Investment performance and strategy

UK With-Profits Funds

Helping insurers understand the drivers of performance

This is the eighth annual investigation Barnett Waddingham has conducted into the investment strategies of UK with-profits funds.

Analysis as at 31 December 2020

Participating firms

We thank the following firms for participating in this survey.

- AEGON
- Chesnara
- Dentists' Provident
- DG Mutual
- The Exeter
- Forester Life
- Foresters Friendly
- Healthy Investment
- Lloyds Banking Group
- LV=
- M&G
- National Friendly
- NFU Mutual
- ReAssure
- Royal London
- Scottish Friendly
- Sheffield Mutual
- Shepherds Friendly
- The Oddfellows
- Utmost
- Wesleyan
- Zurich

About the survey

Our aim is to stimulate debate with insurers as to whether the approaches others take may be appropriate for them, and whether their asset manager has performed well compared to peers.

The data* used in our report is private information that is not in the public domain. We approached the majority of firms who have with-profits funds in the UK, asking for information on asset allocations and investment returns. Our analysis this year covers £182bn of assets spread over 51 funds from 22 insurers.

Contents

**We have used the information provided without any independent verification, although we have queried responses where these looked to be outliers.*

Executive Summary

Looking back at 2020

2020 was a turbulent year for investing, with many asset classes and markets falling significantly in value following the outbreak of the Covid-19 pandemic. However, by the end of the year most markets had recovered these losses, with UK equities being a notable exception. Meanwhile, risk-free yields fell to further record low levels during the year as investors sought refuge in safer assets and in response to monetary policy actions taken by governments to offset the economic impacts of the pandemic.

Investment returns

As might be expected in such a year, this had led to significant variation in returns between different with-profits funds, with a mean return of 4.1%, but a range of -4.9% to 11.4%.

Unlike in previous years, there was no discernible pattern by size in the relative performance of different funds in 2020. However, we still see that the larger funds have generally outperformed the smaller funds over a five-year period. Of course, the return to the customer is not only affected by the investment return on the fund. Our analysis does not take account of the impact of smoothing, guarantees and additional sources of profits that can benefit holders of with-profits products relative to other investment options.

Asset mixes

Most funds have a balanced asset mix backing their asset shares, and the average asset mix has remained relatively stable for many years, demonstrating a long-term investment view. Compared with the position at the start of the year, we see that funds generally have higher amounts of government bonds and lower amounts of UK equity and property. This is driven by a small number of funds that have significantly increased their allocations to government bonds rather than being a feature across the whole market. We are aware that a number of firms took action to de-risk their investment strategies in order to offset the impact of the market falls in early 2020 on their solvency position.

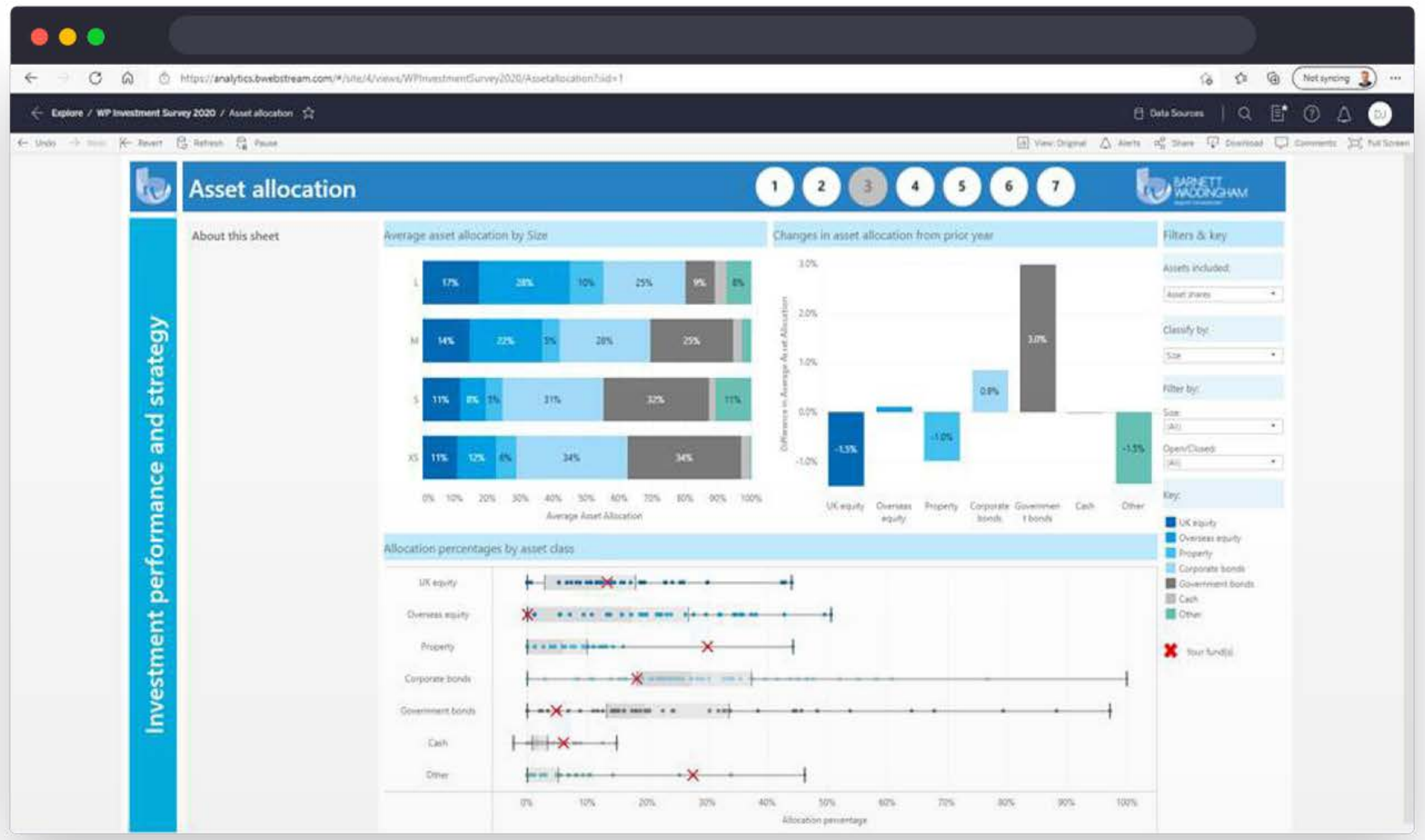
For the first time this year, we have asked firms to provide us with the asset mix of any separate with-profits assets held in the fund that are not backing asset shares. All large funds had such a separate pool of assets, although only a minority of medium and smaller funds did so. As expected, the other with-profits assets were invested predominantly in fixed interest assets and cash.

Sustainability

For the first time this year, we have asked firms whether they have any specific sustainability targets or criteria for any of their assets. These were slightly more prevalent for larger firms. It will be interesting to see how this develops over time.

Interactive Tableau dashboard

Last year, for the first time, participating firms were given secure online access to an interactive dashboard that allowed them to analyse the results in more depth. The interactive dashboard has been updated with the new survey data and enhanced to include the additional data collected this year.



We hope you find the report informative. Please get in touch with any questions and comments you have.

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The data we're reporting on

Grouping of funds

This investigation covers 51 funds across 22 insurers, who provided information on their asset allocations and investment performance to us privately.

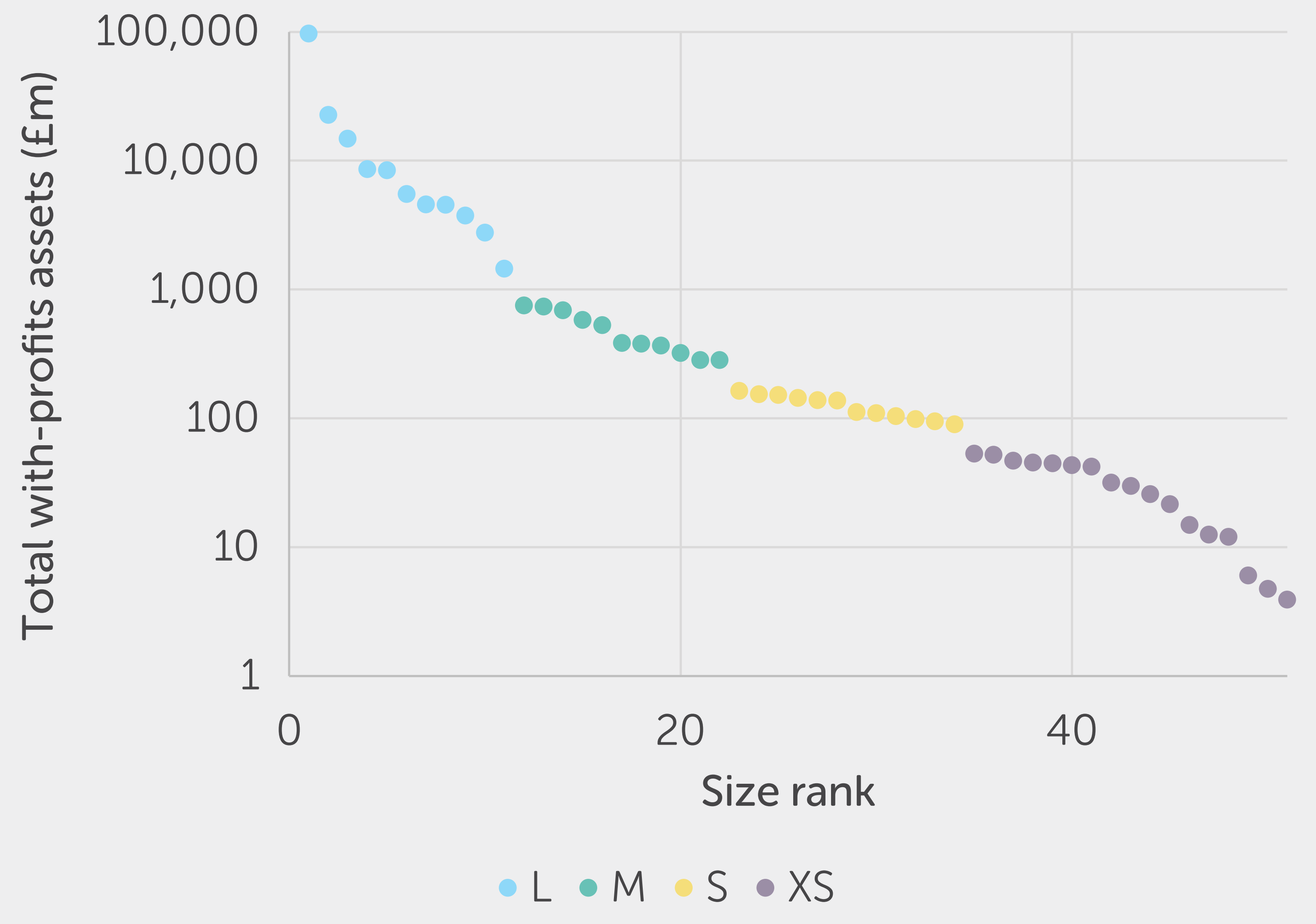
We have split the analysis in this investigation by fund, as different funds within an insurer can have materially different risk characteristics. We have then grouped funds by fund size and, for the first time, on whether the fund is open to new business as set out in Table 1.

Table 1: Fund classifications used in this investigation

Classification	Fund size (£m)	Number of open funds	Number of closed funds	Total number of funds
L	> 1,000	5	6	11
M	250 – 1,000	5	6	11
S	75 – 250	4	8	12
XS	< 75	4	13	17

The distribution of funds by size of total with-profits assets as at 31 December 2020 is illustrated on a logarithmic scale in Figure 1 below.

Figure 1: Total with-profits assets by fund (ranked)



Asset allocation – assets backing asset shares

Figure 2 shows the average asset allocation for assets backing asset shares split by size classification. Figure 3 shows how the average asset allocation across all funds has changed from 31 December 2019 to 31 December 2020.

Figure 2: Asset allocation for assets backing asset shares as at 31 December 2020

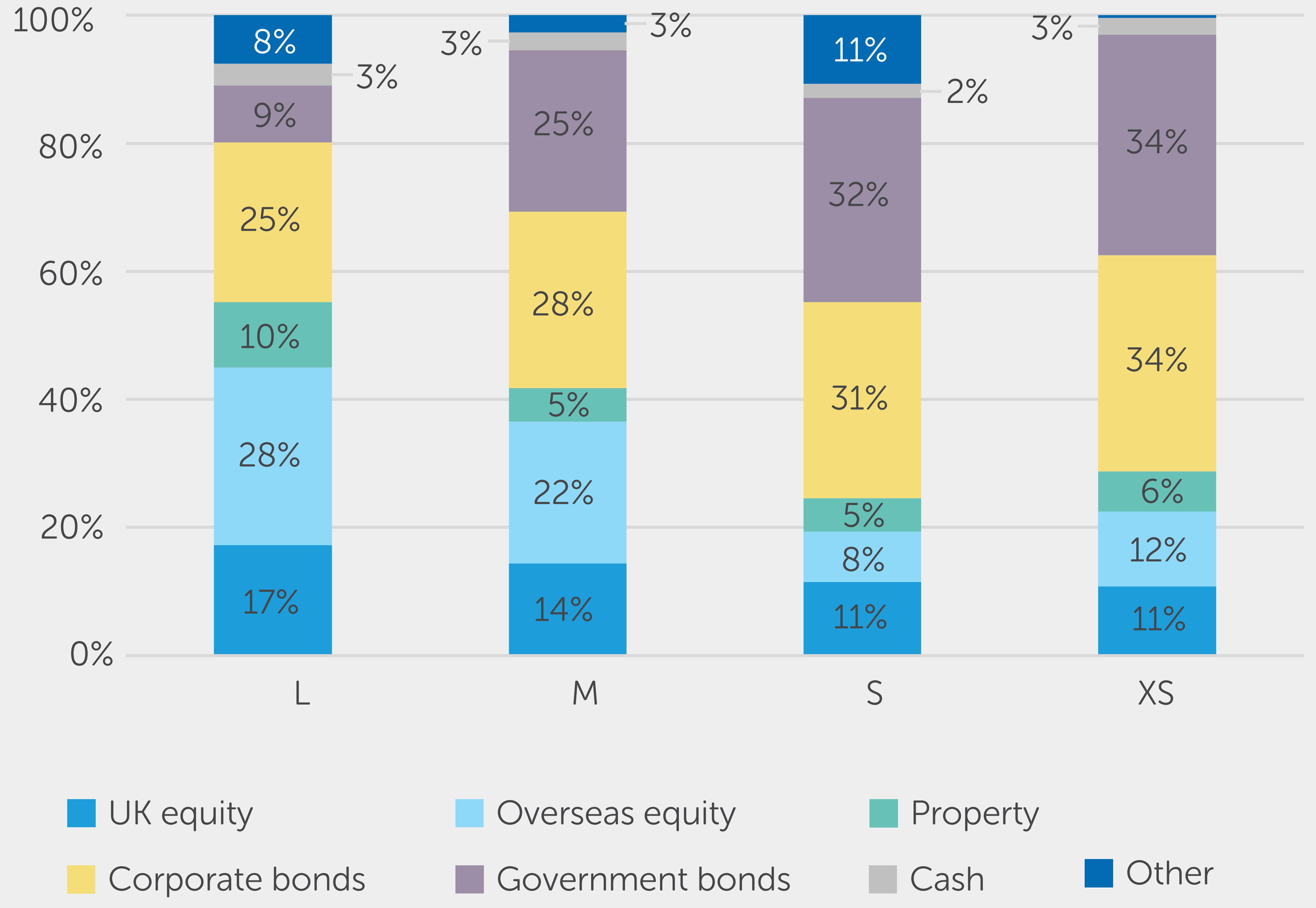
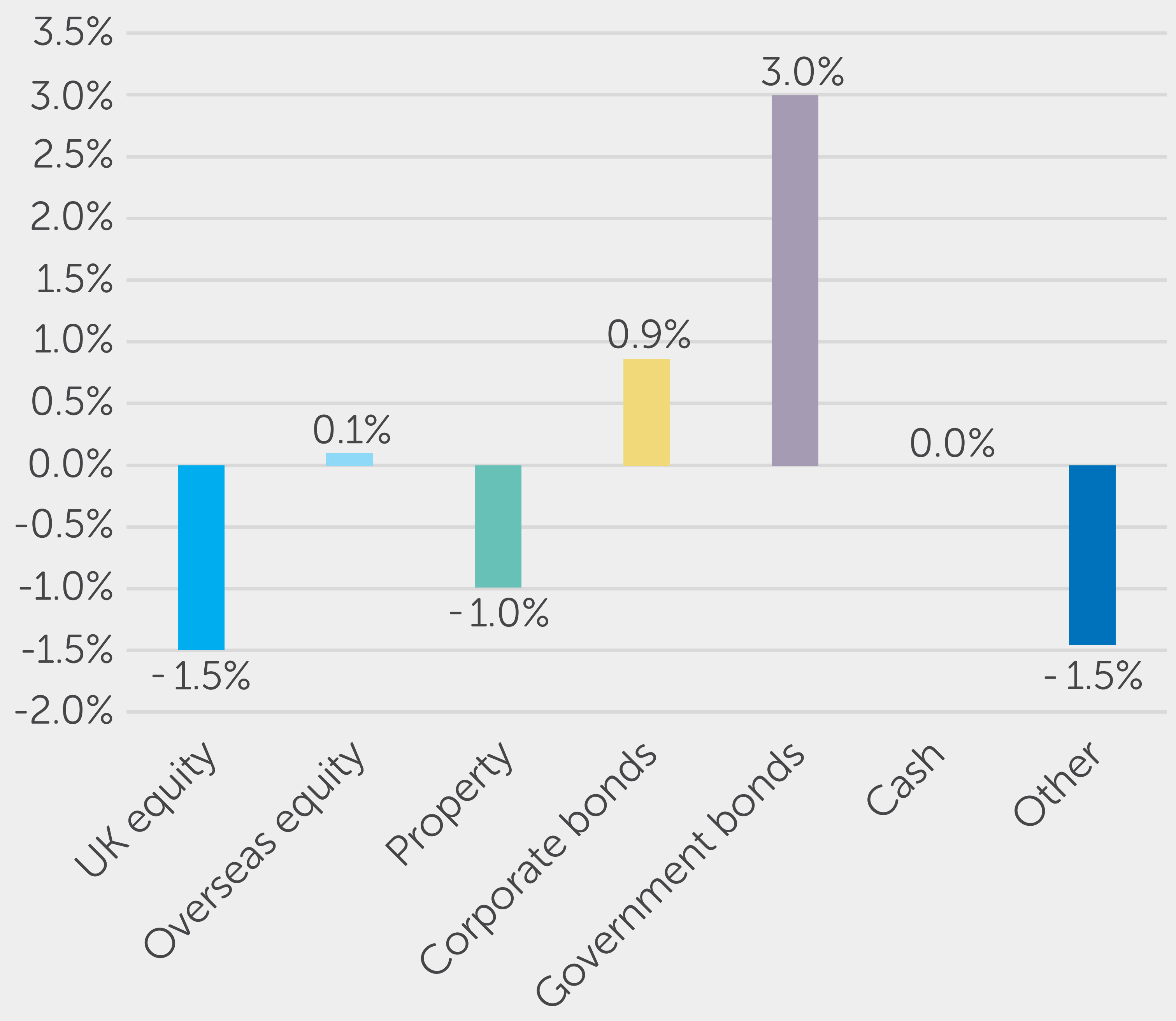


Figure 3: Changes in asset allocations from 31 December 2019 to 31 December 2020



Our insight

Different funds have a wide range of different asset allocations, although most could be described as balanced funds with a mix of all of the major asset classes.

A wide variety of different types of assets are included under "other". For the larger funds, this includes private equity, private debt, overseas bonds, loans and holdings in subsidiaries. For the smaller funds, this primarily represents holdings in collective investments that cannot easily be split into their component asset classes.

On average, larger funds tend to hold a higher proportion of riskier assets such as equities, whereas smaller funds tend to hold more fixed interest assets. There is relatively little difference between open funds and closed funds of similar sizes, indicating that size rather than whether the fund is open or closed is a more significant factor in asset allocation.

As we have observed in previous years, changes in asset allocations tend to occur gradually over time. The most notable change during 2020 was an increase in holdings of government bonds. This is driven by a small number of funds (mostly smaller funds) that have significantly increased their allocations to government bonds rather than being a feature across the whole market. We are aware that a number of firms took action to de-risk their investment strategies in order to offset the impact of the market falls in early 2020 on their solvency position.

Interactive Tableau dashboard +

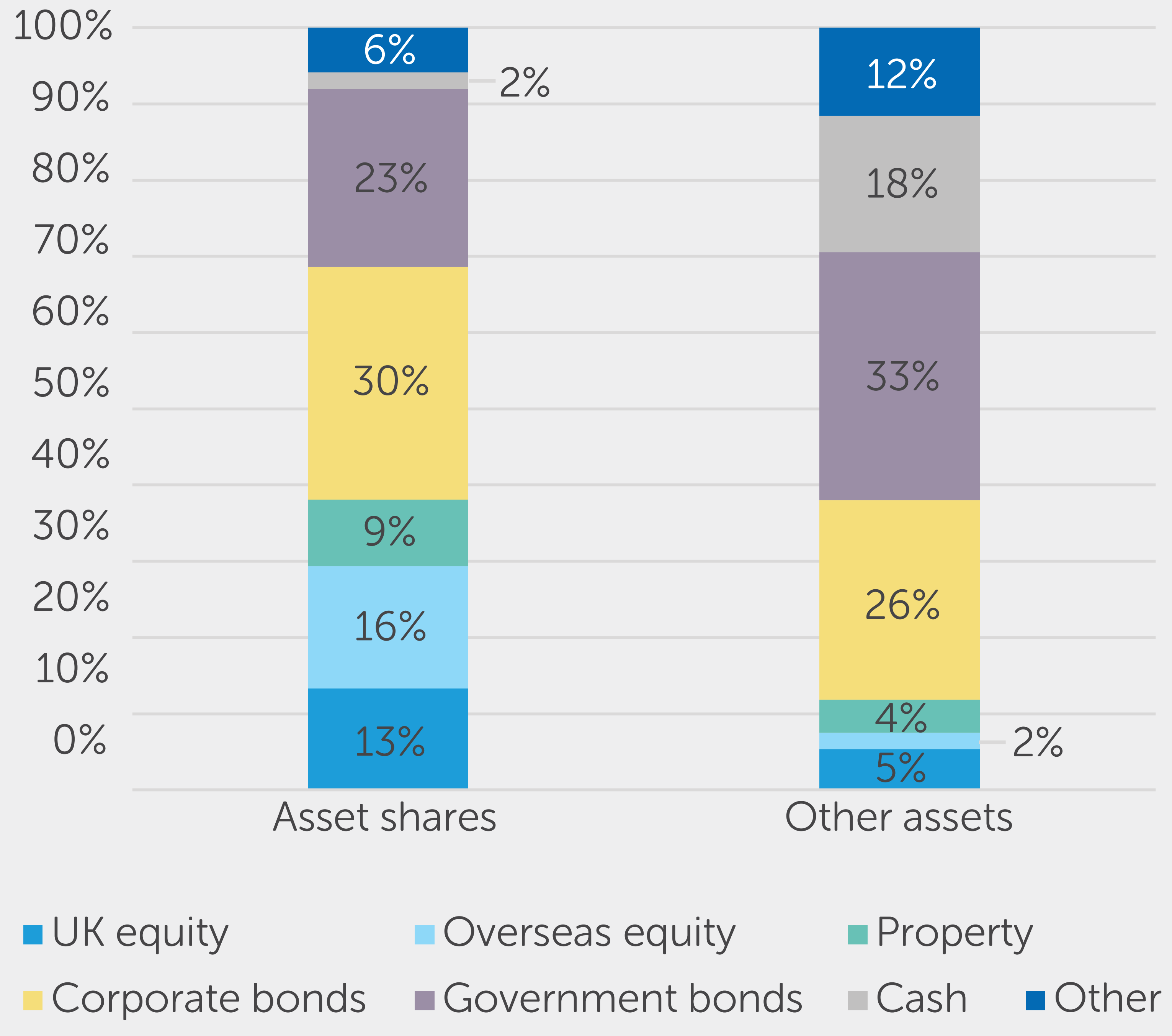
Asset allocation – other with-profits assets

This year, for the first time, we have asked firms to provide the asset mix of any separate with-profits assets held in the fund that do not back asset shares. This may include the assets that form the inherited estate or assets held to back other with-profits liabilities such as the cost of guarantees. We specifically asked for assets backing non-profit business in the fund to be excluded, as these serve a different purpose and are not within the scope of this survey.

Figure 4 shows the average asset mix for those funds that provided a separate asset mix for their other with-profits assets, compared with the average asset mix for the assets backing asset shares for those funds.

All large funds reported a separate pool of with-profits assets not backing asset shares, although only a minority of medium and smaller funds did so. This implies that smaller funds are more likely to be managed with a single investment strategy covering all assets in the fund. As expected, the other with-profits assets were invested predominantly in fixed interest assets and cash.

Figure 4: Asset allocation for other with-profits assets compared with asset shares as at 31 December 2020



Our insight

All of the large funds in our survey provided a separate asset allocation for other with-profits assets. By comparison, only around one in three of the other funds in our survey provided this information. This suggests that it is much more common for larger funds to structure themselves in this way.

There is a stark difference in the investment mix between the two pools of assets, reflecting their different purposes. The purpose of the assets backing asset shares is to deliver a return for policyholders in line with their reasonable expectations and attitude to risk. The purpose of the other with-profits assets might vary slightly from firm to firm, but typically it is to provide the capital of the fund, to absorb losses under stress and (for open funds) to finance the capital strain on new business. The other with-profits assets are predominantly invested in safer assets such as fixed interest assets and cash.

Interestingly, we saw no significant variation in the propensity for closed funds to adopt a separate asset mix when compared with open funds. We might expect that, in a closed fund that is distributing its estate, there is less of a clear distinction between the purposes of these two pools of assets, since ultimately all assets are expected to be distributed to policyholders.

Investment returns by asset class

Figure 5 shows the average return on each asset class across all funds in the survey, in comparison to an appropriate index. The indices used are set out in Table 2. Note that no index return is shown for “other”, due to the diverse nature of this asset class.

Figure 5: Investment returns by asset class compared with index returns

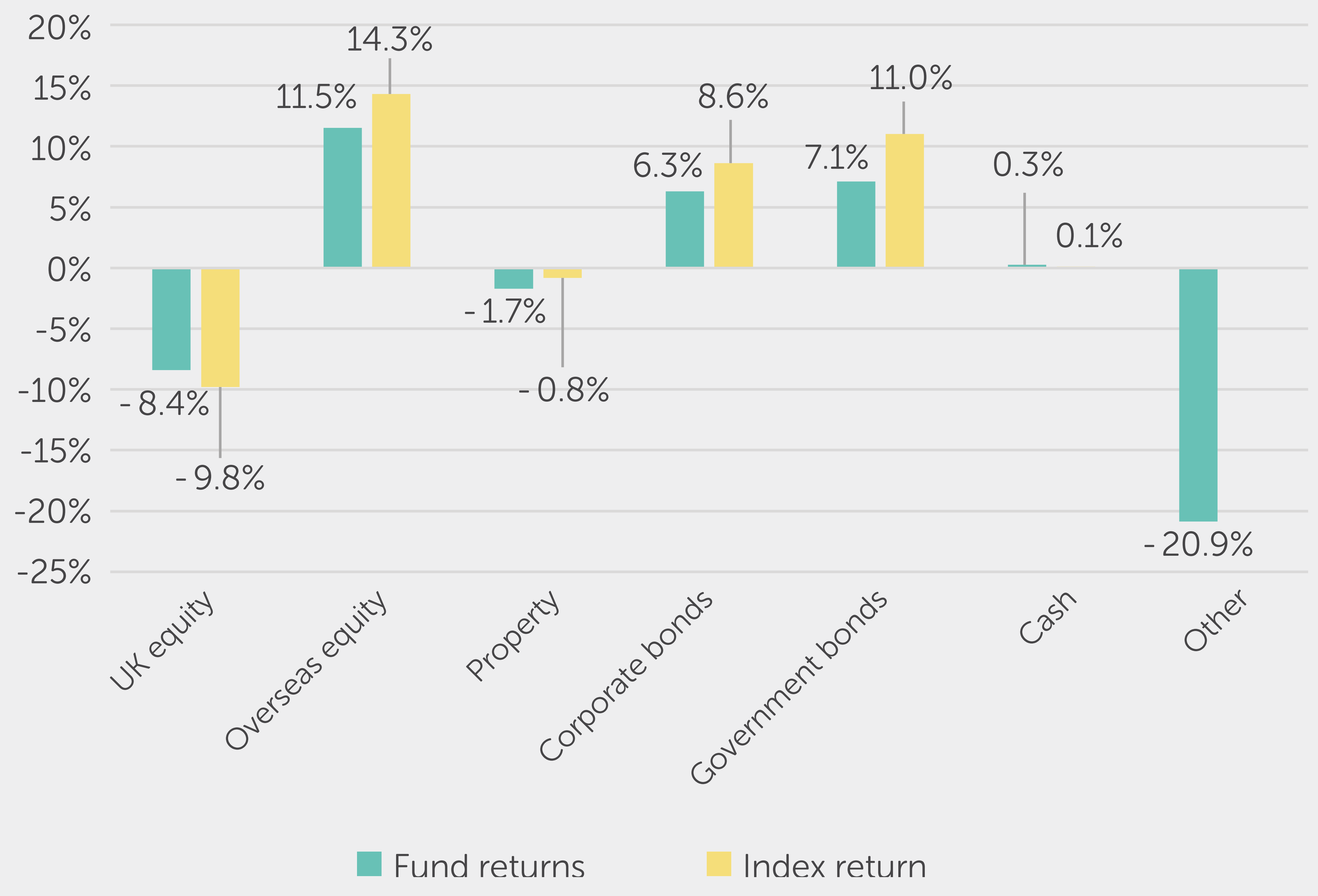


Table 2: Indices used by asset class

Asset class	Index
UK equity	FTSE All Share Index
Overseas equity	FTSE All World (exc. UK) Index
Property	IPD UK All Property Index
Corporate bonds	iBoxx Non-Gilts All Stocks Index
Government bonds	FTSE Gilts All stocks Fixed Interest Index
Cash	Bank of England Base Rate
Other	N/A

+ Interactive Tableau dashboard

Our insight

Despite the turbulent nature of investment markets during 2020, most markets ended the year at a higher level than they started it. UK equities was a notable exception, with the FTSE 100 and FTSE All-Share indices recording their worst year since the financial crisis in 2008. Fixed interest assets also increased significantly in value as a result of falling yields.

The UK equities held by with-profits funds did not suffer as badly as the market overall. However, this was offset by less positive returns on overseas equities. This is likely to reflect a different portfolio composition between different overseas markets relative to the index, as there was considerable variation between different markets over the year. The fixed interest assets held by the funds in the survey also did not increase in value by as much as the government bond and corporate bond indices, which may reflect a shorter duration of assets.

Fund-level investment returns

Figure 6 shows the investment returns achieved in 2020 on assets backing asset shares by fund, ordered from highest return to lowest return. Figure 7 shows the average investment return achieved in each of the last five years by fund size classification and Figure 8 then shows how this translates into relative performance over a five-year period.

Figure 6: Investment returns in 2020 by fund (ranked)

Figure 7: Investment returns by year and fund size classification

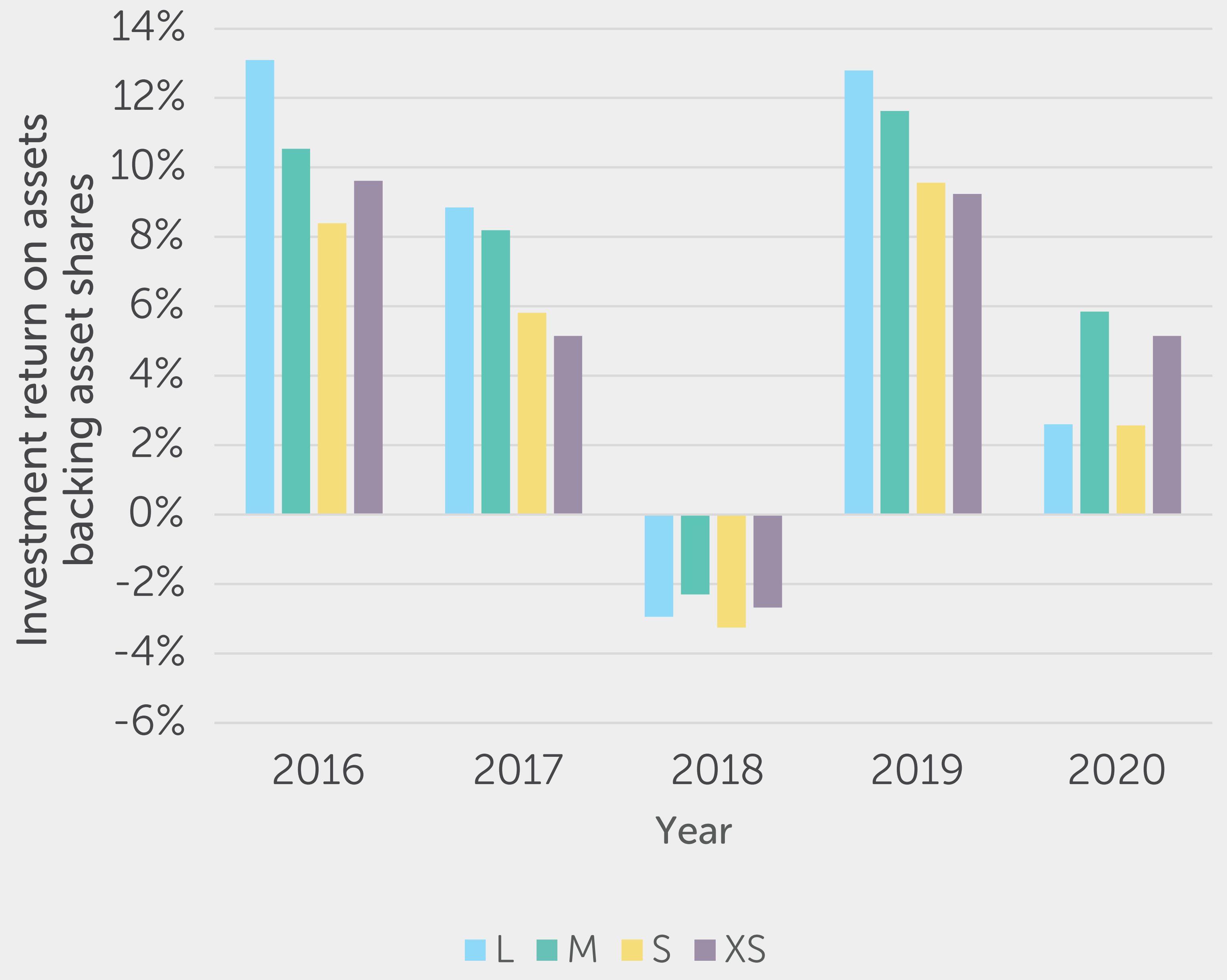
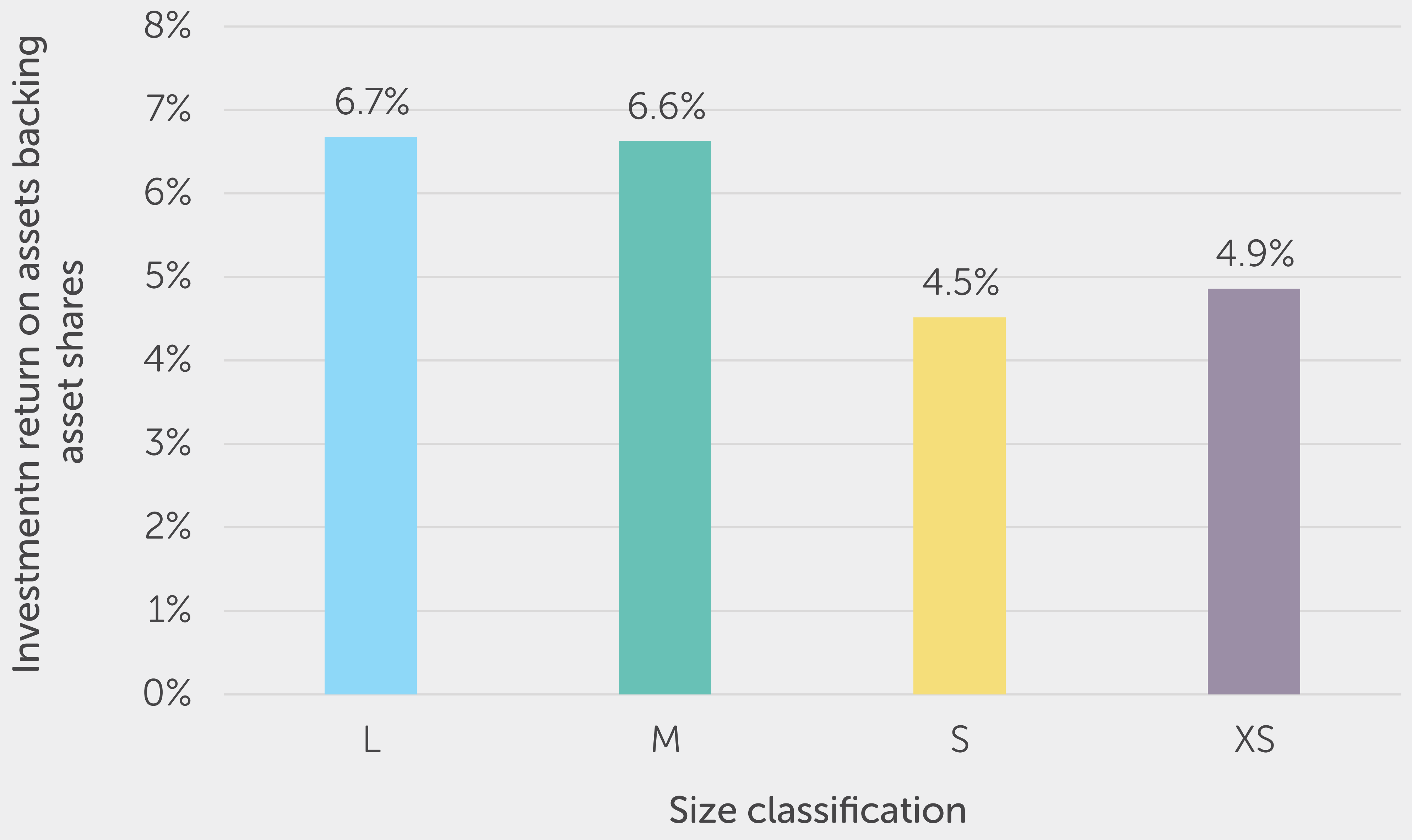


Figure 8: Investment returns by size classification over five years



Interactive Tableau dashboard

Our insight

The funds included in the survey achieved a wide range of investment returns over 2020. This is not surprising given the wide range of investment returns on different assets and asset classes and the different asset mixes held by funds. However, unlike in some previous years, there is no discernible relationship between fund size and investment return. Overall, the larger funds did not benefit from their higher allocation to risky assets in 2020, due to the mixed performance of these assets and the high returns on fixed interest assets.

Figure 7 highlights that larger funds have tended to outperform smaller funds in years where investment returns are favourable, such as 2016, 2017 and 2019. Our analysis of the 2019 returns in last year's survey report indicated that this was primarily due to performance within each asset class, with asset allocation decisions having a smaller impact. However, in more challenging and volatile markets, such as 2018 and 2020, this advantage is not evident. Nevertheless, Figure 8 illustrates that larger funds maintain a relative advantage over a five-year period.

All funds have achieved a positive investment return over a period of five years.

Sustainability

Sustainability considerations (also referred to as "Economic, Social and Governance" or "ESG") are becoming increasingly important in investment management, in response to both regulatory pressure and consumer demand. This year, for the first time, we asked some high-level questions to understand how common such considerations are for with-profits funds and the approaches that are used.

Firstly, we asked whether any of the fund's assets are managed with a specific sustainability target or criteria, with firms able to select responses of "all", "some" or "none". The results are shown in Figure 9 below.

We also asked which of a number of possible approaches were used, with firms able to select multiple options for each fund if applicable. The approaches listed are set out in Table 3. The responses to these questions are shown in Figure 10.

Figure 9: Proportion of funds that apply a specific sustainability target or criteria to all, some or none of their assets

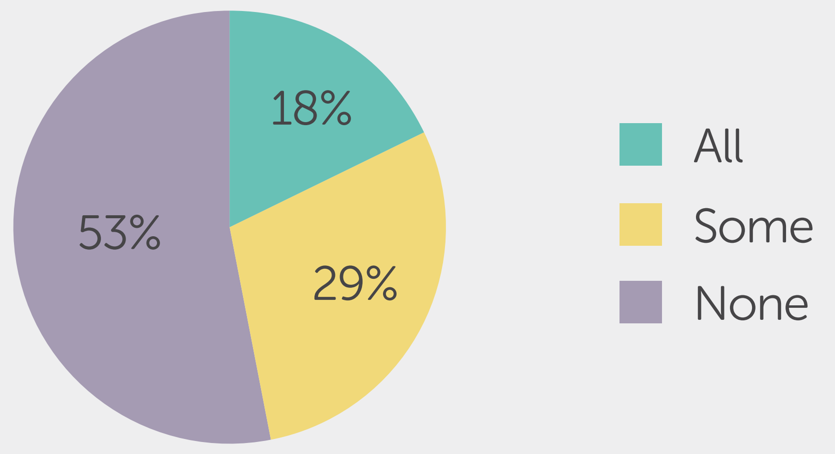
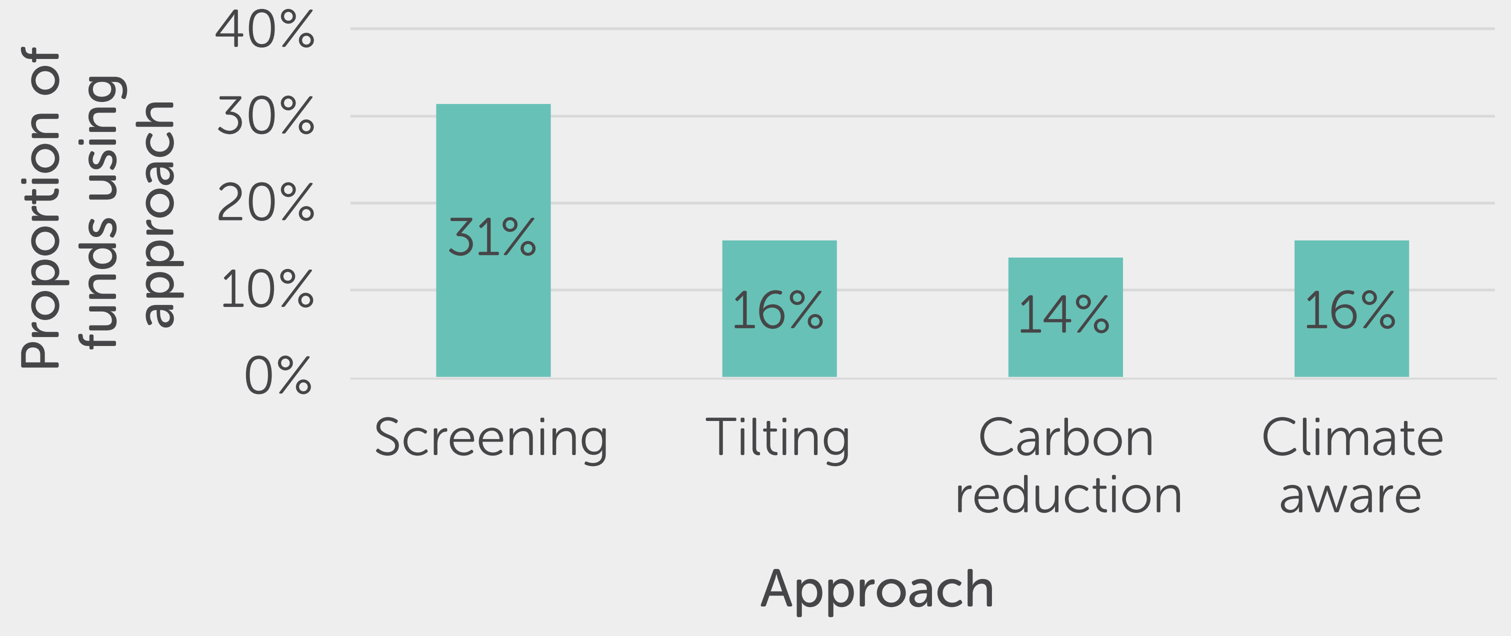


Table 3: Possible approaches to sustainable investment

Approach	Description
Screening	Certain sectors are excluded from the portfolio (e.g. coal)
Tilting	Certain assets are favoured, using metrics such as ESG ratings
Carbon reduction	Carbon emissions data is used to exclude heavy polluters
Climate aware	Portfolio is selected to align to specific climate targets

Figure 10: Proportion of funds using each approach



Our insight

Overall, almost half of funds are managed with at least of some of their assets having a specific sustainability target or criteria. Such targets are more prevalent amongst the largest funds, but only apply to some of the assets. There are smaller funds that apply such targets to all of their assets, which represent all of the with-profits funds of three particular firms. The proportion of funds that apply sustainability targets or criteria to at least some of their funds was similar for open and closed funds, which suggests that sustainability is seen as more than just a selling point for new business.

Of the different possible approaches to sustainable investment, screening is the most common, used by more than a third of all funds and two thirds of funds that have a sustainability target or criteria. The climate aware approach is the most sophisticated approach. While this approach is more common in some other countries, and it is still relatively rare in the UK. However, it is becoming more popular and it is the PRA's metric of choice.

A number of firms noted that their sustainability approach was under development and so it will be interesting to see how these results evolve in future years.

For more information on sustainable investment, please visit the [ESG Investing hub] on our website.

Interactive Tableau dashboard +

Our services for insurers

Our insurance experts provide market-leading advice and support on actuarial, investment, longevity and risk management projects on either a consultancy or a secondment basis. Employing a personal and partner-led approach, we build bespoke teams to ensure we can meet the exact requirements of our client. Our growing client base covers a broad range of life and general insurance firms, from captive insurers and friendly societies to FTSE 100 companies and Lloyd's syndicates.

Our areas of expertise are:

Actuarial function services

Our team of experienced practitioners are on hand to provide all of your actuarial outsourcing or peer review needs.

Risk management

Whether you are looking to outsource your CRO function or to design and implement elements of your risk framework and ORSA process, our experts can assist you.

Strategy and transactional support

From mergers and acquisitions, and product development to transformations and capital optimisation, we work alongside you to develop a strategy that enables you to achieve your goals.

Investment consulting

By enhancing mandates and establishing governance frameworks, we assist in driving performance improvement across your business.

Data and analytics

We provide a comprehensive and practical analytics and visualisation service – using data management, modelling and communication expertise to reach solutions that are tailored to your business.

With-profits

Our team has wide experience of acting as With-Profits Actuary and advising on with-profits issues such as bonus policy, investment strategy, capital management and the fair treatment of customers.

Unit-linked services

Our specialist knowledge covers all aspects of unit-linked insurance management: unit-pricing governance and methodology reviews; independent advice on discretionary practice; error investigation and rectification; and product development and policyholder disclosures.

Bulk annuities

Working with our pensions and longevity consulting teams, we provide pricing, new entrant strategy, modelling and investment advice to existing and prospective market participants.

Audit support

We provide actuarial expertise to support internal and external audit teams.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact Scott Eason, Head of Insurance and Longevity Consulting via the following:

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