

# Principles and Practices of Financial Management

How we manage our Max Income for Life with Bonus Escalation Option



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## *Purpose of this guide*

This guide explains how Old Mutual manages the Max Income for Life with Bonus Escalation Option annuity product, including:

- How do income increases work?
- What is smoothing and what are its benefits?
- What is the bonus smoothing account?
- What happens if investment returns are low or if there is a market crash?
- What investments are held for the benefit of policyholders?

The principles and practices described in this document are important because, although the funds are directly invested in investment markets, income increases are not directly linked to the returns achieved. Policyholders must thus rely on the life company to ensure that the income increases declared are fair in relation to the underlying investment returns.

It is also important to note that these principles and practices may need to be adapted over time to take account of changing circumstances, for example in the business, economic, or regulatory environments. Approval of any change needs to be given by the Old Mutual Board and its Committee for Customer Affairs, and will be communicated to affected policyholders.



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## *How do income increases work?*

Policyholders with an Old Mutual Max Income with Bonus Escalation Option are allocated investment growth by the addition of bonuses in the form of income increases.

Income increases are declared with effect from 1 April each year. Policyholders each have their own income increase month. For example, if a policyholder has an income increase month of July, and the income increase is declared with effect from 1 April each year, then income increases for that policyholder will take effect from the July immediately following the 1 April income increase declaration.

### *Setting income increases*

The main objective of Old Mutual's income increase declaration policy is to ensure that over time the income increases produce a similar return to the underlying assets backing the portfolio (after deducting the pricing interest rate and any applicable tax, contractual charges and expenses that impact on the funds available for the declaration of income increases).

The following are the major aspects taken into account when setting the income increases:

- The overall net investment return earned on the assets backing the portfolio (after deducting the pricing interest rate and any applicable tax, charges and expenses) since the previous income increase declaration
- The difference between the calculated book value and market value of the investments backing the Bonus Escalation Option must be within acceptable limits (see "What is the bonus smoothing account?")
- Prevailing economic conditions, including the level of inflation
- The ability of the fund backing the Bonus Escalation Option to withstand adverse changes in investment conditions
- The income increases declared by Old Mutual's main competitors



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The pricing interest rate is the minimum net investment return that has to be earned before any income increase can be declared. The pricing interest rate is currently 3.5% per annum.

No income increase will be declared that would result in the ongoing viability of the Max Income for Life with Bonus Escalation Option being knowingly threatened.



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### *What is smoothing and what are its benefits?*

The main objective of Old Mutual's income increase declaration policy is to ensure that over time the income increases produce a similar return to the underlying assets backing the portfolio (after deducting the pricing interest rate and any applicable tax, charges and expenses). A secondary objective is to achieve this in a way that reduces policyholders' exposure to market ups and downs.

This is known as "smoothing" of investment returns. During periods of relatively strong investment performance on the fund's investments, a portion of investment growth is not declared as an income increase. It is held back, so that in times of relatively poor investment performance, there are funds available to declare a higher income increase than would otherwise have been the case.

**It is important to note that any funds held back in order to smooth investment returns will be used for the future benefit of policyholders with this Bonus Escalation Option. These funds are kept completely separate from Old Mutual's shareholders' assets.**

The **benefits** to policyholders of the smoothing of income increases include reduced exposure to the extreme ups and downs of the stock market (and the anxiety associated with it!).

In addition, Max Income for Life with Bonus Escalation Option offers a guarantee. This guarantee is extremely valuable. It allows policyholders with the Bonus Escalation Option to have exposure to the market's growth potential, knowing that their income is guaranteed for life, and any increase, once granted, is also guaranteed for life.



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### *What is the bonus smoothing account?*

Old Mutual operates two bonus smoothing accounts (BSAs) for its with-profit annuity funds – a long-term BSA and a short-term BSA.

Part of the portfolio of assets backing the Max Income for Life with Bonus Escalation Option is invested in matched interest-bearing assets to ensure that cash is available over the full period for which income payments are expected to be made. The long-term BSA represents the difference between the current market value of these matched interest-bearing assets and the amortised value of those same interest-bearing assets. The effect of the long-term BSA is that support for income increases from the matched interest-bearing asset component of the assets emerges smoothly over the full expected lifetime of the policyholders, and is not affected by changes in the market value of the interest-bearing assets from time to time.

The short-term BSA represents the remaining difference between the market value of the portfolio of assets (excluding the long-term BSA) and the value of the unmatched prospective income payments. It represents the effect of shorter-term changes in the market value of equities (shares).

**It is important to note that any funds in either of the two BSAs will be used for the future benefit of policyholders with this Bonus Escalation Option. These funds are kept completely separate from Old Mutual's shareholders' assets.**

A positive BSA means that some good past returns have been held back, and can be paid out in future as income increases. A negative BSA means that more has previously been allocated to income increases than has been earned. This will need to be recovered in future by declaring income increases that are lower than the investment returns earned.



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The BSAs represent how much past investment returns earned have differed from their longer-term average.

- The BSAs will be positive when past returns are greater than their longer-term average, and can be negative when returns are less than their longer-term average.
- The short-term BSA is expected to average between 0% and 5% of the value of fund's backing the Bonus Escalation Option over the longer-term, but it could in the shorter-term vary between -10% and +15%. There is no maximum for the long-term BSA, but the minimum would not be lower than -5%.
- Care is taken to ensure that neither BSA becomes too negative, as this would adversely affect future income increases.



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## *What happens if investment returns are low or if there is a market crash?*

### ***Management actions***

If investment conditions are extremely adverse (for example, there is a significant fall in investment values), management actions may need to be taken to ensure the ongoing viability of the Max Income for Life with Bonus Escalation Option. The aim of these actions (which need to be approved by the Old Mutual Board) is to restore the level of the BSA to its longer-term target range in order that reasonable future bonuses can be declared.

While Old Mutual has internal guidelines, there are no absolute BSA levels at which particular management actions are automatically taken - this will depend on the specific circumstances at the time.

Management actions (taking the economic and investment environment into account at all times) are restricted to the declaration of low or zero bonuses.

Guarantees provided by Old Mutual will at all times be honoured.



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### ***What investments are held for the benefit of policyholders?***

The Bonus Escalation Option aims to provide policyholders with smoothed income increases that offset some of the effects of inflation. To achieve this, the investments underlying the Max Income for Life with Bonus Escalation Option are made up of a balanced mix of local and international investments. The benchmark asset split is given in the table below. These investments are actively managed to produce the best possible return for policyholders, without adopting too much risk.

The fund managers may depart to some extent from the percentages below, based on their view of the markets and where they expect to earn higher returns. Although the percentages are not expected to change often, Old Mutual may adjust these if changes occur in the regulatory, economic or investment environment, or if a change occurs in the standards of capital management (in other words, what Old Mutual needs to do to ensure that it can meet any guarantees provided).

### **Benchmark asset split for Max Income with Bonus Escalation Option**

<b>Asset class</b>	<b>Benchmark</b>
Domestic matched interest-bearing	As calculated
Domestic un-matched interest bearing	3%
Domestic equities (shares)	Balancing item
Domestic alternative assets	2%
Domestic property	5%
Global equities (shares)	7%
Global interest-bearing	2%
Global alternative assets	1%



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### *Where you can find out more*

This guide aims to provide a high-level explanation of how the Max Income for Life with Bonus Escalation Option works. Because we have kept it as short as possible we have only outlined the most important information.

If you are an existing policyholder, your policy documentation and / or original quote should contain additional detail about your specific fund. Although every effort has been made to present information consistent with your contract, the terms and conditions in your contract will apply where these differ from this document.

A copy of Old Mutual's official Principles and Practices of Financial Management (PPFM) of Discretionary Participation Business, from which this guide is derived, is available on the Old Mutual website ([www.oldmutual.co.za/personalppfm](http://www.oldmutual.co.za/personalppfm)).

**Note that if there are any differences between this guide and the official PPFM, the official PPFM applies.**

You can also find out more from your Old Mutual Personal Financial Adviser or broker, or by calling Old Mutual's client communication centre on 0860 60 35 00.



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