

Don't be bamboozled by these smoothing operators

Let's suppose I'm a fund manager and I make this promise: I will read the long term trend of markets accurately, I will even read it accurately over 3 to 5 years, and I will trade successfully the fluctuations around the trend, selling into temporary peaks and buying into temporary troughs. Would any but the very gullible hire me on such an extravagantly implausible prospectus? Well, yes, actually: it fits perfectly the job spec for an insurance company actuary managing the 'smoothing' account of a with-profits fund.

What we might not realize, though, is that the market timing skill assumed by the offer to cushion us from market volatility by smoothing the peaks and troughs in the path of markets is the same skill we laugh at if a portfolio manager or IFA is outrageous enough to lay claim to it.

We know perfectly well that if he had the Midas touch in reading market volatility he would not bother to do business with the likes of us when he could be sipping gin on his yacht. Unless we think a lot of actuaries have left the industry for the Caribbean, we should be equally sceptical about the claims professionals make about smoothing reducing investment risk. If insurance company actuaries have retired young, it is probably not because of their success in playing the markets.

In fact, actuaries have an appalling record of managing smoothing, lurching from one extreme to the other, victims of a power much greater than their own that they of all people should respect. They misread the durability of strong equity markets after the ravages of the 1970s and they misread the persistence of high inflation, so throughout the 1980s they consistently underpaid maturing policyholders.

Having decided they got inflation wrong they then offered guaranteed annuity rates that would cost them a fortune if inflation did in fact fall back. It promptly did. Embarrassed by reserves they and everyone else assumed were excessive, they spent the 1990s overpaying policyholders (as well as getting rid of reserves in ways that did not benefit policyholders).

Three years of unexpectedly prolonged but not exceptionally deep bear markets have shown that reserves were not so excessive after all. Now they have gone, solvency problems are dogging attempts to cushion maturing policyholders just when they need it. Forced sales of equities and the need to rebuild reserves will make it difficult or even impossible to pay out in line with market returns even when equities look to the rest of us like they are in a trough, not at a peak.

This matters because smoothing has to work fairly reliably for claims that with-profits are less risky than direct investment to be honest. Otherwise, the range of possible outcomes is either no different from a direct investment in the same underlying asset mix or, by the time solvency regulations have had an effect, the range may actually be wider.

There is also a likely cost: the mean expected return may well be lower than for a direct investment because of the smoothing dynamics and the need to charge the fund for access to working capital for smoothing purposes.

Being honest about the risks, particularly relative to cash-based saving and other direct alternatives, is surely what the FSA, which is reviewing the future of with-profits funds, should most care about. How, then, are we to explain the FSA's stamp of approval for new, sanitized with-profits, with all the nasty toxic elements outlawed but leaving the nice smoothing benefits intact?

The FSA wants us to believe with-profits can be safe. The Treasury has taken seriously a recommendation of the Sandler Review that there should be a 'smoothed investment fund', not necessarily a life-insurance linked product, as part of the suite of simple products that could be sold safely without advice, possibly even bearing the 'stakeholder' mark. It hasn't happened yet, but it may unless we wise up to the risks.

Ironically the reform process will actually make smoothing benefits harder to deliver for most policyholders who need them, that is to say those whose need for the money coincides with weak markets. There are two reasons for this.

- The FSA's proposals for tightening up the 'governance' of with-profits funds will have an intended effect of restricting the size of the pool of capital available for smoothing.

- Fixed maturities are rapidly becoming supplanted by liquid contracts. These replace the small proportion of the fund that matures in a window of falling equities with a much larger proportion of policyholders that can cash in at any time. Unchanged volatility plus unchanged market timing skills plus smaller pool plus larger calls on the pool means that the early bird alone will benefit.

The idea that the smooth emergence of policy value in modern with-profits policies somehow reduces volatility is a hollow sham, a trick of the life company marketing departments. Unless you can cash in your policy at its smoothed 'asset share' or policy value, without claw-backs through market value adjustments, there is no expected risk reduction.

It is inconceivable that sanitized with-profits or smoothed investment funds will be marketed without claiming risk reduction because without it there is no sales pitch. Indeed, companies offering 'reform friendly' contracts that anticipate the Sandler proposals are already up the old trick of claiming that with-profits can fill the gap between cash-based saving and risky investments.

A telling commentary on the state of financial product design and regulation in Britain is that two consulting actuaries who have tested smoothing in the very uncertain conditions I described, incorporating uncertain market behaviour, restricted capital and different consumer responses, have found it barely alters the distribution of outcomes. One was too scared to publish for fear of offending its clients in the life industry. The other was scared of risking the FSA's unchallenged ability to make trouble for regulated firms that offend it. It is a sorry, even alarming, state of affairs when even consultants dare not speak the truth about the emperor's new clothes.