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The variability of unit trust returns

There are many factors you should consider to help you select a unit trust that will suit your personal needs and circumstances. Start by clarifying your goals (as discussed in GrayIssue 138) and your time horizon for achieving them, then be honest with yourself about how much investment risk you can tolerate.

Can you endure a bumpy ride?

Investment returns can fluctuate, often dramatically, but as long as you remain invested for long enough to enjoy the benefits of a potential bounce back, drops in value are only on paper. Disinvesting after your investment has lost value locks in your loss and is the reason why so many investors experience lower returns than the funds in which they are invested (please refer to GrayIssues 111 and 124). You need to carefully consider to what extent you will be able to stomach unpredictable ups and downs.

One of several measures you can use to determine how much fluctuation you can expect from a fund is the variability of returns over time. Variability essentially refers to the extent to which returns diverge from the average return over a period. Funds that invest more conservatively tend to have less variation in returns over any given time period. On the other hand, funds that aim to maximise return, usually those with higher equity exposure, will experience more variable returns, which may be especially dramatic in the short term. ‘Variation from average’ is the annualised standard deviation of monthly returns over the period covered, as shown in **Table 1**.

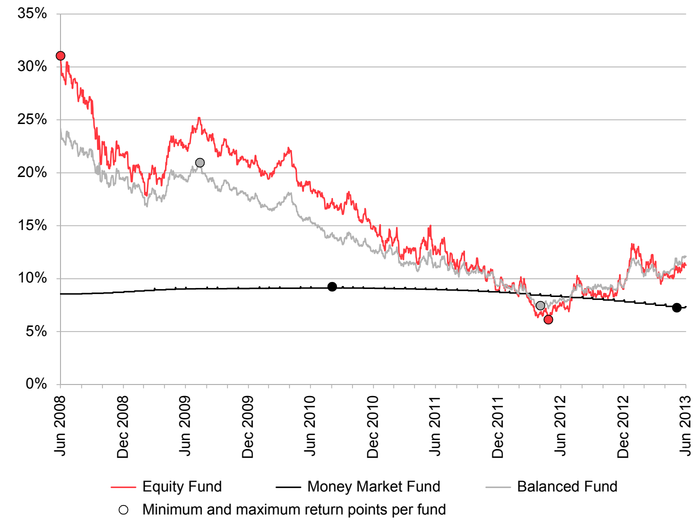
Looking at the range of returns funds have earned in the past will give you an indication of the best and worst case scenarios that you may face during your investment period. This is especially important if you may need to withdraw from your investment in the short term.

Short-term variability can be dramatic

Table 1 illustrates how variability differs between different types of funds, showing the best, worst and average one-year returns for the Allan Gray Equity Fund, the Allan Gray Balanced Fund and the Allan Gray Money Market Fund over the last 10 years.

The table shows that over short time periods the Equity Fund has generated returns far superior to those delivered by the Balanced or Money Market Funds. However, it has also delivered significant drops in value. This should not surprise Equity Fund investors as its factsheet clearly states that it is best suited for investors with a long-term investment horizon who are comfortable with short-term stock market fluctuation and are prepared to take on the risk of capital loss. Meanwhile, the Balanced Fund aims to create long-term wealth more steadily, by taking on less risk of market fluctuation and capital loss than an equity fund. This is also reflected in the table, which shows that the Balanced Fund’s worst one-year return in the last 10 years, although also a drop in investment value, was less alarming than that of the Equity Fund. The Balanced Fund’s variability of 12% is still much higher than that of the Money Market Fund, which aims to

Graph 1 | Five-year annualised daily rolling return in Allan Gray funds



Source: Allan Gray

preserve capital and maintain liquidity, with very low risk of loss and the lowest variability of the Allan Gray funds over any period.

Variability of long-term return depends on the type of fund

Graph 1 shows the returns of the Allan Gray Equity, Balanced and Money Market Funds over rolling five-year periods. Note how there can be variability in fund returns with a high equity mandate, even over the longer term. For example, Allan Gray Equity Fund investors who were invested over the five years ending June 2008 enjoyed the highest return, at 31% per year, while those invested for the five years ending May 2012 received just 6% per year. This means that depending on when investors invested and withdrew, their return experience would have been very different. Given this variability, investors in the Equity Fund face a wider range of possible outcomes than those in more conservative funds.

This illustration is useful to understand variability, but should not be used to predict future performance. The average returns shown are unlikely to be repeated over the next five-year period. Ultimately you need to make sure that your fund’s objective, long-term return potential and the level of fluctuation you can expect marry up with the level of risk, and variation in returns, you are comfortable taking on. Aside from these factors, it is also crucial to select a reputable manager with a strong track record and make sure their philosophy and process resonate with you. If you need help making a decision about which funds are the most suitable for you, you may wish to consult an independent financial adviser.

Table 1 | Variation from average returns in Allan Gray funds over the last 10 years

One-year rolling returns*	Allan Gray Equity Fund	Allan Gray Balanced Fund	Allan Gray Money Market Fund
Maximum	79.7%	49.8%	13.2%
Minimum	-27.9%	-10.7%	5.1%
Average	21.8%	17.7%	8.0%
Variation from average	19.6%	12.3%	2.0%

* Returns include investment management fees. Source: Allan Gray

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