Mitigating cascade deficiency

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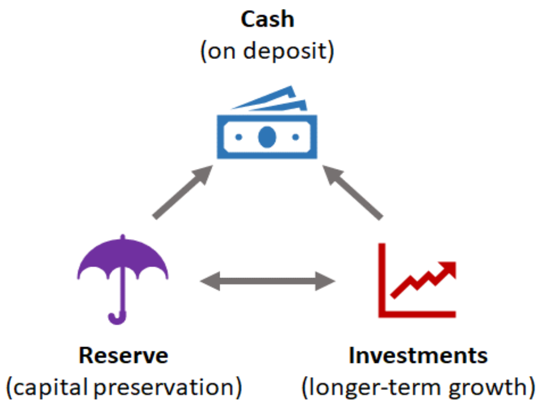
What is cascade deficiency

Multi-pot strategies need clear rules on how assets are transferred between each of the pots and what holdings to populate them with. In many instances, the approach is to move from higher risk assets through to lower risk ones and finally into cash. This forms a 'cascade' effect and risks being inefficient. At the same time, if the holdings used in each pot essentially combine to an overall asset allocation strategy this can also lead to a less efficient deployment of wealth. Together, these issues of inappropriate holdings and a lack of two-way flow between the pots leads to cascade deficiency.

Outcomes-based Multi-pot investing



Two problems in one

In a 2018 academic paper on the issue Javier Estrada looked at data across 21 countries over a 115-year period. He concluded that if the strategy adopted only allows for assets to move from the most risky to the least risky pots then the investor will potentially be disadvantaged. This is because the lower risk pots gain in size relative to the riskier pots in market downturns, creating a drag effect. Although this initially protects wealth, it often results in the overall plan limiting the growth needed to fund the longer-term cash requirements.

Similarly, back in 2014 a US-based financial planning commentator, Michael Kitces, highlighted that if the holdings used in a multi-pot strategy are segmented by asset group (ie. fixed income and equities) and then rebalanced to set percentage weightings, the effect is the same as owning a balanced portfolio. In what he called an asset allocation mirage. This in turn, diminishes the multi-pot structure's ability to alleviate sequence risk.

How can cascade deficiency be mitigated

There are two key issues at the heart of cascade deficiency. The first is only moving assets 'one way', which too often results in not enough wealth being invested for growth. In our modelling we therefore advocate topping up Cash from either the Reserve or Investments, in addition to transferring assets from the Reserve to the Investments where sufficient funds allow and vice versa. Secondly, we believe the debate on how to manage a multi-pot strategy should move from being asset-based to outcomes-based. This changes the mindset around what to select for each pot and improves the ability to alleviate sequence risk.

Outcomes-based approach

To summarise, multi-pot investing spreads an investor's assets over three separate segments (or Pots) – Cash, Investments and Reserve.

The Cash is best placed on deposit for easy access, possibly split across various rates of return.

Investments, meanwhile, are for longer-term growth and likely to be a balanced portfolio of global mixed assets. The majority of an investor's money is held here and it is likely to be the most complex element of the overall financial plan. It will include considerations of the individual's risk profile, assets held elsewhere and tax efficiency.

Finally, the Reserve should be invested with a capital preservation mindset. It needs to be focused on consistency of returns; be easily accessible (even at times of stress); and have a lower likelihood of losses when financial markets decline.

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