

To guarantee or not to guarantee



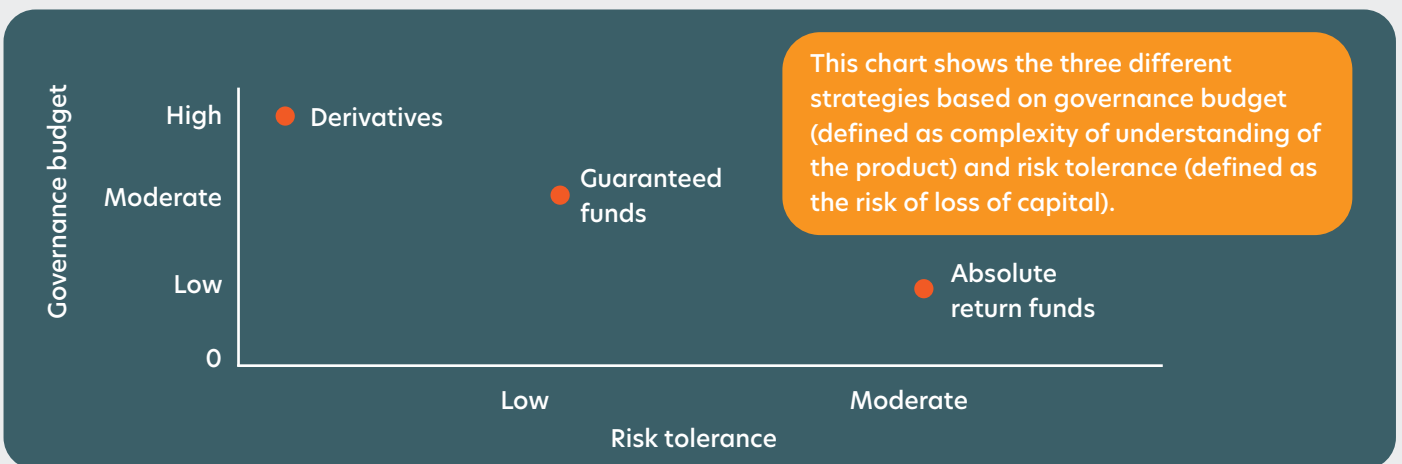
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Many retirement funds have members who prefer low-risk investments that are designed to minimise the potential for loss of capital. This could be due to personal preferences, proximity to retirement or other unique circumstances. To address this, trustees often look for investment strategies that focus on preserving capital. One common approach is to invest in guaranteed portfolios. These portfolios come with a capital charge, similar to an insurance premium, to safeguard against negative returns on the guaranteed portion. This strategy provides security for members who need stability and protection from market volatility, especially as they approach retirement.

This article explores different strategies for capital preservation within investment portfolios and evaluates their suitability for trustee boards. Key factors considered include members' risk tolerance, potential for negative returns and the governance budget available to the board.

The main capital preservation strategies discussed include absolute return portfolios, guaranteed portfolios and structured products such as derivatives - a topic that will be addressed in greater detail in a subsequent article.

Risk tolerance for the various portfolios



Source: Alexander Forbes Investments



Absolute return portfolios

Absolute return portfolios aim to preserve capital over a specified time horizon, typically 12 months, while outperforming an inflation target. Unlike traditional market-linked portfolios, they aim to generate positive returns regardless of market conditions. The dual objectives of capital preservation and inflation outperformance make these portfolios particularly attractive to investors seeking to grow their investments at a rate that exceeds inflation, while minimising the risk of significant drawdowns in periods of market turbulence.

Absolute return portfolios employ various strategies to ensure capital preservation, including tactical asset allocation and the integration of derivative instruments within the portfolio. To preserve capital through tactical asset allocation, these portfolios typically allocate a portion of the investments to interest-bearing assets like cash and bonds, while ensuring a suitable exposure to growth-oriented asset classes such as equities and property. They are also nimble in allocating optimally between growth and defensive assets. Derivative instruments, on the other hand, are used as a tool for capital preservation, particularly through hedging exposure to specific asset classes. This strategy helps ensure that the portfolio remains resilient to negative market fluctuations, allowing for positive returns while limiting potential losses.

One of the key advantages of investing in absolute return portfolios is that they offer full participation in market returns while simultaneously providing protection against downside risk. By employing a cautious allocation of assets alongside the potential for hedging or risk management through derivatives, these funds help to mitigate the impact of market volatility and protect capital.



Traditional guaranteed portfolios

A guaranteed portfolio is an investment strategy that reduces the volatility of returns and aims to deliver a real return while protecting a percentage of capital invested.

A guaranteed portfolio has three components:

Investment portfolio: Generally structured as a well-diversified, balanced portfolio, with assets allocated across various asset classes. This approach is designed to align with long-term retirement savings objectives,

ensuring that the real value of savings and investments appreciate over time and provide sufficient returns to meet future retirement needs.

Smoothing component: A key feature of guaranteed portfolios, designed to reduce the impact of market volatility on investment returns. It works through a mechanism called the Bonus Smoothing Reserve (BSR). This reserve is used to smooth extreme positive and negative market returns by allocating some of the gains in good market environments to instances of poor market returns.

Insurance component: A crucial safety net of guaranteed portfolios, designed to protect capital from market downturns. This means that even if the market performs poorly, investors will not lose the money they initially invested. To provide this guarantee, an insurer charges a fee known as the capital charge. This fee is similar to an insurance premium and is used to cover the cost of maintaining the guarantee. The amount of the capital charge depends on the level of the guarantee offered. A higher guarantee results in a higher capital charge.

Although guaranteed funds have merits, there are downsides to them as well:

- **Costs:** It often comes with higher costs compared to other investment options owing to the associated capital charges in place to guarantee investor capital. These costs can be material, which can significantly impact retirement outcomes over time.
- **Complexity:** It can be quite complex given the multiple components it comprises, such as the investment portfolio, smoothing and insurance. This complexity can make it difficult for trustees and members to fully understand how the portfolios operate and how their returns are generated.
- **Termination:** It has termination conditions, which often have predefined dates and potential penalties.

In response to these limitations, new investment products have been introduced that offer portfolios with a smoothing component but no insurance guarantee. These products still provide reduced volatility and a lower probability of negative returns due to the smoothing component, but they do not offer guaranteed capital protection. This type of investment product offers an alternative for investors seeking relatively lower fees and a more flexible structure, though without the certainty of guaranteed capital protection.



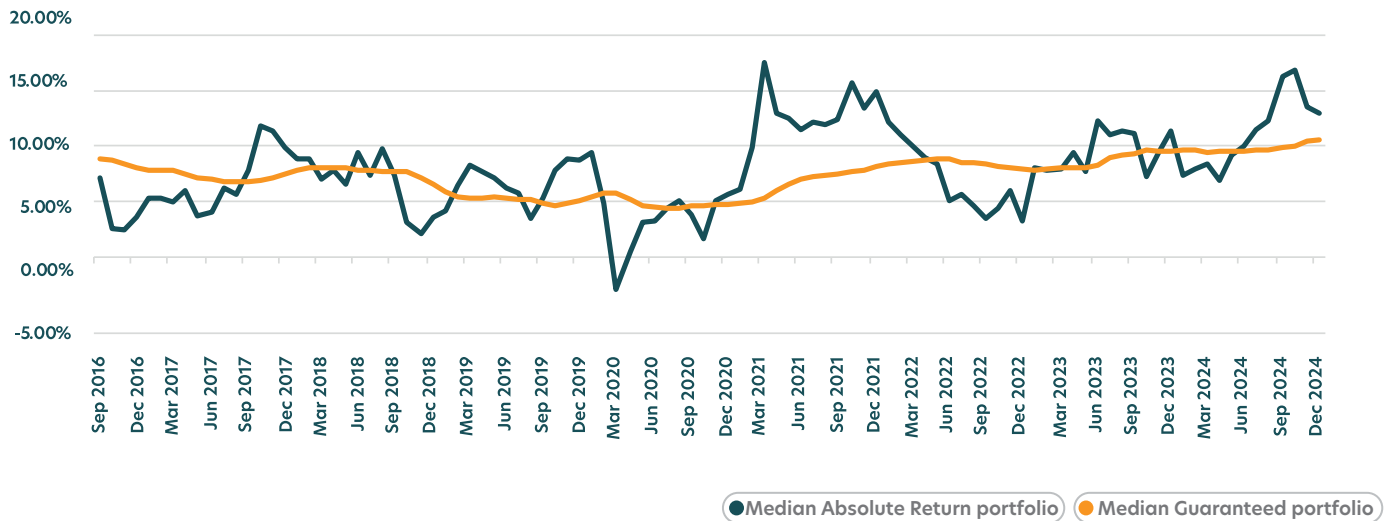
Absolute return versus traditional guaranteed

When monitoring an investment, particularly those with dual objectives, such as the strategies under consideration, investors seek to preserve both their capital and accrued growth over the short term. Additionally, they aim to achieve asset growth over the medium term, typically measured by the ability to outperform inflation and increase purchasing power. This dual focus requires ongoing assessment to balance the immediate preservation of capital with

the longer-term goal of achieving real returns that exceed inflation, thereby enhancing the investor's financial position over time.

The chart below shows the one-year rolling returns of a median of four traditional guaranteed portfolios with a partial capital preservation guarantee, compared to a median of eight absolute return portfolios over a period from September 2016 to December 2024.

One-year rolling returns of absolute and guaranteed portfolios with partial capital preservation guarantee



Source: Alexander Forbes Absolute Return Manager Watch Survey™

*Returns are shown net of fees, and is a subset of data from the Alexander Forbes Absolute Return Manager Watch Survey™

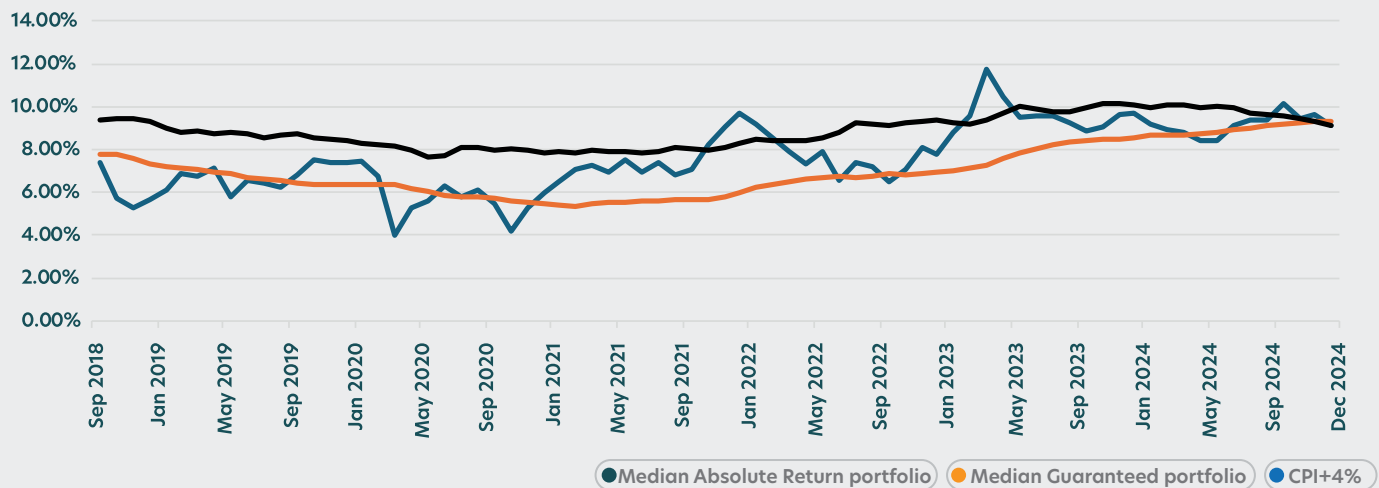
*Bonuses used were obtained from survey data and the managers utilised are shown net of the capital charge and investment management fees.

As is characteristic of guaranteed portfolios, they exhibit considerably lower volatility. This is evident in the smoothness of their return profile, meaning there are no drastic fluctuations in returns.

It is also evident that guaranteed portfolios effectively preserve capital over rolling 12-month periods. However, during periods of market stress, such as the market downturn experienced during the 2020 Covid-19 crisis, some partially guaranteed funds may be compelled to declare zero or even negative bonuses. This highlights the inherent limitations of such portfolios during extreme market conditions, where even the protection provided by guarantees may not fully mitigate the impact of significant market disruptions.

Absolute return portfolios are generally successful in preserving capital across most periods. However, the return profiles of absolute return portfolios are a lot more erratic when compared to those of the guaranteed portfolios. Furthermore, there are instances during periods of market stress – such as the 2020 Covid-19 market crash – where returns fall below zero. Of the eight strategies selected for this analysis, these absolute return strategies experience negative one-year returns approximately 3% of the time (on average). The strategy with the poorest performance recorded five instances of negative returns over the 100-period analysis (5%), whereas the best-performing strategy never experienced a negative one-year return.

Three-year rolling returns of absolute and guaranteed portfolios versus inflation target



Source: Alexander Forbes Absolute Return Manager Watch Survey™

*Returns are shown net of fees, and is a subset of data from the Alexander Forbes Absolute Return Manager Watch Survey™

*Bonuses used were obtained from survey data and the managers utilised and are shown net of the capital charge and investment management fees.

The chart above shows the median guaranteed portfolio and median absolute return portfolio over rolling three-year periods versus the inflation target of CPI + 4%.

The chart demonstrates that, over a medium-term period, both absolute and guaranteed portfolios are capable of increasing purchasing power - effectively outperforming inflation. However, these funds tend to struggle when aiming to meet higher inflation targets. This indicates that while guaranteed portfolios provide a degree of protection against inflation, they may not generate the level of returns necessary to exceed more aggressive inflation benchmarks, particularly during periods of heightened economic pressure. Specific market conditions, such as periods of high inflation coupled with low asset class returns, pose significant challenges to achieving an inflation-plus target. When balancing the dual objectives of growth and capital preservation in such environments, the growth objective often has to be compromised in order to maintain the focus on protecting capital.

The chart illustrates that although both types of portfolios face challenges in outperforming the inflation target, the median performance of the absolute return

funds exceeds that of the guaranteed fund median 71% of the time. This indicates that, on average, absolute return strategies are more successful in generating returns above the inflation target compared to guaranteed funds, although both strategies encounter difficulties in consistently meeting higher inflation benchmarks.

While there are clear instances where guaranteed funds could be effectively utilised to ensure capital preservation, offering a significant reduction in return volatility, we contend that absolute return funds can provide similar levels of capital preservation, albeit with slightly higher risk, coupled with a notable increase in returns.

Trustee boards responsible for managing retirement funds for members with low-risk tolerance should consider the inclusion of absolute return funds in their portfolios. These funds offer distinct advantages, such as lower fees, greater transparency and simplified termination conditions, which may make them a more attractive option for preserving capital while also striving for enhanced returns.





What trustees should consider

When managing retirement funds, trustees have a responsibility to ensure that the investment portfolios used, align with the risk tolerance and financial goals of their members. Here are some key considerations for trustees when evaluating guaranteed funds and absolute return funds:

	Guaranteed funds	Absolute return funds	Alternative "smoothing-only" investment products
Risk tolerance and member needs	Offer capital protection and reduced volatility, making them suitable for members seeking stability.	While slightly more volatile, can provide higher returns and still offer capital preservation.	Offer capital protection and reduced volatility, making them suitable for members seeking stability.
Cost and fees	Often come with higher fees due to the insurance component's capital charge.	Generally have lower fees, which can enhance overall returns for members.	May offer a middle ground, with lower fees than traditional guaranteed funds but still providing some level of capital protection.
Complexity and transparency	Can be complex, with multiple components such as the investment portfolio, smoothing component and insurance guarantee.	While also employing various strategies, may offer greater transparency and simplicity in their structure.	These are less complex than traditional guaranteed funds, as they do not have an insurance component, however other complexities that are similar to guaranteed funds do still exist.
Flexibility and termination conditions	Funds often have predefined termination dates and may incur penalties.	Typically offer more flexibility with fewer restrictions on termination, making them a more adaptable option for changing market conditions or member needs.	Aim to provide greater flexibility, with fewer restrictions and associated penalties compared to traditional guaranteed funds.
Performance and return profiles	Provides smooth and stable returns with lower volatility.	May exhibit more fluctuations but has the potential for higher returns. It's important to balance the need for capital preservation with the goal of achieving real returns that outpace inflation.	Provides smooth and stable returns with lower volatility.
Governance and oversight	Effective governance and oversight are essential for managing investment strategies. Trustees should ensure they have the necessary resources and expertise to evaluate and monitor the performance of both guaranteed funds and absolute return funds. This includes understanding the underlying mechanisms and potential risks associated with each strategy.		

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