Media Release

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Should I set aside cash for my withdrawals?

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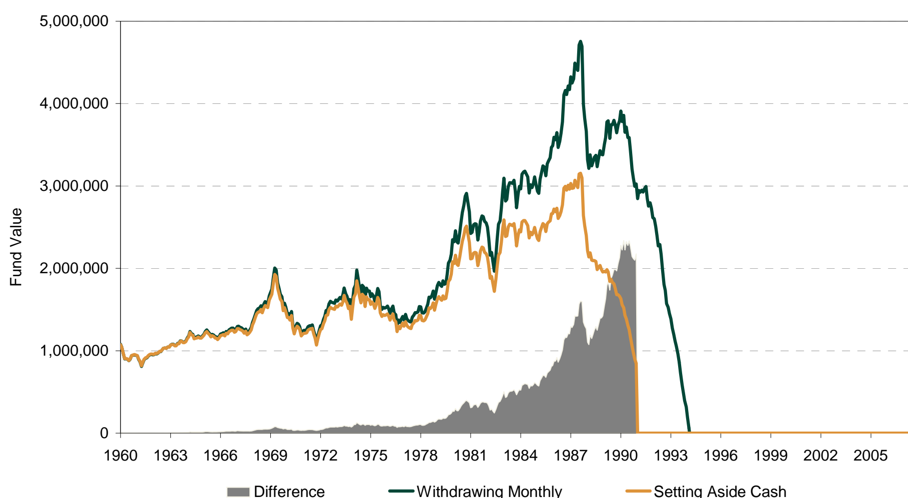
A person drawing down from their investments can choose from a number of different withdrawal strategies. One popular strategy is to set aside enough cash at the beginning of each year to meet that year's spending requirements. The cash set aside earns money market interest rates at very low risk, while the rest of the investment portfolio is subject to the vagaries (and volatility) of the equity markets.

This approach gives investors some degree of comfort, since they are not making withdrawals from their investment portfolio when equities are falling, and instead then only withdraw funds from the 'non-volatile' part of the portfolio. We have done some research, which considers the value of this approach; by comparing the results an investor would have achieved using this methodology, to the results gained by making monthly withdrawals from his investment portfolio.

As an example, let's consider an investor who began making withdrawals in January 1960. Also assume that he had R1 million to invest, that he wanted R6 000 per month in the first year (increasing by inflation each year) and, for simplicity, that his investment portfolio consisted of 60% Equities and 40% Cash.

The graph below shows how his fund values would have evolved over time using both withdrawal strategies.



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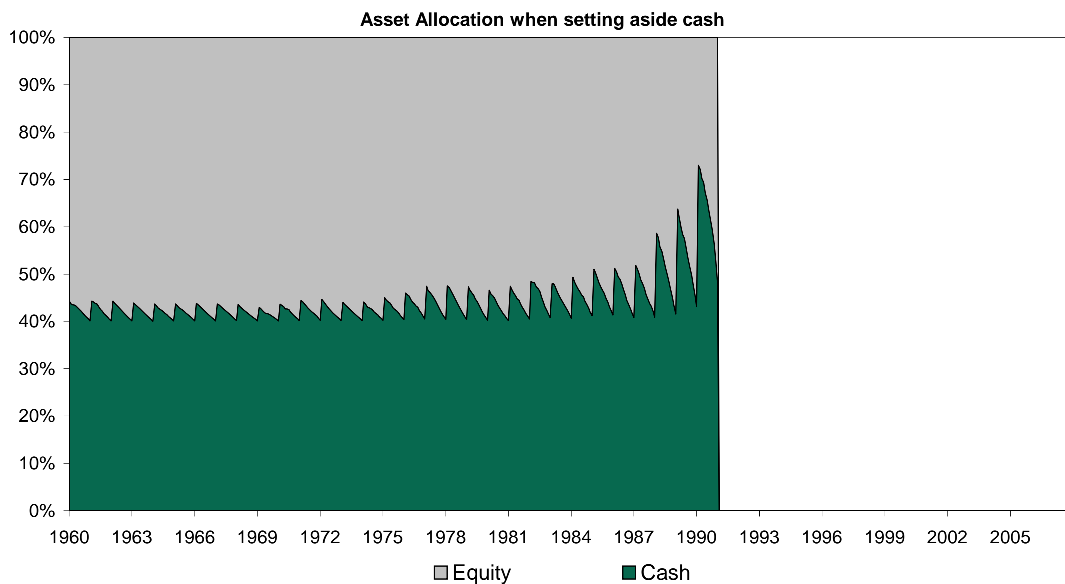
The green line represents the fund values if he withdrew from his investment on a monthly basis, while the orange line shows what his fund values would look like if he set aside cash at the beginning of each year to fund his withdrawals. The grey shaded area represents the difference between the fund values in rand terms.

There are at least two worthwhile things to notice about the above graph. First, the fund value when cash is set aside is almost always lower than the fund value when monthly withdrawals are made. Secondly, the investor runs out of money much sooner than if he makes monthly withdrawals from his investments.

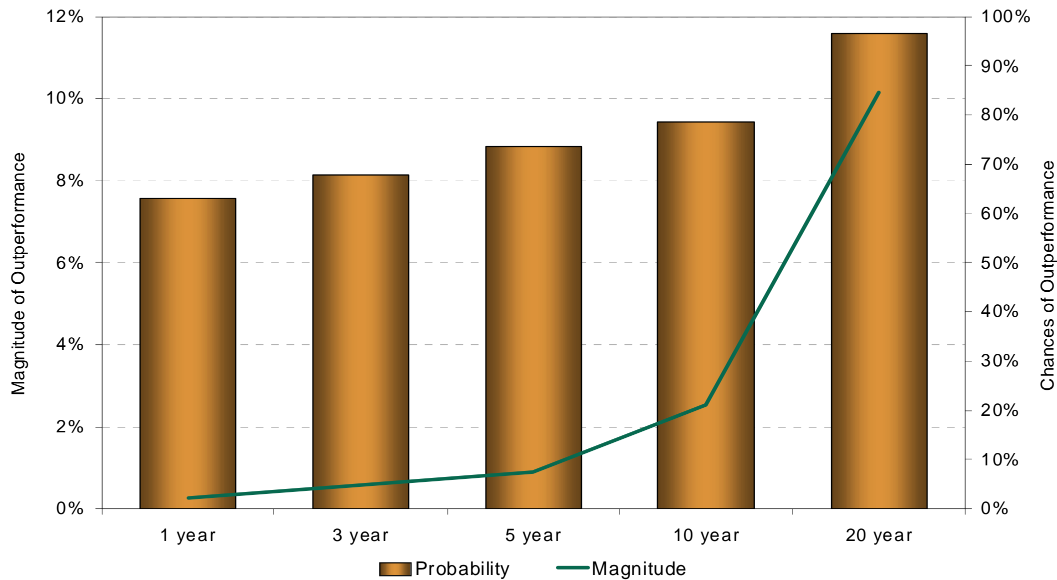
These differences can be explained by the overall asset allocation of the investor who sets aside cash each year to make withdrawals.



One can quite clearly see that the investor's overall asset allocation (investment portfolio plus cash holdings) is different to the asset allocation, which was initially assumed (60% Equities, 40% Cash). The data stops in December 1990, which is when this investor runs out of money. One also notices that the "spikes", which represent the investor's allocation to cash become greater as time passes. This is because more money has to be set aside to meet withdrawals that are increasing with inflation.

Although having more cash in the portfolio means that the investor is better protected when share prices are falling, it also means that these investors lose out in periods when equities are doing well. Indeed, over the long-term equity markets have produced far better returns than cash. Although these good returns have not come smoothly, it is clear that missing them has a detrimental effect on portfolio values.

To extend the analysis we also considered various rolling periods from 1960 to the present, and calculated the probability that a monthly withdrawal strategy outperforms. We also calculated how much higher your fund values might have been if you had made monthly withdrawals instead:



The orange bars in the above graph show the chances that your fund values would have been higher if you employed a monthly withdrawal strategy (measured on the right axis), while the green line shows *how much* higher those fund values would have been (measured on the left axis). Over shorter periods, the chances that a monthly withdrawal strategy outperforms are around 70% with fund values that are 1% higher on average. This may not sound so great, but if one considers the more realistic 20-year case, the chances that a monthly withdrawal strategy outperforms rockets to more than 96%, with fund values that are 10% higher!

This research highlights some of the flaws inherent in the strategy of setting aside cash to make withdrawals. What is perhaps less obvious from this work is further confirmation that the asset allocation decision is critical for success in investing, because the fact remains that asset allocation is actually the only real difference between these two strategies.

Thus far, we have only considered the investment merits of both these strategies, but what is perhaps more important from the planner's perspective are the behavioural issues surrounding the decision. It is well documented that investors are asymmetrically biased against losses. This means that they perceive a loss of R1000, say, with far more emotion than a gain of R1000 even though their actual difference in wealth remains exactly the same.

Investors also suffer from a bias towards overconfidence in their own abilities, leading to decisions, which are insufficiently researched. This is extremely dangerous, as investors believe that they have a good enough understanding of complicated processes when in fact they do not. Their decisions will be sub-optimal as a result.

Related to this is the fact that investors will attribute positive outcomes to their own knowledge and skill, while blaming negative outcomes on external factors such as market 'irrationality' or a 'bad' financial planner.

These are just some of the many biases that affect investors' decision-making abilities. The professional advisor can really add value to the financial planning process by carefully taking a decision, which has investment integrity while still providing a certain level of comfort for clients by managing their biases appropriately.

The financial planner has to be assertive with his recommendations, which in turn should be backed by sound theoretical knowledge and practical experience. The eventual choice should only be made, however, after carefully considering the individual needs and circumstances of the client.

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