Absolute Returns Strategy for With Profit Fund

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Absolute returns for with profit funds – what’s new?

- With profit funds have always had an absolute return objective
- The delivery mechanism was simple - static allocation to equity market risk
- Considerable short term volatility was tolerated
- But the absolute return was expected to emerge over the long run
- So what has changed?

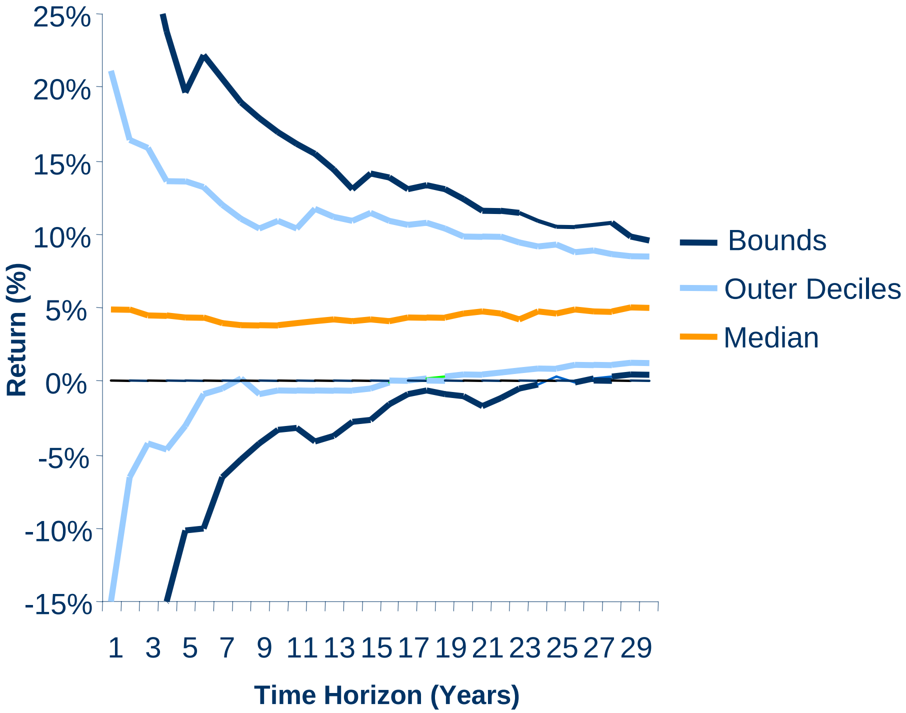
Answer: The timeframe

- There is much less appetite for short term volatility
- Volatility has unpleasant capital implications
- The investment time-horizon has collapsed
- The change is therefore not so much the investment objective but the time period over which it must be delivered

Absolute return every month please!

Equity returns are very unstable over short periods

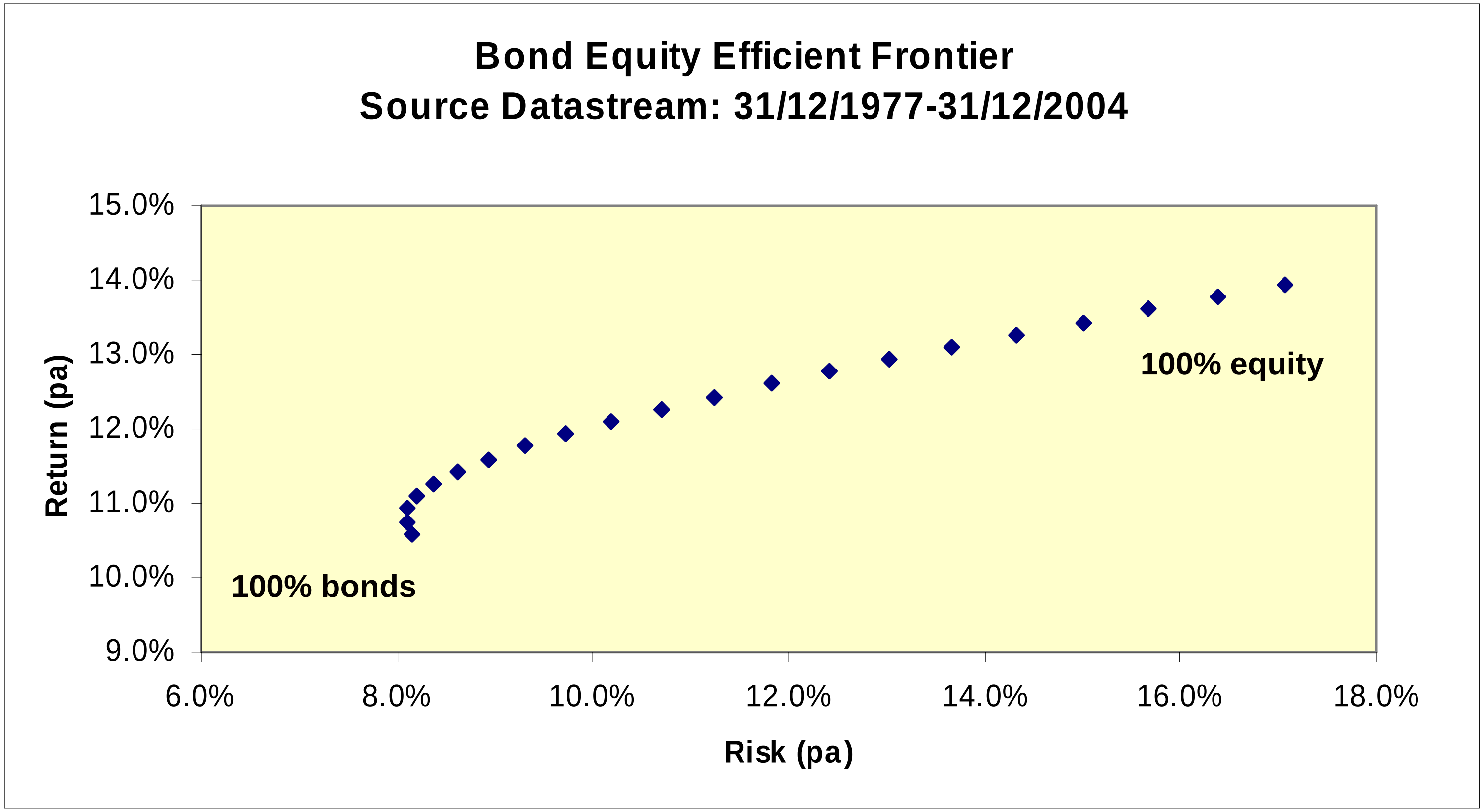
Distribution of excess returns from UK equities over bonds as a function of time horizon



Source: Standard Life Investments, Nov 2004

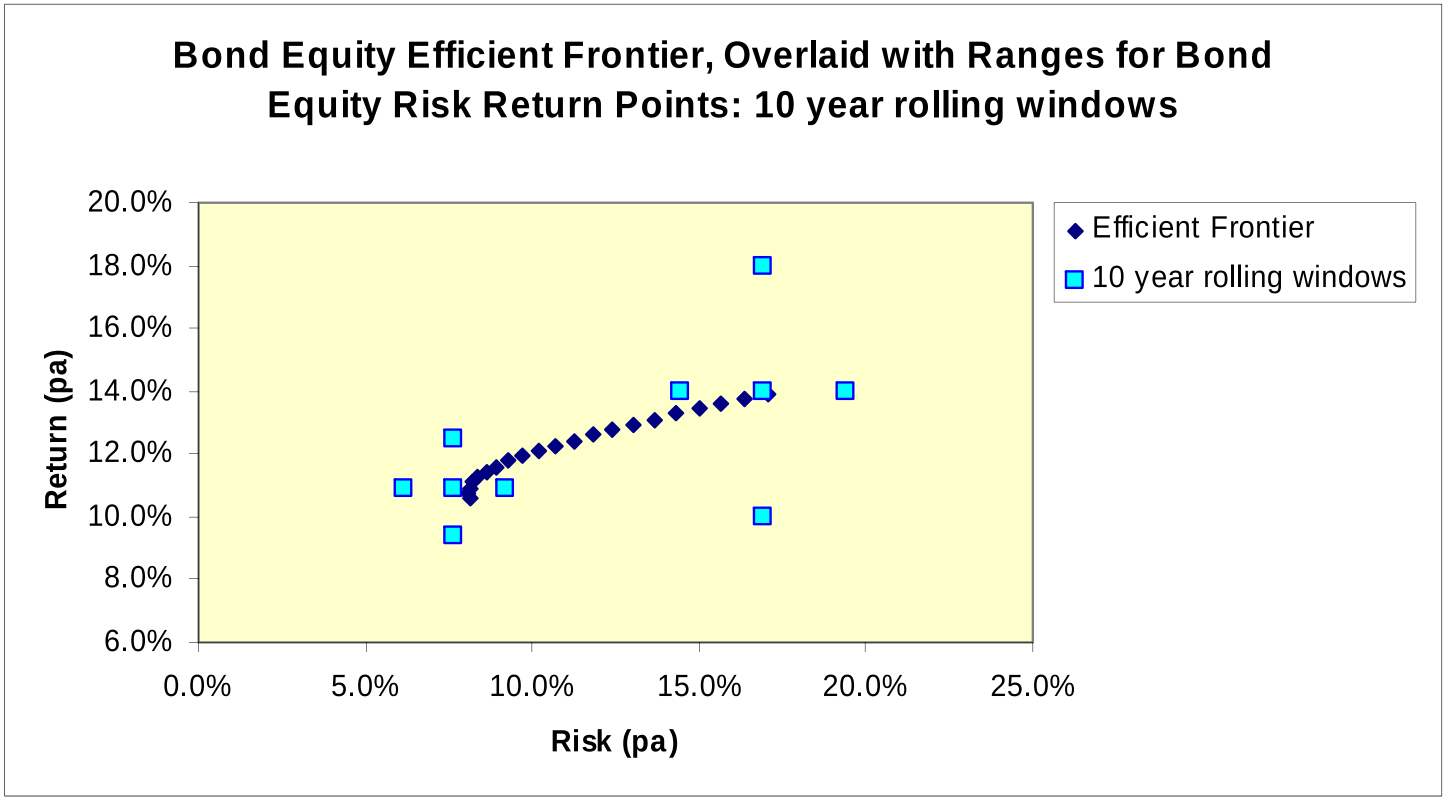
- The excess return from equities over bonds has been 5% per annum over long periods
- We would not expect it to be exactly 5% over 1-10 year intervals

The old way of setting strategy – structural beta



- A traditional efficient frontier using all available data

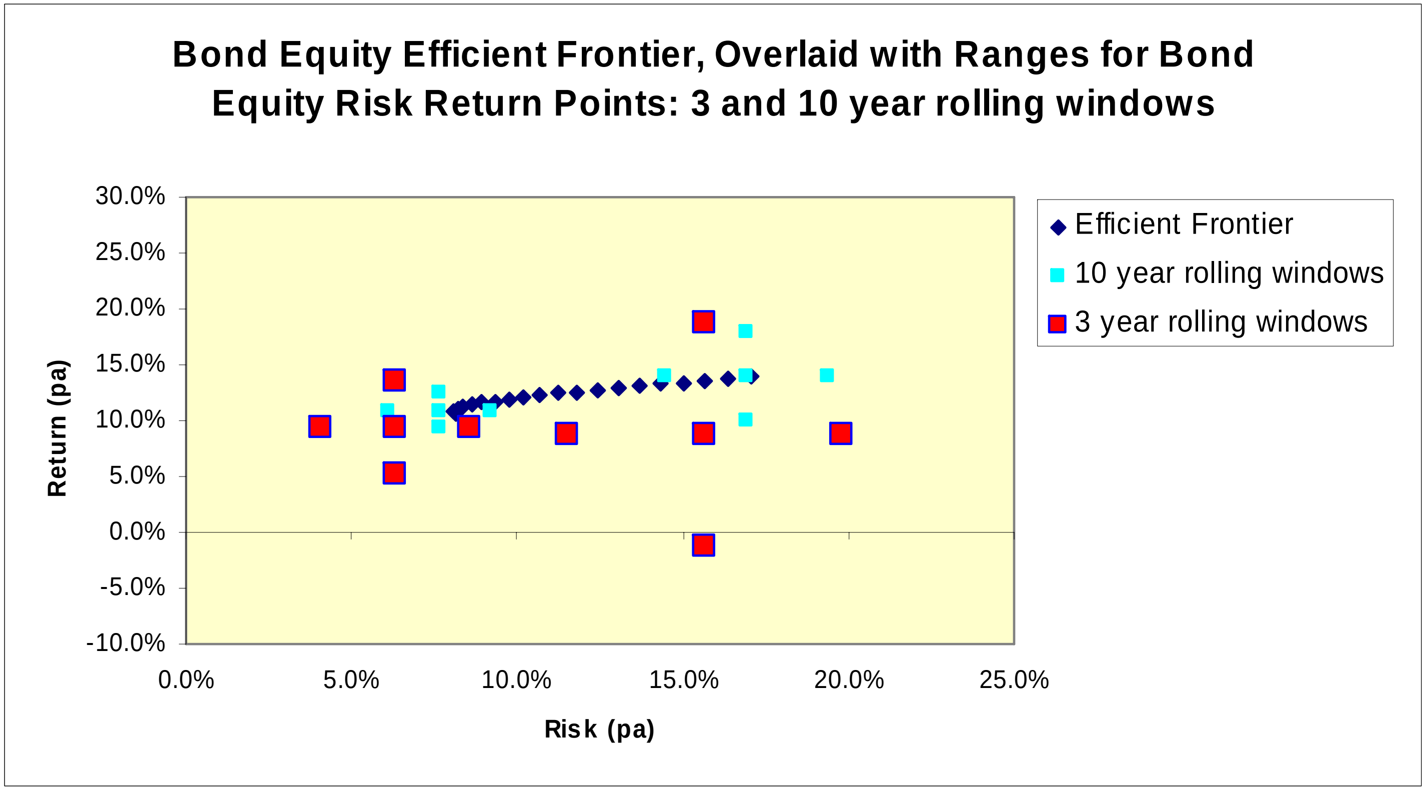
Structural beta less certain over 10 years



Source: Datastream 31/12/1977 - 31/12/2004

- The ‘area of possibility’ for a traditional efficient frontier, using 10 year rolling data windows

Structural beta is a lottery over 3 years



Source: Datastream 31/12/1977 - 31/12/2004

- The 'area of possibility' for a 3 year rolling data windows
- The efficient frontier breaks down on these timescales

With this shorter time horizon what is the new strategy

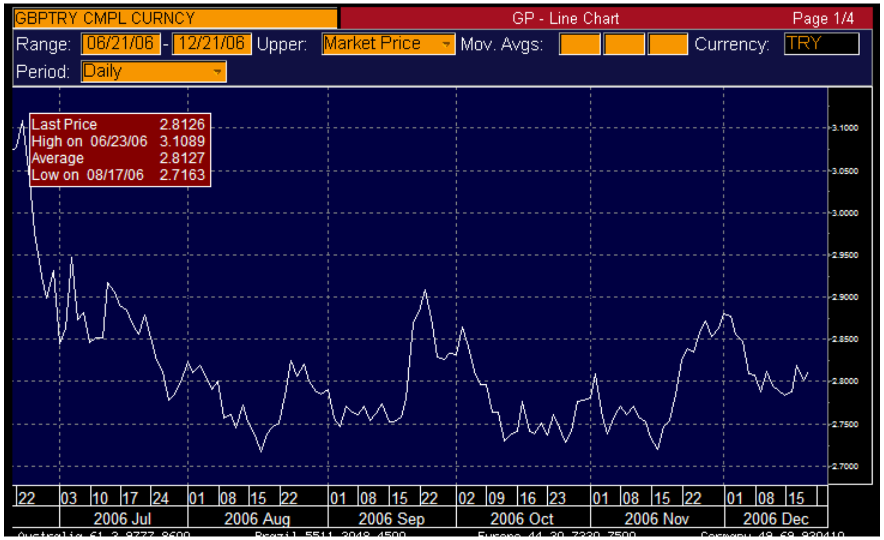
- A base level of structural market risk is taken subject to the level of risk that can be tolerated
- This is usually split between UK and Overseas equity markets, property and perhaps private equity
- The stronger the financial standing of the fund, the greater the allocation that can be made to these risk assets
- The danger is that when risky assets become more expensive the fund becomes more solvent and more will be bought – the risk is obvious
- A formulaic approach to this return strategy that guarantees against absolute loss has been marketed as CPPI

Is there an alternative?

- Yes but it involves increased reliance on skill based investing
  - Stock picking
  - Dynamic management of market risks
- And diversifying the market risks away from equity market
  - Currency carry trades
  - Yield curve plays
  - Leveraged exposure to credit and mortgage backed securities
  - Commodity exposure

Return strategy example: Long Turkish Lira Forward

GBP/TRY FX rate – Long term, Short term

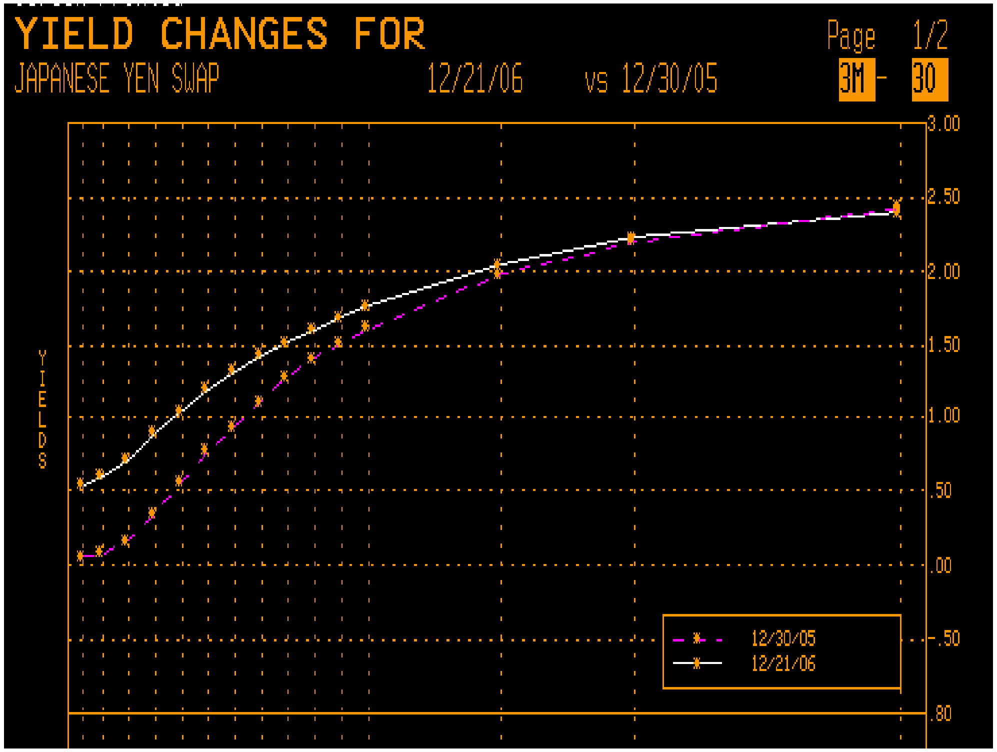


- Current yields provides returns of c. 16% over cash
- Levels have stabilised following recent sell-off driven by US rate fears
- High risk position, expected to be well rewarded

Source: Bloomberg

Return strategy example: 30 year Japanese hedged interest rates

30 year Japanese Government bond yields
Dec 2005 – Dec 2006

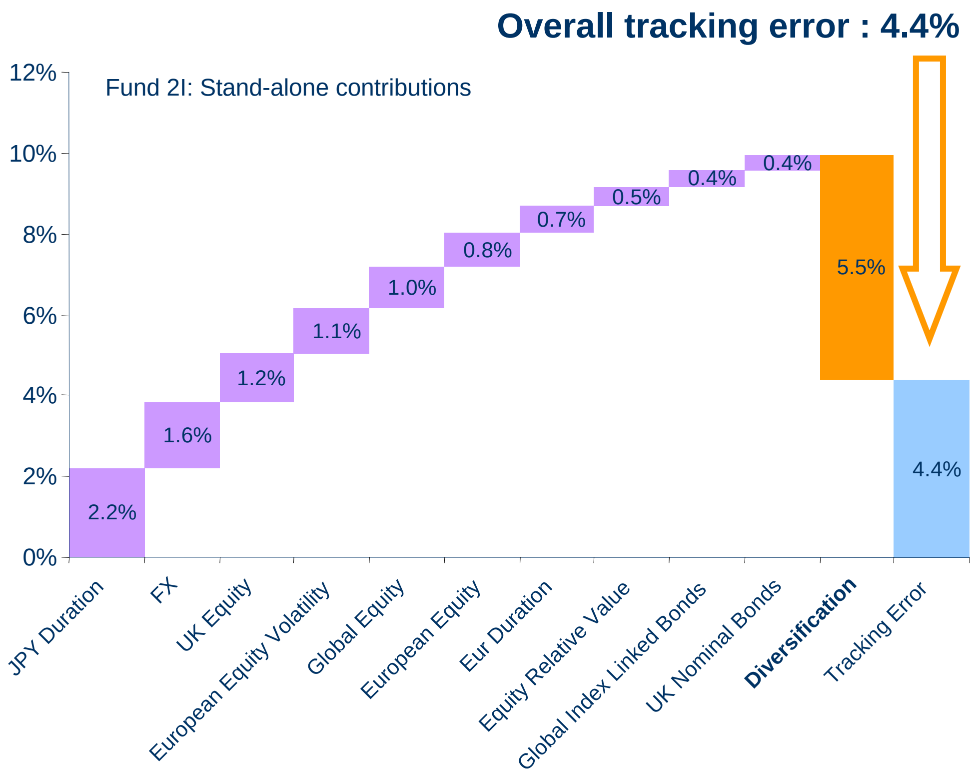


Source: Bloomberg

- We swap 30 year Yen fixed rates for Yen floating rates
- The swap uses zero initial capital, but a balance equivalent to the notional amount of the swap is put on deposit
- This gives an attractive running yield of 2.2% over cash
- Position loses money if long dated Yen yields rise, we expect the opposite
- Return balanced against risk

Risk profile of diversified beta strategy

Stand-alone risk breakout



- The portfolio is exposed to multiple diversified market risks
- Most positions are expected to be rewarding over time horizon
- Some positions will act to mitigate losses in the event of others being unsuccessful
  - For example duration exposure typically rewards when equity markets fall

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Source: Standard Life Investments 31st October 2006

Why has this not been adopted by WP funds

MARKETING REASONS

- Treating customers fairly is interpreted as meaning that maintaining as high an EBR as possible is a good thing
- There appear to be good and bad ways to lose money (Equities - OK, Turkish Lira – reckless)

MODELLING REASONS

- Life funds are not hedge funds – need to optimise return per unit capital NOT return per unit risk
- Capacity to model esoteric risk is limited

PRICE REASONS

- The price of skill based investing is higher than a long term passive beta approach
- Often the entity paying the fund management fee only benefits from the success of the strategy in a diminished form (i.e. through a 90/10 gate)

The challenge for with profit funds

- With profit funds want absolute returns but do not want to take risk
- This can only be achieved by broadly diversified and rewarding risk taking
- The big challenge is to deliver this in a way that meets end client expectations and at a reasonable cost
- The alternative is a diluted and twitchy version of what has always been done incorporating significant path dependence.