

Time, a silver bullet?

By Merlijn van der Lans, Gerben Draaijer en Olivier Roodenburg

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?

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.

Sequence matters

Investment returns are path-dependent: 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 explain as much as 65%¹ (the balance made up of actual contributions). This is due to the fact that the portfolio balance is relatively low during the beginning of the accumulation period. Initially, contributions are the key driver behind portfolio growth, while market fluctuations will have a lesser effect. As the accumulated assets grow over time, market fluctuations will have an increasing impact on the portfolio and the annual contributions made by the participant will be of lesser relevance. Consequently, below average returns late in a working career could overshadow higher returns achieved earlier.

Higher volatility can linger

In practice, the assumption of stable market risk becomes increasingly unrealistic as the investment horizon lengthens. Market shocks such as financial crises can materially alter the risk profile of a portfolio. While a crisis occurring early in the accumulation phase may have a limited immediate impact on wealth levels, its associated increase in volatility can persist. If elevated volatility lingers, it may affect returns for a long time, including periods when portfolio balances are substantially higher later in a participant's career.

Analysis of financial markets during crisis periods yields remarkably consistent findings. Severe market disruptions, such as the Global Financial Crisis or the COVID-19 pandemic, are invariably accompanied by sharp increases in volatility. Research indicates that such shocks can have long-lasting effects on financial conditions, influencing not only expected returns but also the entire distribution of returns faced by investors. Following the Great Depression of 1929, for example, the market price of risk remained elevated for more than a decade². This suggests that crises can shift markets into periods characterised by heightened downside risk and persistent uncertainty.

Empirical studies further 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 returns³.

Insights from the Shiller P/E ratio

Within this context, market conditions at the time of writing in March 2026 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 dotcom bubble⁴. The Shiller P/E ratio is a through the cycle P/E ratio that uses 10-year inflation adjusted earnings. Temporary fluctuations in earnings are smoothed out, providing a more comprehensive view of the market's valuation. The current Shiller P/E ratio is not necessarily an indicator of an imminent market crash. However, higher Shiller P/E ratios have the historical tendency to be followed by ten - to fifteen year periods of below-average returns. This further supports the idea that market cycles can be long and can impact a substantial part of the retirement savings horizon.

The impact on behaviour

People are also emotional beings with memories. Experiencing a financial crisis can therefore impact the investment behaviour of participants. Under the flexible premium, participants have a higher degree of freedom to choose how to invest their pension pots, along with visibility of how the investments are developing. Participants who have taken on more risk initially, might be reluctant to keep doing so after experiencing a market shock. Research suggests that such experiences can impact investment behaviour for several decades⁵.

Reducing the allocation to risky assets following a market downturn might feel safe but can be a costly decision. It means that there will be lower participation in future periods of market recovery and growth, with potential negative implications for final retirement outcomes.

Within the context of Wtp

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 riskier 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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M. van der Lans MSc is Consultant Financial Risk Management at KPMG. G. Draaijer FASSA is Manager Financial Risk Management at KPMG. O. Roodenburg AAG MSc is Senior Manager Financial Risk Management at KPMG.