



Forty years old and still going 'smoothly'

Smoothed bonus funds like market-linked funds, aim to provide investors with inflation-beating returns over the medium-to-long-term. The distinguishing feature of smoothed bonus funds is that they are designed to reduce the impact of market fluctuations experienced in underlying investments, namely local equities, property, fixed interest instruments, as well as foreign securities. Bonuses are declared on an annual basis, aiming to provide a stable return over time.



Roger Birt
Head of Guaranteed Investment Portfolios
Old Mutual Corporate

Investment

This is achieved by retaining a portion of the returns during times of good market performance in order to beef up bonuses declared in bear markets. Investors receive returns in the long-term which can be compared to a balanced fund, with less short-term volatility risk. Smoothing as a concept, it is proposed, is preferable to other methods of achieving capital security such as investing in cash. Smoothing does not vastly impair returns, unlike other strategies investing in lower risk asset classes.

The smoothed bonus strategy is designed to reduce investment volatility without impairing expected long-term performance, to a large extent. Poorly timed decisions can be severely detrimental to an investor's retirement savings. This risk becomes heightened when close to retirement age, as has been experienced in the current extreme environment.

It is useful to examine the experience of investing in smoothed bonus funds versus market linked balanced funds (which experience the ups and downs of the equity market) by highlighting the mixed fortunes experienced by the two strategies in 2008. For example, while the SA Equities (All Share) return for the year ending 31 December 2008 was -23%, most smoothed bonus products offered by the major South African life insurers still managed to declare positive returns.

The difference in performance of these two investment strategies last year has highlighted how smoothed bonus portfolios can reduce the risk of investors close to retirement age. Such investors may have to consider postponing their retirement dates in order to recover built up savings.

Over the years, whilst the underlying concept of smoothing has remained consistent, products have been adapted to market needs. These include products which:

- invest in more aggressive asset classes thereby improving the long-term growth prospects expected;
- provide various levels of guarantees catering for different client risk appetites and consequent return expectations; and
- provide more frequent bonus declarations.

Transparency has long been an issue for potential investors in guaranteed funds. Smoothed Bonus products in general have been criticised for non-transparent management practices. The main areas of concern centre around:

- the methods of declaring bonus rates;
- policyholder funds being segregated from shareholder funds; and
- the impact of bonus smoothing reserves on the allocation of investment returns to investors through bonuses.

To prevent investors purchasing new policies or surrendering existing policies to the detriment of existing policyholders (anti-selection) smoothed bonus funds have traditionally not provided investors with much detail around the latter of these issues. This has led to a concern in the industry over the level of disclosure by smoothed bonus funds. In order to address this matter, better governed smoothed bonus funds have utilised external auditors to provide clients with detail on insurers' processes. In addition, the Financial Services Board since 2008 requires life insurers to publicise how they manage these products in their Principals and Practices of Financial Management document.

Shifts in some retirement funds' attitudes towards smoothed bonus portfolios were examined in the 2008 Old Mutual Retirement Fund Survey. This survey's outcomes suggest that smoothed bonus and absolute return products are set to gain favour among retirement funds, by aiming to spread risk and by setting goals to achieve consistent, long term returns.

Results from the funds surveyed showed that 60% of these funds see room for smoothed bonus products in a life-stage portfolio, while 40% of funds interviewed are willing to pay a premium (approximately 70 basis points on average) for capital guarantees. These findings seem to indicate that while smoothed bonus products may need to continue to evolve to suit changing investor needs, the underlying principle will endure, as it has done for more than 40 years. □

