Long Term Capital Depletion

Most individuals, whether they are high net worth or not, will be forced to draw down, to some extent, on investment capital over their lifetimes to meet their financial needs. The biggest risk to which investors are exposed to is therefore the risk of uncontrolled capital depletion.

Uncontrolled capital depletion is where an investor is taking capital or raising the yield on a portfolio without addressing the impact on the ability of assets to meet needs over time and where the portfolio is not structured to meet these needs as and when the arise.

Why is capital depletion a fact of life?

The interest and dividend income from a portfolio is often insufficient to meet all an investors needs both now and in the future. To meet the balance of expenditure, capital needs to be drawn from the portfolio.

Many individuals want to be able to maintain a higher lifestyle in the first few years of retirement while they have the health to enjoy it. Living off only interest and income does not always provide this necessary flexibility.

It does not make sense for an individual to have saved throughout their life only to find that they can only spend the interest or income generated by these savings.

There are only two ways in which you can prevent depletion of capital.

1. **One is to reduce the financial demands on your assets.**

2. **The other is for the return on your assets to exceed the rate at which you are spending capital. One has a negative affect on your quality of life, while the other cannot be guaranteed or relied upon.**

You can of course increase the income from a portfolio without depleting capital today. Just increase the amount invested in interest bearing investments. The problem here is that these types of investments are exposed to inflation risk and ultimately incur a capital depletion risk.

Over a 10 period a 2% annual rate of inflation is equal to a loss of capital in real terms of 22%. All other things being equal, it also means a loss of income of 22%. If the investor wants to maintain the level of income, they may have to draw down on capital. Advisors who only structure portfolios for today are ignoring investors' long term problems.

The risks of capital depletion

The following represent three examples of a client being exposed to the risk of capital depletion but is unaware of it.

The first is where a portfolio is being managed to meet current financial needs only. Each year the portfolio is rebalanced to meet the income requirement and/or capital is raised to meet a capital expenditure objective.

In this example there is no planning for the effects of future income and capital expenditure on the ability of the portfolio to meet financial needs. The portfolio may be structured to provide the income you want from dividends and interest alone, but the discretionary capital expenditure will be eating away at the portfolio.

This scenario also results in either forced sales of assets or involuntary deferral of expenditure in the event of declining markets. Careful planning of portfolio structure would avoid these risks.

It also takes up much more time on the managers behalf and will increase the costs of portfolio manager as the structure of the portfolio has to be completely reassessed every year. Every time a manager receives a request for capital he or she needs to sell an asset and restructure the portfolio. Planning would structure the portfolio in advance and reduce costs.

The second situation is where the return assumptions used to predict what your portfolio will be worth and how much you can take are not reflecting the risks to returns.

At the end of 1999 and 2000 many in the industry were using average historical returns to determine what the portfolio could provide. Anybody using these assumptions would have been exposed to significant unnecessary financial risk. This is especially the case where the investor continues to draw down capital at the planned rate. In this case the portfolio would be depleted at a much faster rate.

The third example relates to portfolios incorrectly structured to meet financial needs. This problem relates mainly to retail packaged investment solutions.

These portfolios are not actually structured to meet financial needs as and when they arise leading to additional transaction costs and the risk of forced sales of assets.

Many of these vehicles are also exposed to high management charges. Even if the underlying investment performance of the funds is well above average, the investor will be negatively affected by the increased costs and risks of a portfolio that does not match their financial needs.

The industry's view

The asset management industry in general views investment planning as a financial planning issue. Few asset managers actually model the ability of assets to meet needs over time or structure your portfolio in a way that it is dedicated to your personal financial needs over time.

Indeed, few asset managers will actually take into consideration, or have the systems and processes that can take into consideration all an investors assets. It is, for them, much simpler to manage a separate chunk of money.

While financial planners have long provided projections on future wealth accumulation (how much do you need to save, how much capital will you have to retire on) they do not in general possess the expertise to structure portfolios to meet needs nor do they possess the expertise needed to model the risks to the ability of assets to meet needs over time.

Interestingly, there is little educational focus within the industry on this problem. Most education is either related to products and sales or to technical aspects of stock selection and portfolio theory. If the risks of capital depletion were in fact risks that affected the financial institutions, they would be managed more effectively.

How should capital depletion be managed?

1. Your portfolio should be structured to meet your financial needs as and when these needs arise without having to sell any investments at the time of the need.

2. All income and capital needs should be met from portfolios structured years in advance to meet these needs.

3. All transactions designed to rebuild and restructure portfolios should be effected years in advance, allowing the manager to take advantage of high points in the valuation of stock markets and securities and to avoid forced sales of investments.

4. All portfolios should be capable of meeting the planned income and capital expenditure of investors irrespective of what happens to the stock market in the short term and for prolonged periods of time.

5. All modelling of the ability of your assets to meet your needs should use conservative assumptions that have already hit your portfolio with the effects of higher inflation, stock market crashes and economic recessions throughout your lifetimes.

The only way this can be managed is through the management of total financial assets and total financial needs over your lifetime. This requires a framework for the management of assets and financial needs, it also requires asset and liability modelling and investment planning disciplines needed to integrate asset management expertise with the management of personal financial needs.