A portfolio based around solid global companies has been proven time and time again to give positive returns above any other asset classes. Diversifying your investment portfolio is one of the best ways to reduce risk, and thus promote growth.

What You Can Do to Minimise Risk

First thing is to realise there is no silver bullet to solve the problem. There are currently no fund options with capital guarantees and guaranteed positive returns without a catch or additional cost involved. You cannot get a higher yield without taking on some form of risk.

To counteract the effect of Negative Rates and Inflation you have to **work some of your money**. It is that simple. Equities, historically, offer the potential for the highest returns and to have any opportunity to maintain their capital (see table below).

Since 1990	
Irish Consumer Price Index (inflation)	**S&P 500 Share Index * increased**
2x	**8x**
€100 invested in 1990 in the S&P 500* would be worth today €1,183 allowing for share growth and dividend reinvestment each year.	
A basket of goods and services that cost €100 in 1990 would today cost €190. **	
Conclusion: Mainstream equities are an extremely effective way for the long-term investor to build and protect their wealth and purchasing power both while building up their pension funds and in retirement.	
* The S&P 500 is the stock market index that tracks the stocks of the top 500 large cap U.S. companies by reporting the risks and the returns.	
** Source CSO Website	

S&P 500 Share index growth versus inflation

Oakwood
FINANCIAL ADVISORS

Weighing Up Options – Equities Outperform

The market is always vulnerable to **negative surprises** and this will be always the case. However, overtime, equities have outperformed all other asset classes with an upward trajectory – see the chart **Wall of Worry** on page 4. We previously outlined the strategic alternatives below for investors in our January note:

- **Sit in cash at a guaranteed zero to negative return and wait for a more stable environment**. My experience is that, individuals who take this approach will always have a reason not to invest as they always perceive the glass to be half empty. Not a good approach. Going to cash is extreme and certainly not advisable now. You would have a zero return while you wait for the correction and a "good time to invest". It is the time invested, rather than timing the investment, which makes the difference.

- **Approved Retirement Funds (ARF) - Cash can be futile and costly**
For individuals with an ARF fund invested in cash it is an even more futile approach. A double blow of negative returns and an annual management charge. A guaranteed circa minus 2% return a year, for a start, before you withdraw any income. And this doesn't even allow for the risk of inflation coming back due to the low interest rates and expected consumer spending splurge.

- **Reduce risk, in deference to the high level of uncertainty, and accept even-lower returns.** That makes sense but then your returns will be lower still.

- **Increase risk in pursuit of higher returns.** This one is "supposed" to work. But it is no sure thing. There is a tipping point, which if exceeded, can have a huge impact on the capital and long term returns. If time is on your side, and you have no requirement for income, then this can be considered as you can sit out any dips. If such is the case, this option is worthy of consideration.

- **Put more into special niches and alternative funds/investment managers.** Look at alternatives, private equity and alternative markets (Green Energy/Bitcoin) where there might be more potential**. *But doing so introduces illiquidity and manager risk*.** There are no free lunches.

Market Extremes – February decline to all time high

If we look as recent as 2020, it was a year of extremes. At one point the S&P 500 index was down -34% (19th Feb – 23rd March) yet still ended the year with a positive 16% return (please see the chart on page 9 for further details on Annual Returns along with Intra Year declines). Cashing in your investments at market lows is crystallising a permanent loss rather then sitting out a volatile period in the markets and then realising the gains.

Avoid Overvalued Assets

Making sure what you own is not overvalued offers some protection. If we look at the US market today, the S&P 500 Index is at an all-time high. Relative to history it doesn't take a genius to work that the broad US equity market offers poor value at present. On that basis if looking at investment options a reduced US exposure would make sense with a move towards a Global exposure.

Wall of Worry

A Timeline of Negative World Events

Oakwood®
FINANCIAL ADVISORS

The chart below shows the growth in world equity markets despite a never-ending stream of negative world events.

Despite ongoing uncertainty, $1 invested at the start of 1988 grew to $6.59 by the end of 2020. This is an average annual return of 5.88%

"History is the record of man's steps and slips. It shows us that the steps have been slow and slight; the slips, quick and abounding." – B.H. Liddell Hart

Source: Bloomberg, Humans Under Management.
Returns are based on the MSCI World price index from 1988 and do not include dividends. For illustrative purposes only.

Human Behaviour

Some people fear a falling stock market and don't want to invest. In fact, many investors want to cash in their investments at these moments. The opposite should apply in these situations - the thing to do would be to invest a bit more, but people are naturally averse to that in case the market falls further.

How much should you invest?

If you work on the basis of investing only half of your cash, this half will need to do the heavy lifting to generate enough growth to outrun inflation after costs and compensate for the funds losing value on cash deposit.

The invested half realistically will need to grow at between 5% and 6% p.a. to do the job if you are starting capital is to breakeven in real money terms. This is assuming negative rates remain at these levels and inflation runs 2% yearly.

Ideally, leave only what you are comfortable in Cash Deposit. That is, just what you need in cash to fund major short-term cash calls and support lifestyle costs. Move the rest. The minimum to move is half, but ideally move more.

How Long to Invest

If you want to counteract the double setback of negative rates and inflation you have to consider putting at least half your cash pile to work in moderate risk investments that can fluctuate up and down in value anywhere between +/- 4% and +/- 15% in any given year (see the chart on page 9) and to stay in for at least five years, ideally long-term over seven to ten years.

The kind of investments should you consider?

As stated earlier a well-structured and diversified portfolio helps to reduce those risks. A portfolio should be **tailored to your requirements** and managed sensibly to help protect against inflation and a decline in purchasing power.

- **Equities, carefully chosen in companies** that have the capacity to drive earnings higher than inflation and whose value will not get hammered when inflation arrives. This means specialist equity funds and segregated accounts.

- **Gold** (not more than 15% of Cash), ideally physical storage in Zurich Life, Certificates from the Perth Mint or a fully gold backed ETF.

- Global **Inflation-Linked Government Bonds** hedged to the Euro.

- A Global multi-asset fund offering a combination of the above assets - tried and tested over time where its objective is "do not lose capital" heavily weighted in **Defensive Equities, Gold and Inflation-Linked Bonds**, with the rest across a mix of alternative investments.

- A low cost **Passive Index Fund** is an option also worth considering for those with a long term investment perspective.

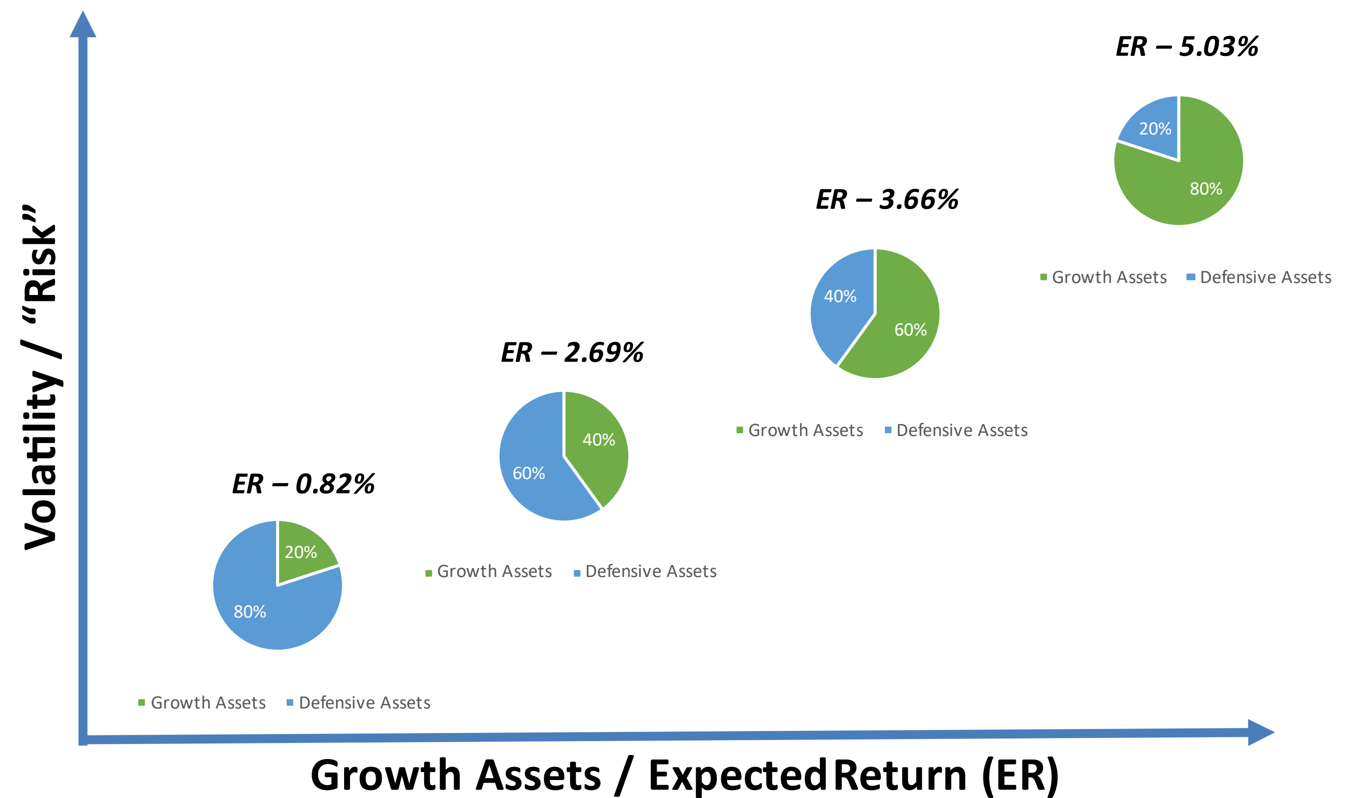
Expected Return and Growth Asset Relationship

Growth Assets

Growth assets are equities, property, commodities, alternatives. Equities on average grow by 8% per annum (gross) but have a higher volatility (25%) than defensive assets. Equities are the primary driver of investment performance.

Defensive Assets

Defensive assets are fixed income (bonds) and cash. Historically bonds have delivered 4/5% per annum with relatively low volatility. However, the forecast for fixed income and cash is 0-1% per annum for the next 5 years.



Automate your Regular Savings

One habit that successful investors share is that of **automating their monthly savings**. In simple terms this is a regular monthly investment plan (ideally increasing the monthly amount by 5% each year). Think of this as your **most important monthly expense**. This can apply just as much to retirees as to a young couple saving for their own retirement or an education fund for a child or grandchild.

Know how much time is remaining in your wealth window. Savvy investors know this number to the month, if you are 10 years away from retirement you have 120 months left in your wealth window, if you are 14 years away you have 168 months to go.

Benefits of Saving Regularly – Reducing Risk

The main advantage of regular saving each month is in the principle of what is called **'euro-cost averaging'**. This method or strategy can help to reduce risk during times of market volatility and can avoid the pitfalls of attempting to 'time' entry into investment markets.

Make market volatility work to your advantage

You won't be putting all your money into the market when it is at a peak. Neither, of course, will you be putting it all in when the market is low – but for many investors that is not something they would rush to do. The way to look at it is that you can buy more units with a fund when stock market prices are low and fewer when prices are high and, in this way, you make the volatility of the stock market work to your advantage. It also ensures that you have a permanent interest in the equity markets, rather than trying to time your investments – a strategy that most investment professionals regard as impossible.

Other Prudent Steps to take

First and foremost, clear off any borrowings or debts. Start with the highest interest rate. Say a loan is costing 3% p.a. and you are getting -0.65% on your deposit, the gap is 3.65% p.a. so clearing it guarantees a saving of 3.65% tax-free.

If you clear any debt first remember to then funnel the monthly savings into buying investment assets through monthly savings products, in particular if its monthly savings into a Pension product with full tax relief.

- **Exit unsafe banks**, any bank with a low-grade Credit Rating and Credit Unions that use low grade banks.
- Think about **An Post**, it is likely to go negative slowest. When you give money to An Post, you pass it onto the Irish Government balance sheet, which is less likely to default than banks.
- The banking system, especially in Europe where buffers are thinner than in the USA, is likely to be severely tested by a new swathe of defaults on consumer and corporate debt in the fallout from the COVID pandemic. Depositor Guarantee Schemes are only as strong as their Guarantor. Nothing is absolute and any deposit over €100,000 in total at any one bank can be raided in the extremis as occurred in **Cyprus in 2013**.

Oakwood
FINANCIAL ADVISORS

Achieving a Balance - Between Short and Long Term Considerations

You should have a balance in your portfolio between growth assets (equities) and defensive assets (deposits & bonds). It is about a balance, assessing your short-term needs in line with the risk of longer-term investments.

Realistic and Optimistic

We remain optimistic about the future. **Fiscal stimulus coupled with low interest rates and vaccine rollout will support continued equity performance in 2021.**

As stated, there are always negative surprises. However, overtime, the great companies of the globe continue to generate profits and growth providing an opportunity for investment growth.

As always, please contact me with any queries.

Ronan McGrath
Managing Director
Oakwood Financial Advisors
M: +353 (0) 86 6098615
E: ronan@oakwoodfinancial.ie

April 2021

Warnings:

Past performance is not a reliable guide to future performance.

The value of your investment may go down as well as up.

If you invest in any of the funds you may lose some or all of your money.

The information contained in this document does not constitute financial advice.

Please note:

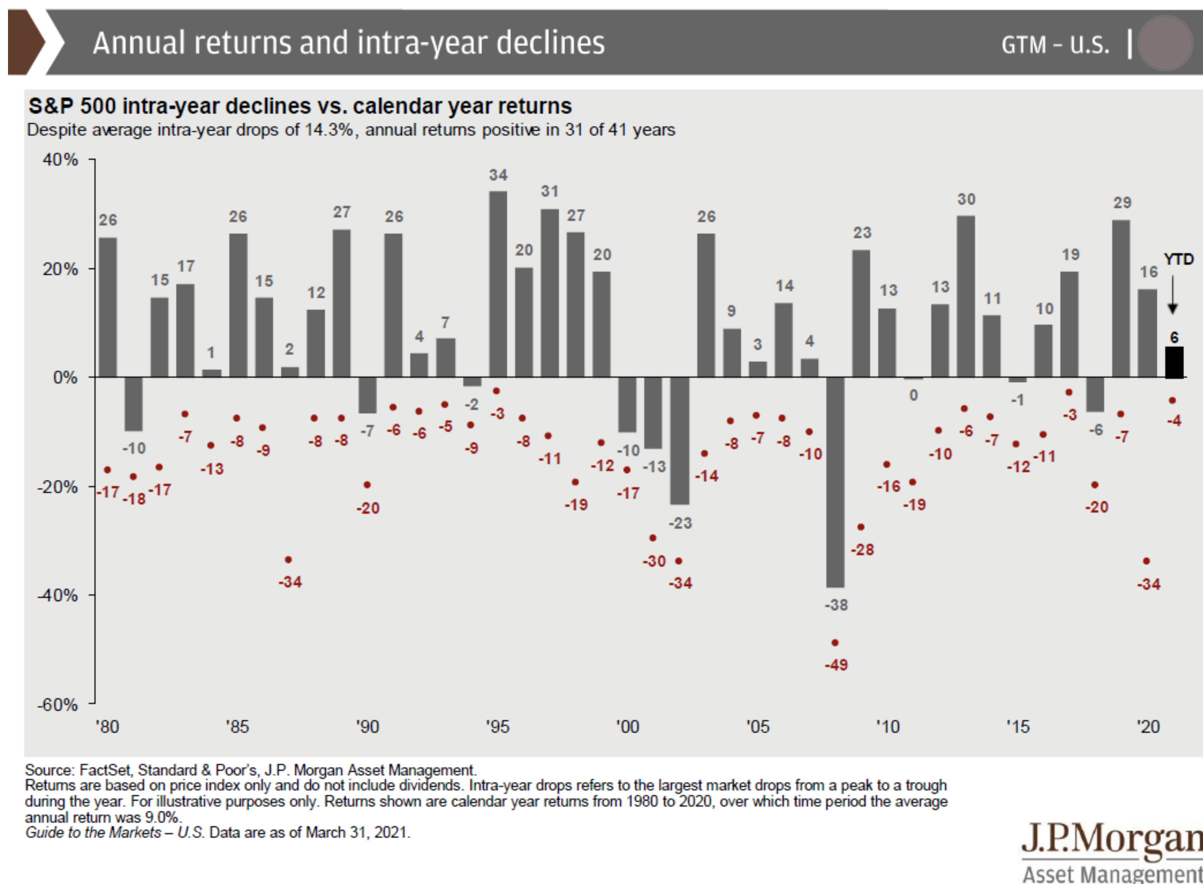
This document does not constitute financial advice.

Before any investment recommendations are a financial review and risk assessment needs to be carried out to ensure the investments recommended are appropriate to each individual clients needs.

Annual Returns and Intra Year Declines

In an effort to put some perspective on market volatility we have illustrated the annual returns and declines on a US Equity fund. The chart below from J.P. Morgan tracks annual returns in conjunction with intra-year declines for the S&P 500 Index (US top 500 equities) from 1980 through to March 2020.

The annual returns are denoted by the grey bars. Notice there are many more positive grey bars than negative. In fact, it's about 1 in every 4 years that end up having a negative annual return. That statistic is based on an annual January 1 to December 31 calendar year.



However, if you also look at the red dots and their corresponding values you will find that many of those positive yielding calendar years had a period within the year ("intra-year") that was negative.

For example, in 1998 the market was up about 27% for the year but at some point "intra-year" the market was down 19%. Measuring from 1980, the average intra-year decline is 13.8% annually. *This puts some of the market volatility into perspective:* On average, we can expect with an equity fund that at some point in the year the market will dip down on average 15% yet still have positive returns 3 of every 4 years.

If we look as recent as 2020, you will see at one point the market was down -34% (19th Feb – 23rd March) yet still ended the year with a positive 16% return.

It also serves as a helpful reminder when trying to assess portfolio performance and picking selective timeframes. The shorter the time frame, the more volatile the market can be. However if we look at rolling 5 year periods or more it smooths out these market fluctuations and keep focused on the long term.

Bear Markets

If we take Global financial Crash in 2008, the worst Bear Market (drop over 20% in market values) over the last 80 years as an example, it took 17 months for the market to reach its lowest point in March 2009 a further 32 months to recover to pre 2008 values (it takes roughly twice as long to recover as the time it took for the markets to drop). Structural bear markets such as the GFC 2008 take longer to repair than event driven bear markets as happened with the COVID 19 impact in 2020.

DATES OF MARKET PEAK	DATES OF MARKET TROUGH	% NEGATIVE RETURN	DURATION OF MARKET DROP	MARKET PEAK	MARKET TROUGH
29/05/1946	**23/06/1949**	**-29.50%**	36.5 months	19.3	13.6
02/08/1956	**22/10/1957**	**-21.50%**	14.5 months	49.7	39
12/12/1961	**26/06/1962**	**-28.00%**	6.5 months	72.6	52.3
09/02/1966	**07/10/1966**	**-22.20%**	8.0 months	94.1	73.2
29/11/1958	**26/05/1970**	**-36.00%**	18.0 months	108.4	69.3
22/01/1973	**10/03/1974**	**-48.00%**	20.5 months	120.2	62.3
21/09/1976	**03/06/1978**	**-19.40%**	17.5 months	107.8	86.9
28/11/1980	**08/12/1982**	**-27.00%**	20.5 months	140.5	102.4
25/08/1987	**04/12/1987**	**-33.50%**	3.5 months	336.8	223.9
26/07/1990	**11/10/1990**	**-20.00%**	3.0 months	369	295.5
27/07/1998	**21/08/1998**	**-19.30%**	1.5 months	1186.8	957.3
24/03/2000	**09/10/2002**	**-49.20%**	30.5 months	1527.5	776.7
09/10/2007	**09/03/2009**	**-57.00%**	17.0 months	1565.1	676.5
29/04/2011	**03/10/2011**	**-19.40%**	5.0 months	1363.6	1099.2
20/09/2018	**24/12/2018**	**-19.80%**	3.0 months	2930.8	2351.1
19/02/2020	**23/03/2020**	**-33.90%**	33 days	3386.15	2237.4