think tank

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Pamella Magcoba, Consultant

Can you have your cake & eat it?

The pros and cons of structured products and guaranteed funds

Guaranteed funds and structured products are targeted at investors who want a combination of capital protection, if the market performs poorly, and potential performance upside, if the market performs well. It's a seeming manipulation of risk and return, but where's the catch? Pamella Magcoba, a consultant at RisCura explains the pros and cons of these not so new-fangled products.

Guaranteed Funds

Guaranteed funds are the original products offered by insurance companies and aim to deliver smoothed returns over time for conservative investors. These funds have been around for years and used to be a popular alternative for investors wanting to minimise the potential downside of investment returns.

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Ins and Outs

An investor buys a product from an insurance company which has specific guarantees attached to it. These guarantees are based on a formula and captured into a policy document. The investor's assets are then invested into a larger pool of assets owned by the insurer, and from then on, are not directly linked to the product's performance.

The guarantee has certain constraints attached to it, such as a minimum amount the investor can withdraw from the policy and the "market value" of the assets relative to the "guaranteed value". The valuation of an insurer's assets is conducted by an actuary and uses subjective actuarial valuation techniques based on expected future performance rather than actual historical performance. The "declared value" of the assets therefore may be quite different to the "actual value". However, competitive forces generally keep asset values reasonable.

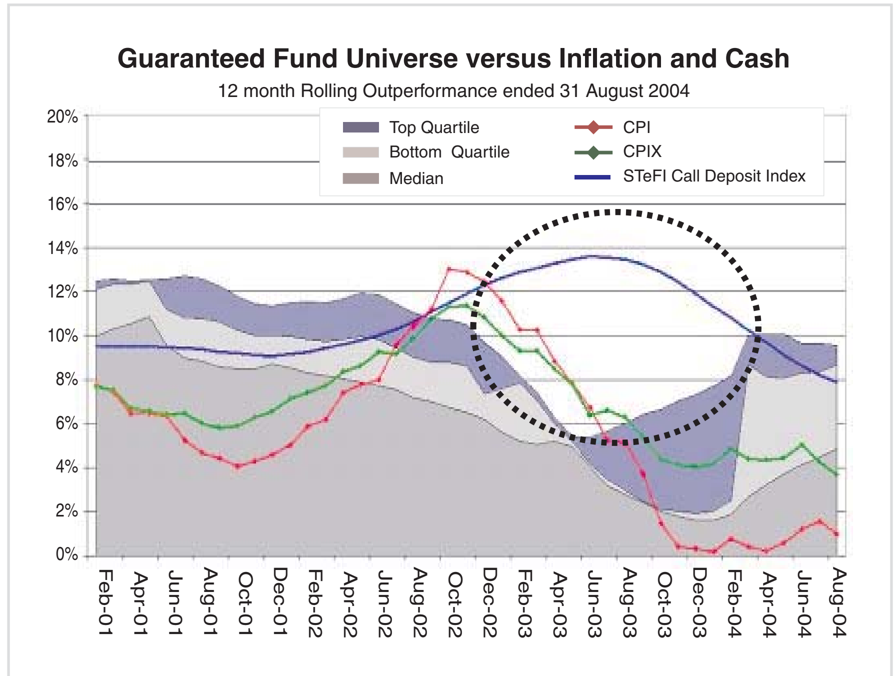
The assets are managed to provide long-term outperformance of the set targets, which may be linked to short term cash or long term equity market performance. The insurer periodically values the assets. The value is determined using the last asset value, increased by any bonuses declared by the insurer. These bonuses depend on the performance of the assets over the applicable period, the surplus or deficit in the fund at the start of the period, market conditions at the time of valuation and the insurance company's profitability.

Bonuses are declared in two forms – vesting and non-vesting. Vesting bonuses are added to the fund's asset value on declaration while non-vesting bonuses are only added over time based on a formula outlined by the insurer (e.g. may be added over 5 years after declaration).

In the event of a massive collapse in asset values, the insurer generally reserves the right to delay or spread payment or even reduce asset values, in which case, guarantees thought to exist by the investor may not exist at all. These conditions are outlined in the policy document.

The Catch

- Guaranteed funds offer a false sense of security as they have underperformed both cash and inflation over a range of time periods as illustrated in the graph below. Withdrawals from these funds have been huge, as investors seek more transparency in terms of performance and costs.



- Lack of transparency regarding performance – the link between the performance and market value of the investment is unclear. Because performance is based on actuarial assumptions, an increase in asset values won't necessarily translate into an increase in the fund's value.
- Disclosure of costs is poor with costs estimated to be between 2%-3% per annum. Such costs require exceptional performance for the product to be competitive. These costs include policy fees, guarantee charges and asset management fees.

"...guarantees thought to exist by the investor may not exist at all."

- Guarantees are not golden and may be subject to change when they are most important, for example, when a stock market crashes.
- All tax and legislative constraints and risks are passed onto the investor or pension fund. The guarantees will therefore not stand if tax or legislation changes impact on performance.
- Withdrawals are facilitated as long as they are less than 10% of the value in any one year. Large cashflows are prejudiced in terms of cost.
- The investor takes on credit risk to the insurer issuing the policy. This is the risk that the insurer may go bankrupt and not be able to stand by the guarantees.

Structured products

Structured products grew out of investors' dissatisfaction with guaranteed funds. They provide a similar guarantee to investors using derivatives but unlike in guaranteed funds, guarantee conditions are objective, clear and explicit.

The Ins and Outs

A simple example:

A fund approaches a bank to purchase a structured product which guarantees the investors' initial capital of R100 as well as participation in equity market upside (based on the All Share Index). The bank provides this guarantee. The bank backs the guarantee with the purchase of a zero coupon bond (possibly issued by the SA government), which will guarantee the return of the R100 in say 5 years. The price of this instrument was R80 (for guaranteeing R100 in 5 years), allowing for the remaining R20 to purchase market upside (or call options). Call options allow direct participation in the stock market, but limit the loss, should the equity market fall, to the initial capital (in this case R20). So for example, if the stock market was down at the end of the term, on purchase date of the call option, the investor would lose the R20. However, the bond would have grown to R100 (the guaranteed capital), a superior return to equity over this period. If the market was up, the call option would participate in the upside equal to the underlying index on which the call option was based.

While this sounds ideal, cost make the strategy less appealing and many variations exist regarding term and payout. The beauty of these products is that you get what you pay for. Beyond credit risk (i.e the bank providing the guarantee could be liquidated), the rules of payout are very clear.

The Catch

- The costs associated with these products are not fully disclosed allowing for potential abuse. However, if effectively structured and administered, costs can be minimised. The price of instruments can be compared as the market is fairly large, and with the correct pricing models, implicit costs can also be estimated.
- Guarantees have very little flexibility. If the term is 5 years, then the guarantee will only apply after 5 years with any shorter term having capital risk.
- Withdrawals pre-expiry are difficult and may prejudice the status of guarantees.
- The investor takes on credit risk to the bank backing the guarantee.
- Performance of these products is based on an underlying index and the specific guarantees provided and will depend on the structure.

"The beauty of these products is that you get what you pay for."

Investments that make a difference...

Mxolisi Mbekwa, Director

Mxolosi Mbekwa, senior consultant and Director at RisCura, looks at the growing trend of socially responsible investing and how investors can ensure that the money they invest works for them and for our society.

What are "socially responsible investments"?

Traditionally, an investor's key concern has been to find investments that provide solid returns over time, without too much risk of losing capital.

Over the past decade however, investor concerns have widened and a socially responsible consideration has crept into their consciences. Investors have started to pay attention to the way companies are run, and the potential impact businesses may have on their society and environment. This had led to a trend called "socially responsible investing" which has grown significantly in international markets. It's also something we believe South African investors will become more conscious of, given the poverty in our society and the need to preserve our environment and natural resources.

How do I invest in a socially responsible manner?

Socially responsible investors choose social, environmental and other criteria that are important to them, and will only invest in companies/securities that meet these criteria. Once an investor has decided to invest in a socially responsible manner, they need to clearly define the areas they want to have an impact on, as well as gain an understanding of how this might affect their risk and return objectives. Socially responsible investments are not "charity" contributions but should be carefully selected to fulfill the dual purpose of providing capital growth over time (without too much incremental risk), and making a difference to our society.

What are the various ways that I can make a difference through my investments?

There are currently 3 key ways for investors to be socially responsible:

Social and environmental issues

An investor will decide which criteria companies must fulfill in order to be considered as an investment. Numerous criteria can be established, such as how the company treats their employees, their empowerment equity status, the safety and usefulness of the product and the environmental impact of production etc. Some examples that are generally excluded by socially responsible investors include companies with interests in tobacco, alcohol, firearms and gambling.

Community issues

Investors wanting to contribute positively to their broader society would invest in those businesses/projects that contribute to disadvantaged communities via the supply of infrastructure, loans, communication facilities or other services. Providing these business with access to capital could potentially have an enormous effect on people's everyday lives.

Shareholder activism

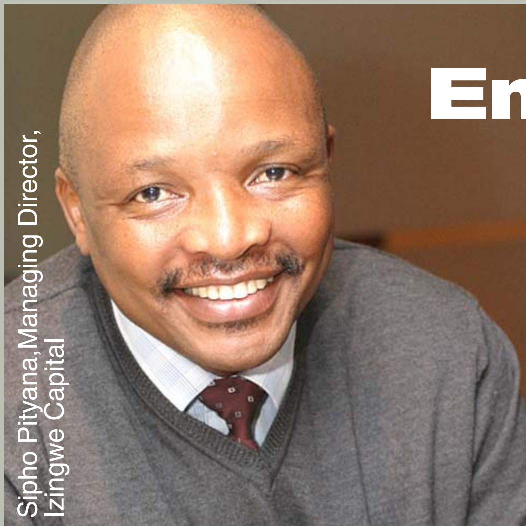
Investors in companies become shareholders or part owners of the business. They therefore have a responsibility to ensure that the company is being run with integrity and maintains an awareness of the impact it has on society and the environment. Shareholder activism is about fulfilling that responsibility and engaging in shareholder meetings and voting in order to potentially influence irresponsible company actions.

Am I not sacrificing potential performance by restricting my investments to socially responsible companies?

Investing in a socially responsible manner is not only about investing in companies that are responsible to their society and environment, but also about identifying companies that are likely to grow over the long term. Although many investors may believe that investing in companies that consider these "softer" issues will diminish performance, the reality seems to be quite different. In general, companies that 'do the right thing' seem to win more contracts, avoid litigation and attract higher premiums as more investors take socially responsible factors into consideration.

In practice, responsible businesses seem to be rewarded by both peers and investors. Even socially responsible investments in infrastructure can offer fair rewards through appropriate funding structures and margins. However, there is always potential for socially responsible investment returns to be lower than those of unrestricted investments due to a variety of reasons including risk and the smaller universe of applicable shares available limiting investment opportunities. Investors need to be aware of this risk, and ensure its appropriate for their long term objectives.

what's new? Empowerment Partnership


Sipho Pityana, Managing Director, Izingwe Capital

RisCura partners with Izingwe Capital

RisCura's search for an empowerment partner has finally borne fruit. In November 2004, we finalised a deal with Izingwe Capital whereby the company acquired a 20% stake in our business.

Izingwe Capital is highly suited to RisCura due to their skill in penetrating BEE sensitive markets, and their strong connections with, and understanding of labour unions. The company also has established alliances and networks, which should add significant value to our strategic marketing and business development program. Izingwe Capital's business presents no conflicts of interests to our business.

Izingwe Capital is headed by Sipho Pityana who was previously a Group Executive Director of Nedcor Investment Bank Limited and Managing Director of Strategic Business Development at Nedbank. Prior to that, he was Director General of the Department of Labour and Director General of the Department of Foreign Affairs. He was also one of the architect's of NEPAD and remains a member of NEPAD's business forum. Sipho has been appointed Chairman of RisCura's Board of Directors.

Izingwe Capital is an investment business that focuses on successful companies operating in empowerment sensitive markets. Izingwe aims to work with companies that embrace South Africa's transformation agenda. Their goal is to create solutions for internal transformation within a company, as well as position companies to penetrate BEE sensitive markets through their strong networks and strategic alliances.

Izingwe Capital's shareholding in our company, combined with our current black economic empowerment initiatives takes us well over the Financial Services Charter requirements.

Multi-managers: reducing risk but for a price

Laurett Jardim, Senior Consultant

There is a strong argument for specialist mandates in the South African market. Very few investment managers are proficient at managing a balanced portfolio. Most investment managers excel in a particular investment style or asset class. For example, a manager that produces above average equity performance will usually produce below average bond performance (or visa versa) resulting in average overall performance.

Investment style risk is the risk that a particular investment style (such as growth or value) underperforms the general market and/or the peer group over the short term. Multi-managers aim to mitigate this risk by providing diversification across managers and investment styles.

Investing in one asset manager may result in substantial fluctuation in returns over time, while diversifying assets across a range of managers should result in a more stable return series. The most important factor to consider however is manager style continuity – that is, whether managers stick to the investment style they purport to follow, through all market conditions. This can only be determined through a rigorous manager selection process and continuous monitoring of asset managers.

The key performance and risk driver for any fund is its level of exposure to different asset classes (equities, bonds etc). Funds with a high exposure to equities will be more volatile, and can expect to benefit or suffer from changes in equity market conditions. Similarly, funds with a higher fixed interest content should have a less volatile perf-ormance profile, though also potentially lower returns over time.

Risk and Performance

The risk and performance attributes of a multi-manager fund are different to those of a single manager fund. Because of the inherent diversification in a multi-manager fund, the active risk (i.e the risk of the fund underperforming the benchmark) is expected to be lower than for a single manager fund. However, the potential for the fund to well outperform the benchmark, will also be lower. Manager risk, which is the risk that a negative event at one asset manager (such as the departure of key personnel or sustained poor performance) will have a significant impact on an investment, will also be lower in a multi-manager fund.

> "Most investment managers excel in a particular investment style or asset class."

There is no one way that multi-managers select the underlying asset managers. The selection process and methodology across managers may vary. The performance of a multi-manager fund will depend largely on the skill of the underlying managers, and a multi-manager that is success-fully able to choose the best managers over time, should yield superior invest-ment returns. Investors wanting to make use of a multi-manager structure therefore need to take this factor into account, and ensure that they assess the manager selection ability of the multi-manager.

Costs

One issue that cannot be avoided in any multi-manager discussion is that of cost. Multi-managers clearly don't provide their expertise for free, and a multi-manager fund will typically have two, possibly even three layers of costs – their fee, the fee paid to the underlying asset manager, and if applicable, a performance fee. Pension funds contemplating making use of a multi-manager structure should ensure that the multi-manager is adding skill above that of the investment consultant, in order to justify this cost. Investors should do a proper cost benefit analysis and ensure that costs paid are being rewarded by superior performance at lower risk. An alternative to a multi-manager is that the fund selects specialist investment managers with the assistance of their consultant. However, here too the fund should do a cost benefit analysis.

Nadine Van Deventer

Head of Reporting

Job Description: Nadine manages the reporting process and is responsible for ensuring that the reporting function at RisCura is both accurate and timeous.

Experience: Prior to joining RisCura, I worked for 3 years as a portfolio administrator for TMA investments. I joined RisCura as a risk analyst in 2001 and currently head up the reporting team.

Passionate about: I am passionate about life, family and friends. I believe that everything in life happens for a reason and that there is always a lesson to be learnt in any situation you encounter or from any person you meet.

Dislike: I dislike dishonesty, laziness and people who have no passion for what they do or who they are.

Spend my spare time: I am a bit of a shopaholic at times! I also enjoy spending time with friends and family. If I am feeling particularly lazy I head straight for the movies. I try to ensure that my spare time is relaxing and stress-free.

Favourite book: Richard Branson's Autobiography "Losing my Virginity".

Best thing about living in SA: I enjoy our culture, people and the outdoors. We are so privileged to have such a great outdoor life and to be able to enjoy nature.

What motivates you: I motivate myself - I never rely on something or someone to provide me with the motivation to go out in the world and go for what I want. I know that in some small way I contribute to the future and that is all the motivation I need.

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