The power of compounding

By **James Hart**, Investment Director of Witan Investment Trust plc

IN 2015, PARLIAMENT PASSED THE NEW PENSION SCHEMES ACT WHICH ALLOWED GREATER FREEDOM TO WITHDRAW LUMP SUMS FROM PERSONAL PENSIONS, ALBEIT WITH A DEDUCTION FOR TAX. THE CONCERN OF SOME PUNDITS WAS THAT ILL-INFORMED PENSIONERS WOULD CASH-IN THEIR PENSION POTS AND BLOW THE LOT ON A LAMBORGHINI. ASSUMING THAT THE VAST MAJORITY OF PENSIONERS WERE NOT SUFFERING FROM A COLLECTIVE 'MID'-LIFE CRISIS, THERE ARE SOME MORE 'SENSIBLE' OPTIONS AVAILABLE.

Let's roll the clock back a few years to back-test various options. Assuming the same freedoms were available 20 years ago, one could have purchased a Lamborghini Diablo for £165,000. The same car (assuming it was well looked after) would be worth c. £200,000 today. Alternatively, for the price of the Diablo, a 65 year-old retiree could have purchased an annuity in 1997 which, due to elevated rates at the time, would have paid c. £16,500 per annum for life (or £330,000 assuming our investor survived for twenty years). Current annuity rates would provide approximately half that level of income for the same capital outlay today. Bonds are another option but, with interest rates at historic lows (and with many government bonds yielding less than inflation), retirees risk becoming poorer in income terms during retirement.

What about equities?

Here, we use the track record of Witan Investment Trust (a global equity investment trust) as an example. The calculations include stamp-duty but not other transaction costs (which may vary). In 1997, the same £165,000 could be used to purchase 51,386 Witan shares. First year income of £3,751 equated to a yield of 2.3% but this rose to £10,534 (or a 6.4% yield on the initial outlay) in 2017. In total, over the twenty year period, our fictional investor would have enjoyed an income of £115,310. In capital terms this investment would have grown to £554,457. But please bear in mind that investments in equities are inherently riskier than government bonds and it is possible that you may not get back the amount originally invested.

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Dividend re-investment over the long-term helps produce even better future cash flows (please note the risk warning below). For example, if our future retiree accumulated a 'Lamborghini' fund at age 55, and reinvested the dividends the numbers are quite different. Let's wind the clock back again, this time to 1987, when many schoolboys had a poster of the Lamborghini Countach on their bedroom walls. The real thing cost £80,000 (£220,000 in today's money). Let's assume that our fictional 55 year-old investor purchased 78,813 Witan shares instead of that Lamborghini Countach. Reinvesting, rather than spending, the dividends for the first 10 years until retirement in 1997, would result in a holding of 104,111 Witan shares.

Upon retirement, our fictional investor chooses to stop re-investing so that the income received from these shares over the subsequent 20 years is £233,626. The initial income was £7,636 per annum (a yield of over 9% on the £80,000 1987 investment) and grew to £21,342 per annum in 2017 (an average income of £11,681 per annum over 20 years) while the capital value now surpasses £1,123,000. It should be emphasised that these capital values and dividend growth are historic and certainly not guaranteed.

Witan has managed to increase its dividend for 43 consecutive years at an annualised rate of 9.8%, in addition to capital growth over the long-term but future returns are subject to many long term caveats and risks. Our retiree in this illustration could have accumulated a very significant asset provided they were comfortable with the risk involved in equity investment and adopted a long term investment view.

Clearly, a pension fund the size of a supercar (today's flagship model costs c. £275,000) is out of reach for many but is not far short of the £300,000 postulated as necessary by recent research for the average retiree to maintain their current lifestyles, based on current annuity and state pension rates. After some prudent investing, our fictional 1987 investor could buy that 1987 Lamborghini Countach after all, while retaining a significant pension pot. These 30 year-old classics change hands for c. £350,000 today, which is comfortably ahead of inflation over the period and perhaps a little more fun than owning Witan shares. However even an iconic Lamborghini has not matched the power of growing dividends in compounding investment returns over a long period. ■

James Hart was appointed as Investment Director of Witan Investment Trust plc in April 2015. Previously he worked at Cayenne Asset Management Ltd as a Portfolio Manager specialising in listed investment companies and as an emerging market specialist and Head of Funds at Bank Julius Bar (London) Ltd.

Discrete performance(%)*	Q2 2013 Q2 2014	Q2 2014 Q2 2015	Q2 2015 Q2 2016	Q2 2016 Q2 2017	Q2 2017 Q2 2018
Share Price (Total Return)	22.6	13.9	-2.5	36.2	10.9
Net Asset Value** (Total Return)	12.1	11.2	7.3	28.0	8.7
Benchmark*** (Total Return)	10.9	6.8	7.6	22.7	8.3
Relative NAV Performance	1.2	4.4	-0.3	5.3	0.4

** Source: Morningstar/Witan, total return includes the notional reinvestment of dividends. Annualised figures updated each calendar quarter.*

*** The Net Asset Value figures value debt at fair value and include the notional reinvestment of dividends.*

**** Since 01.01.2017, Witan's benchmark is a composite of 30% FTSE All-Share, 25% FTSE All-World North America, 20% FTSE All-World Asia Pacific, 20% FTSE All-World Europe (ex UK), 5% FTSE All-World Emerging Markets. From 01.10.2007 to 31.12.2016 the benchmark was 40% FTSE All-Share, 20% FTSE All-World North America, 20% FTSE All-World Europe (ex UK) and 20% FTSE All-World Asia Pacific. Source: FTSE International Limited ("FTSE"). FTSE is a trade mark of the London Stock Exchange Group companies and is used by FTSE under license. For more information go to www.witan.com/legal-information.*