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Time, a silver bullet?

Public debate on the *Wet toekomst pensioenen* (Wtp) intensified around its entry into force on 1 July 2023. A central theme is intergenerational fairness and how differing investment horizons shape outcomes for different age cohorts. The new Defined Contribution (DC) system with individual pots holds greater investment risk for participants. Although lifecycle investing is designed to reduce risk with age, the transition still requires careful management.

The widely held notion that time is a silver bullet for investment risk also warrants closer examination. While longer investment horizons generally increase the likelihood of recovering from market downturns, a full recovery is not always guaranteed. This raises a key question – how much risk are younger participants bearing and is this fully understood?

LONGER HORIZONS REDUCE UNCERTAINTY PARTLY

Research on long-term investing challenges the idea of declining investment risks over time. It is commonly found that longer horizons reduce uncertainty around average annual returns, but this is not the full picture. The sequence of the returns can have a meaningful impact on accumulated savings at retirement. For a 30-year retirement savings horizon, returns during the first 15 years may explain 6% of final wealth accumulation while returns during the last 15 years may as much as explain 65% [1] (the balance made up of actual contributions). This means that below average returns late in a working career could overshadow higher returns achieved earlier.

Empirical studies suggest that inflation adjusted recoveries after major market declines can take decades. This means that even long investment horizons may coincide with extended periods of below average real returns [2].

Further analysing the behaviour of financial markets during crisis-periods resulted in remarkably consistent results. Periods of severe market stress logically result in higher volatility. Although individual asset prices may recover from sudden declines, portfolio risk is not likely to revert to a pre-crisis level for a long time. Instead, increased volatility may linger in the portfolio, increasing the risk of further adverse movements [3,4].

THESE INSIGHTS HAVE DIRECT IMPLICATIONS FOR THE WTP

Within this context, current market conditions also deserve some scrutiny. Based on the Shiller P/E Ratio, the S&P500 is trading at valuation levels last seen in the period leading up to the burst of the dot-com bubble [5]. The Shiller P/E ratio is a through the cycle P/E ratio that uses 10-year inflation adjusted earnings. This is not necessarily an indication of an imminent market crash, but a high Shiller P/E ratio typically corresponds to subsequent 10-15 year periods with below average real returns.

These insights have direct implications for the Wtp, as the new DC system revolves around the investment outcomes of individual participants. Younger age cohorts are more likely to be assigned more risky asset allocations by pension funds, and when having the option to allocate assets based on their own preference, also tend to take a more risky approach than older generations. This increases the expected returns and pension outcomes at retirement. However, while time horizons do provide more time for recovery after market shocks, they also increase the probability of experiencing a shock at least once during their careers. If these shocks persist, this may impact outcomes over a significant portion of the accumulation phase.

The new Defined Contribution (DC) system with individual pots holds greater investment risk for participants. From an actuarial perspective, this requires a careful balance between growth and resilience against long-term market shocks. However, it is also important to understand the limitations of time as a mitigant for market risk. Perhaps, it is not a silver bullet after all. ■

Sources:

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