Weighted Average Return

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Many people buy endowments that come in all sharp and sizes. Some give you regular cash back called dividends. People buy endowment because they felt that they cannot take any risk. But they don’t realize that endowments are not low risk. These days, hardly of these endowments promise to guarantee the return of capital. Much of these are merely projections. Moreover, even if there is a promise of return of capital – the real value of capital is not guaranteed. Inflation changes every year. Inflation is completely unknown in the future – there is no such thing as capital guarantee. Capital guarantee is merely a marketing gimmick for the financially uninformed.

But if you really insist of being financially uninformed and want a return of capital, you should not buy long-term contracts too. Here is how I approach financial planning using the weighted average return by using a simple approach. I’ll illustrate this with an example.

Assuming you have $100,000 in assets. And you split the portion into two parts called the 80% and 20%.

80% or $80,000 is invested into something that gives you 2% per annum. After 20 years, your $80,000 will grow to $118,876.

For the remaining 20% or $20,000, you put into something high risk with no assurance of capital guaranteed. Let’s say the assumed rate of return is 10% per annum. Thus, if the assumed rate holds return, $20,000 would have grown to $134,550 after 20 years.

In total the “maturity amount” is $253,426. Relative to the original capital of $100,000 this represents a net return of 4.76% per annum.

If the 20% high risk becomes zero (worst case scenario), you will only have $118,876 at maturity.

1. If you think about it, these days endowment cannot even guarantee your return of capital and yet the above method actually guarantees your capital and even more!

2. Is it possible to get 2% per annum guaranteed for this 80% portion? Many people are already getting this return or even more. If you consider the monies in CPF-OA, SA and Medisave, these are already yielding 2.5% – 5% depending on the amount. For fixed-deposit, if you are a bargain hunter you could get 1% or more. So having 2% on average is not difficult. If most of your assets are in CPF, you are already getting more than this return.

3. Is it possible to lose all your 20%? If you select your investment such that it is diversified, liquid, regulated and not a scam, it is very hard to lose it all. However, this 20% should be high risk in nature such as single country funds. Avoid sector funds because sector moves in long cycles and they can stay low for very long period of time.

4. The advantage of the weighted average approach is that it is highly liquid. You can terminate your fixed deposit any time. Your CPF-OA can be utilized for property purchase and local tertiary education for your children. Medisave can be

used for medical bills, premiums for medical insurance and long-term care insurance. Also for the high risk 20%, if you invest in plain vanilla ETFs or unit trust, you can liquidate it anytime without penalty. Of course, you would try not to do so if it is in the red.

I used a 20 years time horizon because this is the minimum period which many people would commit to a long-term contract such as an endowment.

For ILP, it is the worst kind of product because it provides nothing guarantee in investment returns. You still have to do your own in funds selection.

If you noticed, the weighted average approach hardly needs to buy any product. For the “20%”, if the person buys ETFs, there is no commission. Even he or she buys unit trust, it hardly earns anything in commissions. That’s why many financial advisers do not recommend the weighted average approach.