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High returns aren’t always best investment

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High returns are always better, right? Unfortunately, SMSF and other investors who focus on average returns while ignoring the volatility of those returns may be setting themselves up for substantial long-term underperformance.

Overall, Australia’s SMSFs have proven to be as capable as their professional peers. Investment returns in fiscal 2015 averaged 6.2 per cent, the fifth consecutive year of positive returns.

This was generated from an asset allocation averaging 31 per cent listed shares, 26 per cent cash and term deposits, 11 per cent non-residential real property, 9 per cent unlisted trusts and 5 per cent other managed investments, according to the ATO.

However, over the nine-year period to 30 June 2015, SMSFs on average achieved a 5.1 per cent annual return, while the larger super funds (corporate, industry and retail) posted a marginally better 5.26 per cent gain.

Given the deeper global financial crisis drawdown experienced by the large funds, it is tough to chalk this one up as a win for the professionals, and safer to conclude that neither camp is producing stellar returns. Further, examining the volatility of the various asset classes SMSFs are currently investing in shows a low level of risk-adjusted returns.

While most investments move up and down to some extent, excessive volatility is not only difficult to cope with psychologically, but can also can dramatically reduce long-term performance.

Apples versus oranges

As an example, consider the case of two different Australian managed funds that are both reporting an average annual return of 8 per cent over a five-year period. On paper, both would appear worthy and identical investments.

Fund A is a consistent performer, showing an 8 per cent return each year, regardless of market conditions. The value of $100,000 invested in this fund therefore grows to $146,933 by the end of the fifth year, making this fund a genuine performer worthy of any SMSF's consideration.

Meanwhile, Fund B has also generated an 8 per cent average return over five years. However, unlike its consistent cousin, this fund has seen some volatile years, undoubtedly reflecting its investment strategy.

In the first year, Fund B delivered a standout 30 per cent return. Champagne corks were undoubtedly popping, with this fund likely appearing at the top of the annual winners' list.

Sadly for Fund B investors though, the next year brought a 20 per cent decline as conditions turned against it. The next year, it was back in the good books with a 25 per cent return, however, once again it disappointed the following year with a 20 per cent loss.

Finally in year five, Fund B delivered a 25 per cent gain, helping it achieve an average annual return of 8 per cent over the five-year period. Yet disappointingly, a $100,000 investment in this fund was worth $130,000 after five years, some $16,933 less than its rival fund, despite both having an identical average annual return on paper.

This was because the true return of Fund B was 5.39 per cent, compared to its stated 8 per cent average return, due to the effects of volatility.

Extrapolated over 30 years, Fund B's investment would be worth $483,038, yet the consistent performers at Fund A will have delivered a portfolio worth more than twice as much, at more than $1 million, assuming no withdrawals from either fund.

Lessons for SMSFs

When picking new investments, SMSF investors should pay equal attention to fluctuations in annual returns as much as comparing average figures, as clearly shown by the above example. Pick the wrong fund, and you could lose half your portfolio value over the long term – not an outcome super funds set up for the future should accept.

The latest SMSF data has shown SMSFs are increasingly willing to invest in new asset classes, in search of yield and capital gain.

In this regard, reducing overexposure to share market risk should be a key consideration, given long-term United States data showing share markets fall by around 35 per cent every 3.5 years on average.

Rushton Financial Services suggests SMSFs could reduce portfolio volatility, and at the same time provide valuable downside protection, by adding an allocation to one of its highly diversified market-neutral funds, which have the ability to perform equally well in both rising and falling markets.

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