

Life after with-profits

Stuart Fowler follows up his previous article on with-profits with some suggestions for the future.

IN MY JUNE ARTICLE, 'No future for with-profits', I ended by questioning why we were trying to reinvent the with-profits contract as a mass-market savings vehicle when better alternatives exist. If I am right, the market will take care of 'son of with-profits', including Sandler's 'smoothed investment funds', and probably 'managed funds' too. Product packages will replace these, with customised asset-mix exposures to match individual risk preferences, both at the outset and over the course of a plan.

There is nothing novel about the concept of synthesising packaged products by associating various holdings, including both savings instruments and pure investment exposure, as combinations that together should fund an individual's financial goals. What is novel is the systems capacity to carry out mass customisation. This is the quiet revolution that threatens the established gatherers and managers of retail investment pools, particularly life companies.

The principles of mass customisation

Sandler got this bit right: it is all about asset allocation. Exposure to asset classes and markets explains almost all of the risk and returns of a diversified portfolio by almost every definition. This is already entrenched in actuarial practice in the institutional market: we model portfolio behaviour by modelling the underlying asset classes and markets; we control managers by setting asset allocation exposure ranges and tracking error limits. We rely on the outputs of probabilistic asset models, equivalent to quoting odds, to quantify investment risks and express differences between strategies. We use these to help clients find some internally consistent balance between the target they are aiming for, the risks they take, and the resources they must contribute.

The same techniques should be applied to individuals' balance sheets. There are some practical obstacles to doing this on a large scale at low cost for small amounts, but these obstacles are diminishing.

The risk spectrum

One essential condition is being able to get exposure to separate building blocks at different locations on the risk spectrum. The fewer locations there are, the easier it is to distinguish how they behave. The minimum is a group of risk-free assets, each more or less suited to the particular goal of the investor, and equities. The latter might be enriched by separating the UK and the major international markets, without too much loss of simplicity.

Because the Treasury accepted Sandler's case for a single location on the risk spectrum, there will not be lightly regulated building blocks to support customi-

sation, only standardised products. This is a grave error but not one that will prevent customisation. Sandler also fell into the trap of assuming that location can be fixed just by playing around with the mix of risky assets, instead of by varying the balance of exposure to risky and risk-free assets.

This error follows from the conventional balanced management approach which treats conventional fixed-income investments as the main balancing asset for equity exposure. In terms of smoothing the path of returns, the required low co-variance between gilts and equities is not at all reliable, varying hugely with economic environments. In terms of narrowing the range of outcomes for real terminal wealth, which is what counts for most individual investors, conventional bonds are inefficient unless the model inputs ignore their historical real return risk over long periods. Optimism about the predictability of inflation has made fools of many clever people, but we are not about to hear that from the Treasury!

Risk is reliably fixed only by combining risky assets with a risk-free asset. It is also more intuitive – like mixing scotch and water. The best risk-free approach for a different individual goal might be rolling over cash or index-linked National Savings Certificates, or even matching an index-linked gilt to the time horizon of the task. It is significant that these could be instruments rather than products. It is not always necessary to hold them in a product or in the same product as risky assets. Doing so reduces customisation and flexibility and increases costs and agency conflicts.

Separating the package exposure into risky and risk-free, or investments and savings, also provides flexibility over the way contributions feed from savings to investment, as part of the asset mix tolerances consistent with the customised plan. Life company investment pools may have provided economies at the asset management level but they are disastrous for gathering small contributions, hence the problem of making money in a 1% world. It is not the 1% that is wrong.

Changing the asset models

A second condition of applying institutional techniques is that the asset models and optimisation processes should be further developed so they can be relied on systematically. Almost all use normative assumptions for mean expected values, such as for real equity returns, but projected outcomes need to be much more consistent with changing portfolio values. If you make the assumptions stable, you force the instability into the messages the customer relies on for confidence in the plan, such as the chance of achieving the planning target or the contributions required to hit the target with the required planning certainty.



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Second, the asset mix process should be realistically dynamic. The customer's core building block exposure in the package should be responsive to both changes in market conditions and the ticking of the clock, based on the risk utility function specific to the plan. Dynamic rebalancing of the risky/risk-free balance can control the impact of portfolio volatility on terminal wealth consistently for all customers, whereas with-profits smoothing can only ever be a lottery.

Technology

Technology is the third condition. Systems are critical to cost-effective fulfilment of four key aspects of mass customisation:

- Interacting with the individual to determine the customised package.
- Packaging and monitoring the underlying exposures.

- Optimising how contributions are handled.
- Managing the package and communicating progress.

The first and last are 'expert system' challenges, requiring adaptations of existing quantitative techniques. The processes are likely to be licensed by specialist firms and may even be accessed through advice and execution platforms shared by many different firms. There are already four stochastic asset models available in the UK to drive enterprise-wide decision processes, including my own firm's, and several US firms are likely to adapt their asset models to the UK. Early systems solutions from software firms, such as Misys and 1st Software, may be joined by other fully integrated business process systems using probabilistic models.

The middle two aspects are IT challenges, requiring embedded logic in customer and investment databases to associate separate positions, perhaps in different

places, as if they were a product. This is already a principle used in investment planning where legally separate clients, holdings, and tax wrappers may all be associated for resource planning, portfolio management or reporting purposes. Whatever the customer's means of access, it is internet connectivity that supports the relationships between different agents for package components and different transaction platforms.

Competitive advantage

External technology enablers make it easier for new asset gatherers to challenge the institutions. These new leaders will have a service-centric business model rather than a product-centric model: interaction and communication rank more highly than the building blocks. They are likely to contrast their own approach to earning trust with historically mistaken reliance on institutional brands – an advantage handed to them

on a plate by life companies.

In terms of sourcing products, it looks like a retailing model, favouring banks, stockbrokers, and financial advisers, who then exert pricing and quality pressure on the building block providers. Distinctions between information and advice or selling and advising will become blurred or redundant, as information and advice are integral parts of customisation. As far as the revenue model is concerned, service charges may become detached from product charges, further loosening manufacturers' control over distribution.

Life insurance companies will have to reinvent themselves to compete effectively. They will have to do it at the same time as reforming their with-profits funds. It is not clear they can. Given the inherent life company tensions between shareholders and policyholders, and between existing policyholders and new policyholders, it is not clear they should. □