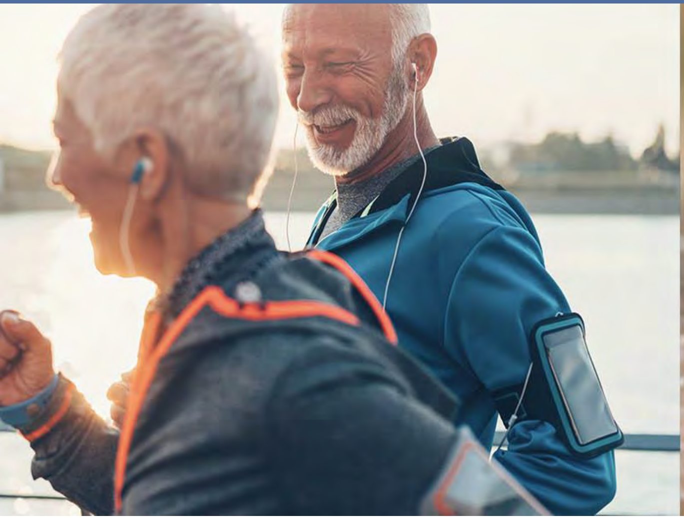

THE ROLE OF SMOOTHING FOR INCOME PORTFOLIOS

FRANCIS MARAIS

HEAD OF RESEARCH: GLACIER BY SANLAM

THINK WORLD CLASS

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WHICH WOULD YOU PREFER?
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WHICH WOULD YOU PREFER?
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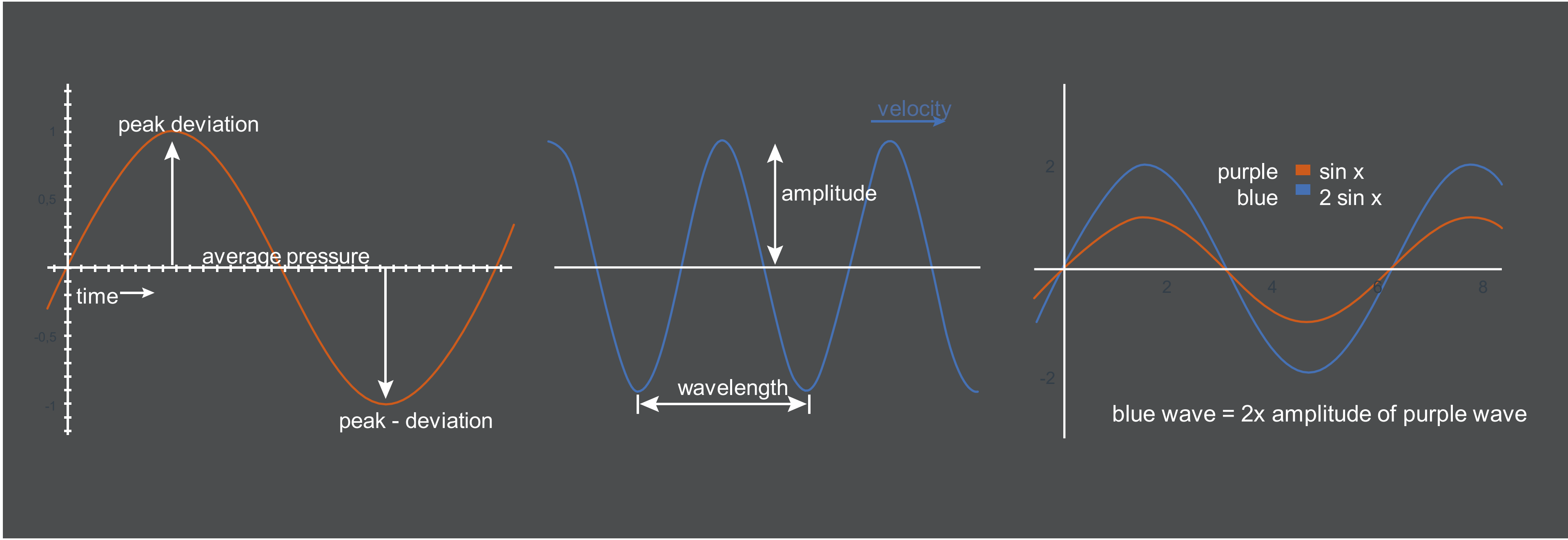
WAVE THEORY



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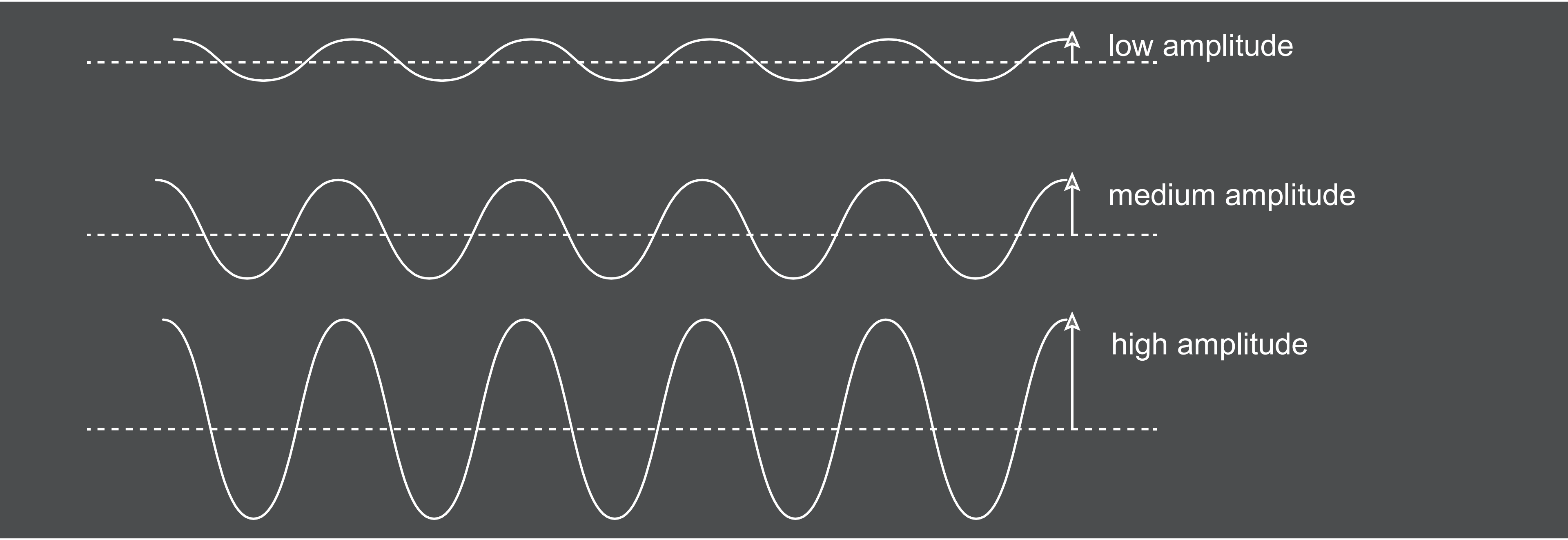
WAVE THEORY



WAVE THEORY

Low amplitude

1. Lower energy
2. Softer sound
3. Dimmer light
4. Calmer seas

High amplitude

1. Higher energy
2. Louder sound
3. Brighter light
4. Rougher seas

A high amplitude wave carries more energy, **so it can travel further**, but it might be uncomfortable over the shorter term, i.e. loud noises and bright light.

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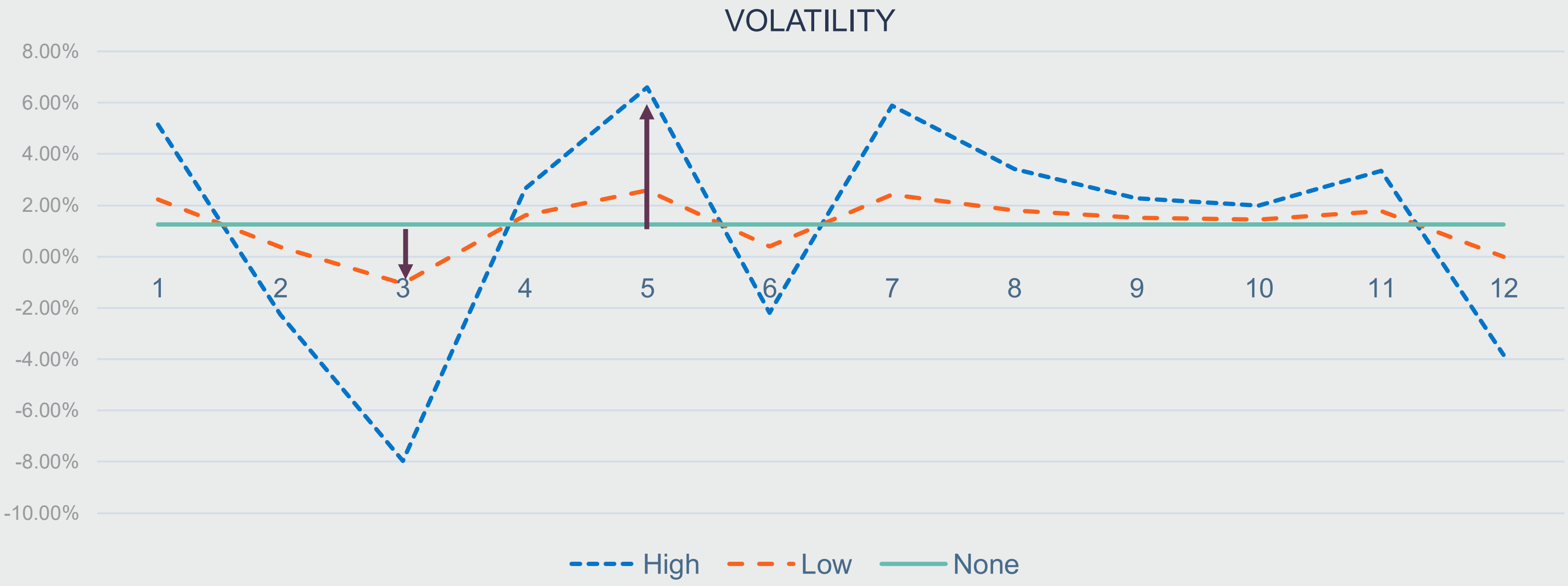
VOLATILITY AND INVESTMENTS



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WAVE THEORY AND VOLATILITY

An investment with volatility can be compared to a wave with peaks and troughs, where the size of the wave represents volatility.

You want to reduce and avoid volatility because it is uncomfortable, similar to rough waves on the ocean, loud noises and very bright light.

Removing volatility completely is similar to removing energy, i.e. you reduce risk or growth assets and portfolios might therefore not be sustainable of the long run.

Can we therefore reduce volatility in a clever way, without putting the long-run sustainability or growth potential of the portfolio at risk?

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NO INCOME

	0	1	2	3
1	1,18%	2,47%	-1,10%	2,47%
2	1,18%	-0,46%	-0,46%	2,63%
3	1,18%	1,90%	-0,01%	2,62%
4	1,18%	2,48%	0,01%	2,53%
5	1,18%	2,62%	0,53%	2,48%
6	1,18%	-0,01%	0,70%	1,90%
7	1,18%	0,70%	1,90%	0,70%
8	1,18%	-1,10%	2,47%	0,53%
9	1,18%	2,63%	2,48%	0,01%
10	1,18%	0,01%	2,53%	-0,01%
11	1,18%	0,53%	2,62%	-0,46%
12	1,18%	2,53%	2,63%	-1,10%
Mean	15,17%	15,17%	15,17%	15,17%
Std	0,00%	4,60%	4,60%	4,60%

ALL OF THESE VALUES END AT EXACTLY THE SAME PLACE!

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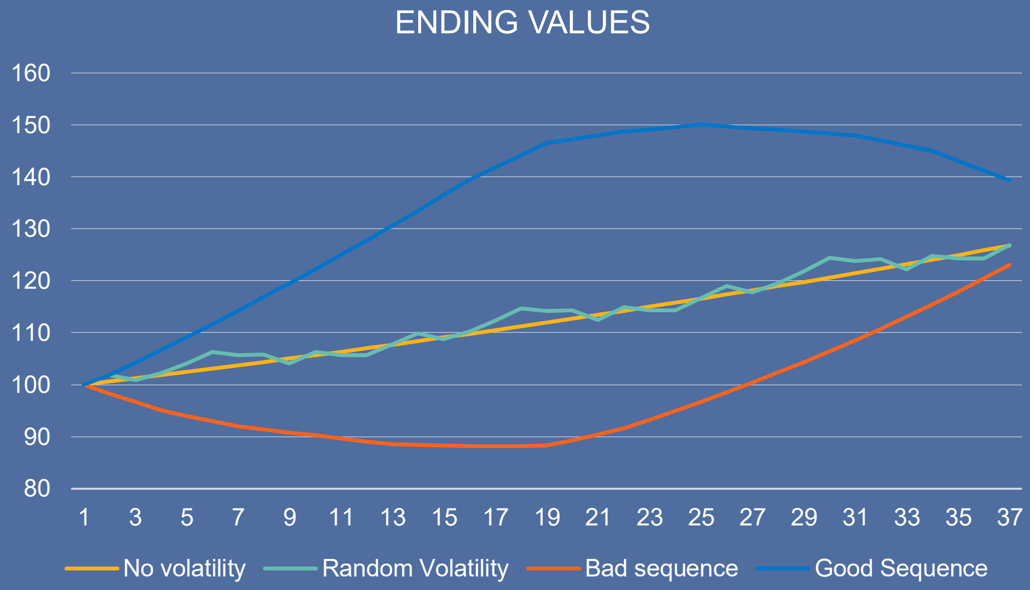
TAKING INCOME

	0	1	2	3
1	1,18%	2,47%	-1,10%	2,47%
2	1,18%	-0,46%	-0,46%	2,63%
3	1,18%	1,90%	-0,01%	2,62%
4	1,18%	2,48%	0,01%	2,53%
5	1,18%	2,62%	0,53%	2,48%
6	1,18%	-0,01%	0,70%	1,90%
7	1,18%	0,70%	1,90%	0,70%
8	1,18%	-1,10%	2,47%	0,53%
9	1,18%	2,63%	2,48%	0,01%
10	1,18%	0,01%	2,53%	-0,01%
11	1,18%	0,53%	2,62%	-0,46%
12	1,18%	2,53%	2,63%	-1,10%
Mean	15,17%	15,17%	15,17%	15,17%
Std	0,00%	4,60%	4,60%	4,60%



SIGNIFICANT DIFFERENCES!

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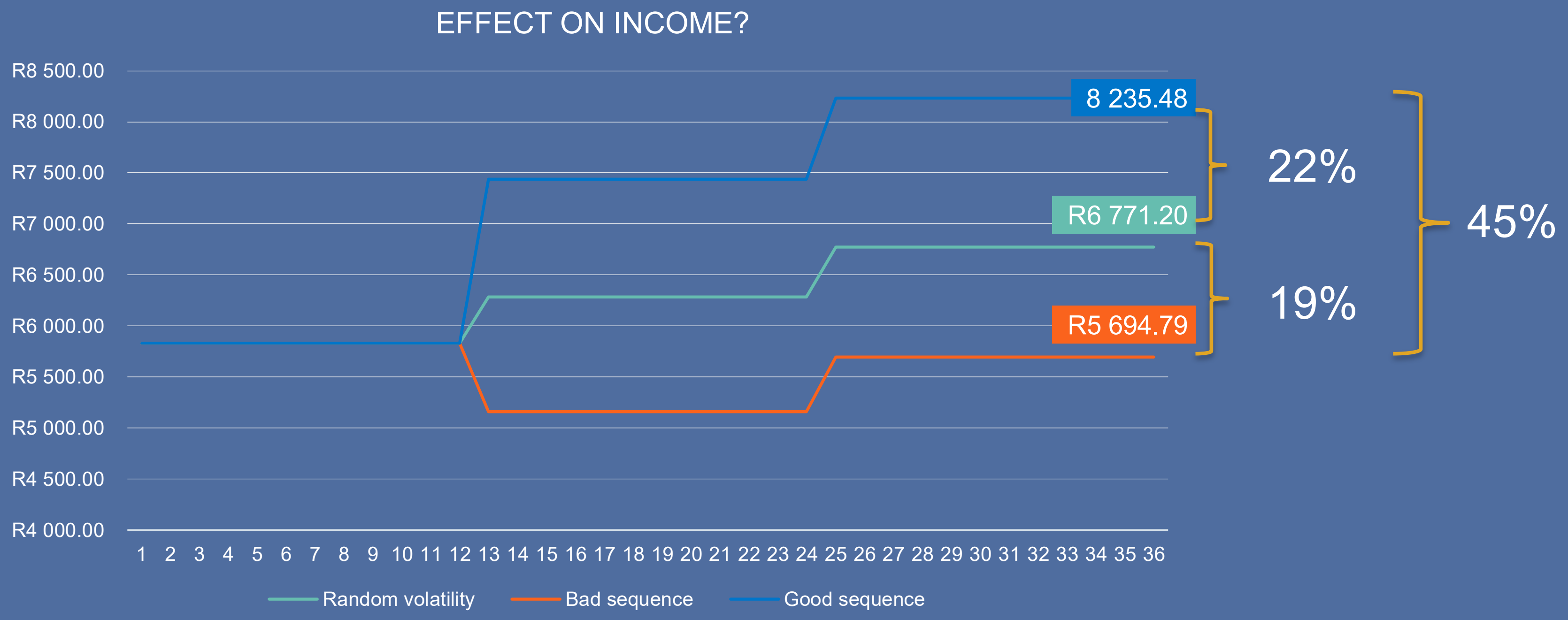
TAKING INCOME



SIGNIFICANT DIFFERENCES!

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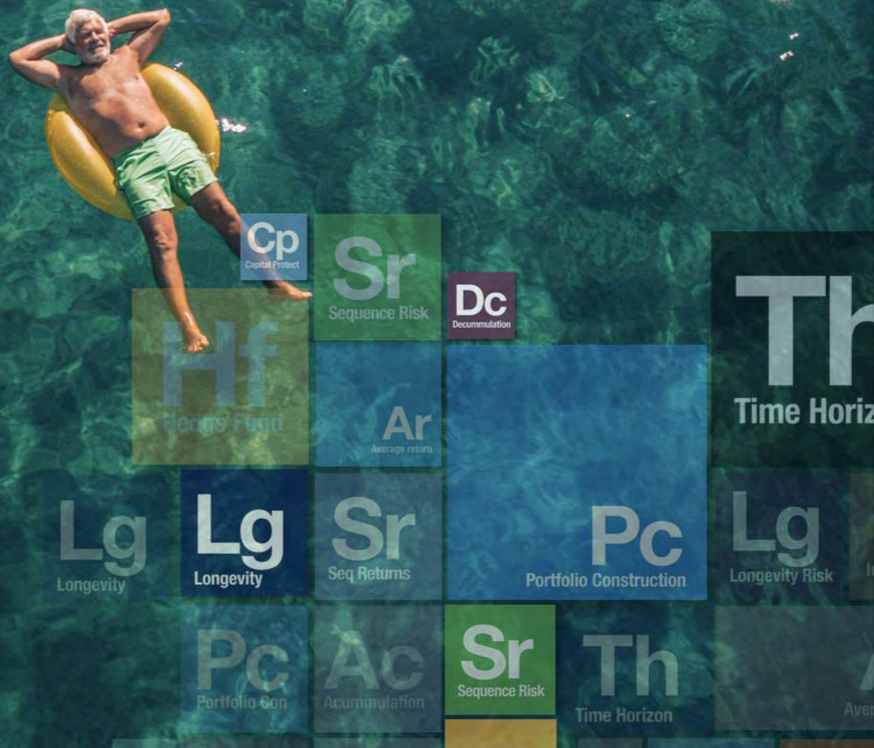
VOLATILITY SUMMARY

Overall volatility is important, but only when cash flows are applicable.

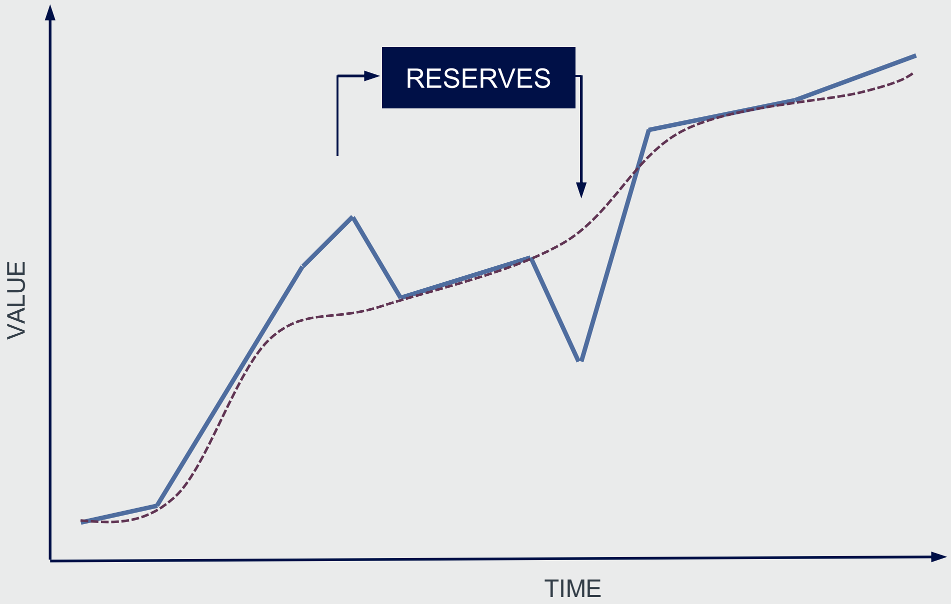
More important is the sequence of those returns, however.

So while volatility is merely uncomfortable for most investors, it manifests in a very real risk for clients drawing their income, either decreasing their available capital, or their income.

SMOOTHING OF INVESTMENT RETURNS



HOW DOES SMOOTHING WORK?



Excess returns are used to build up a reserve.

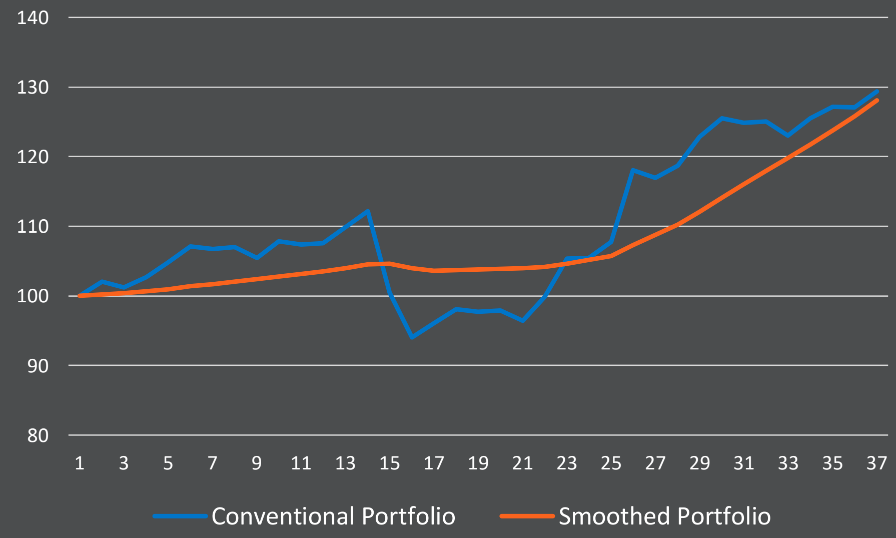
Reserves can then be used to prop up returns during poorer performing months.

Basically, averaging our returns over a period through a smoothing formula.

Source: Du Preez, 2020 retrieved from https://www.businesslive.co.za/money/2020-06-08-there-is-still-some-rough-with-the-most-popular-smoothed-returns/

SMOOTHING CASE 1 – INCOME

CASE 1



Bonus = i + (FL – 103%) / (24 – m) – fees

- i: Monthly equivalent of CPI + 4%
- FL: Funding level of the product
- m: months
- fees: See below

Return	15.05%	14.79%
Vol	10.75%	2.63%

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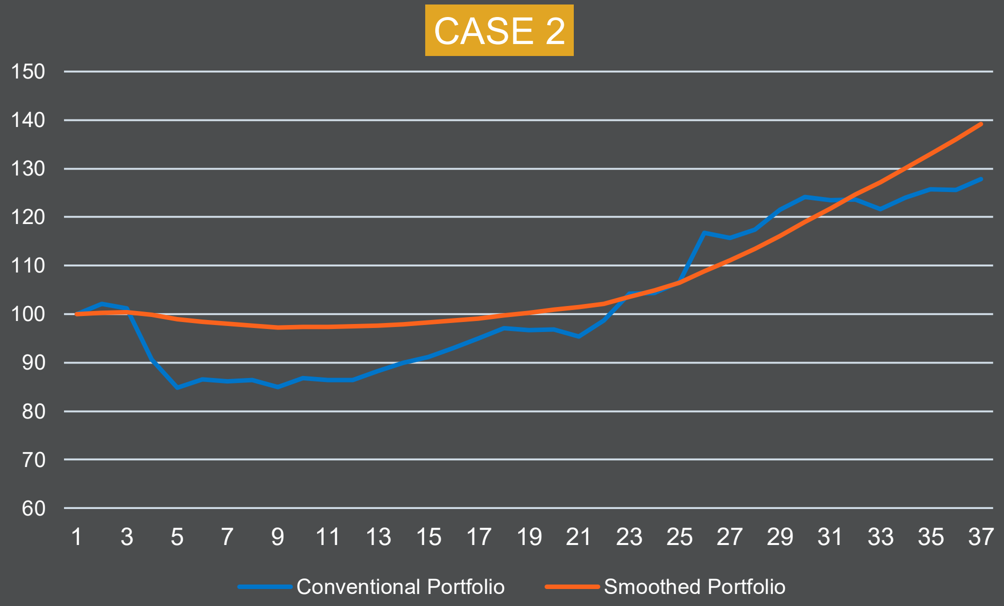
SMOOTHING CASE 2 - INCOME



Return	15.05%	18.01%
Vol	10.75%	3.84%

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SMOOTHING SUMMARY

This addresses **both sequence of return risk and longevity risk**

By doing this, you can invest in more growth-orientated assets

Smoothing helps to manage volatility

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MULTI-MANAGED SMOOTH GROWTH FUND

1

High exposure to growth assets, but with reduced short- term volatility.

2

Return objective: CPI + 4% over the longer term.

3

Less market volatility, but bonuses can be 0 or negative during periods of extreme market drawdowns.

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MULTI-MANAGED SMOOTH GROWTH FUND

Bonus formula (FL > 92%):

Bonus = i + (FL – 103%) / (24 – m) – fees

- i: Monthly equivalent of CPI + 4%
- FL: Funding level of the product
- m: months
- fees: See below

85% < FL < 92%, Bonus = 0

80% < FL < 85%, Bonus = -10%

FL < 80%, Bonus = -20%

Investment charges:

Management fee:	1.05%
Smoothing charge:	0.20%
Total charge:	1.25%

Underlying fund:
SMM Select Balanced Fund

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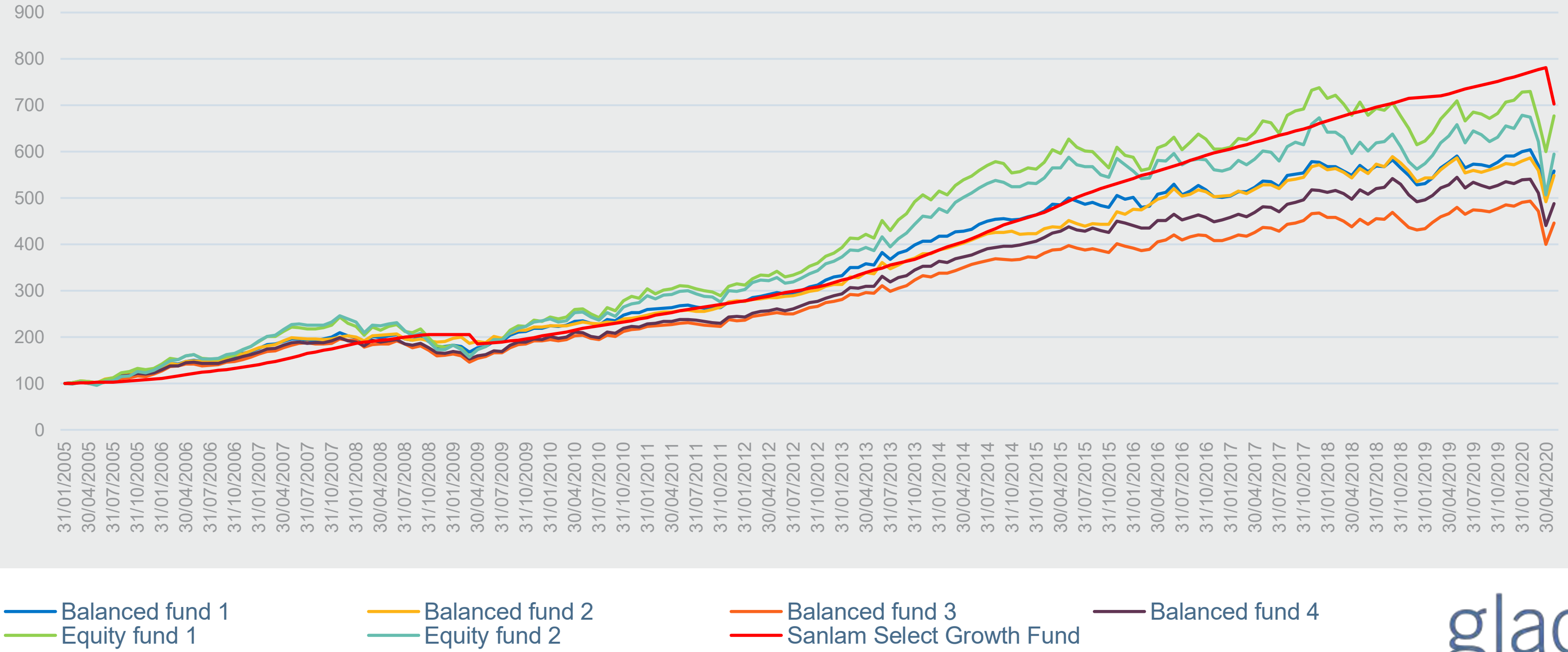
MULTI-MANAGED SMOOTH GROWTH FUND

MODELLED PERFORMANCE SINCE 2005



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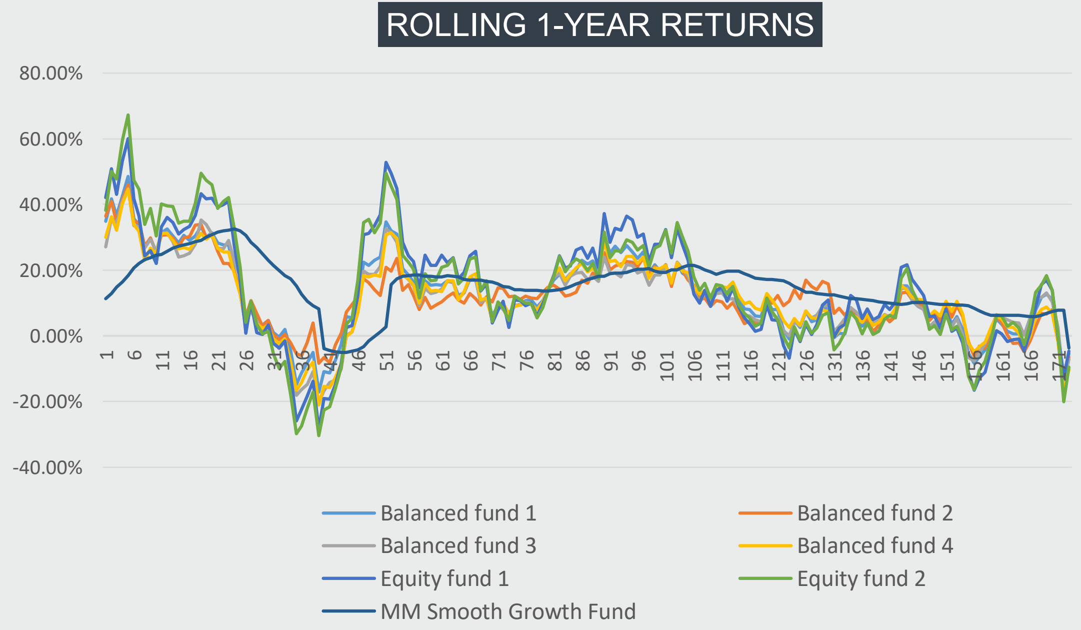
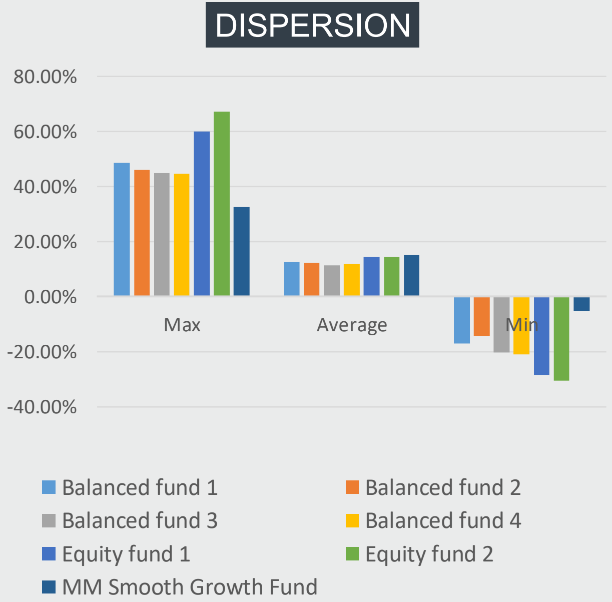
MULTI-MANAGED SMOOTH GROWTH FUND





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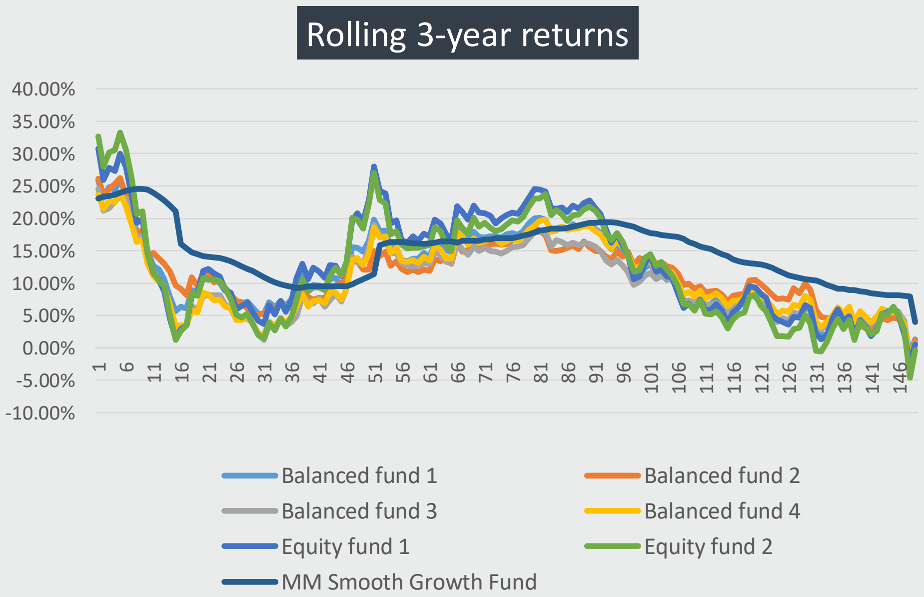
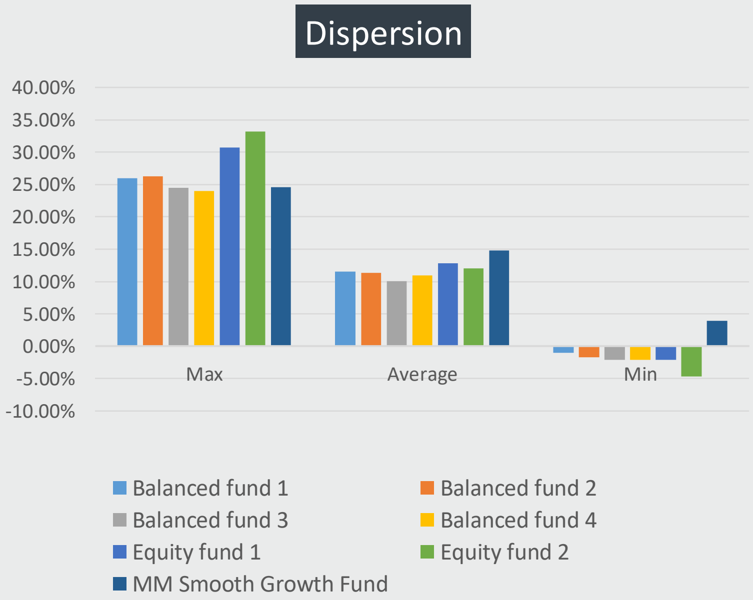
MULTI-MANAGED SMOOTH GROWTH FUND





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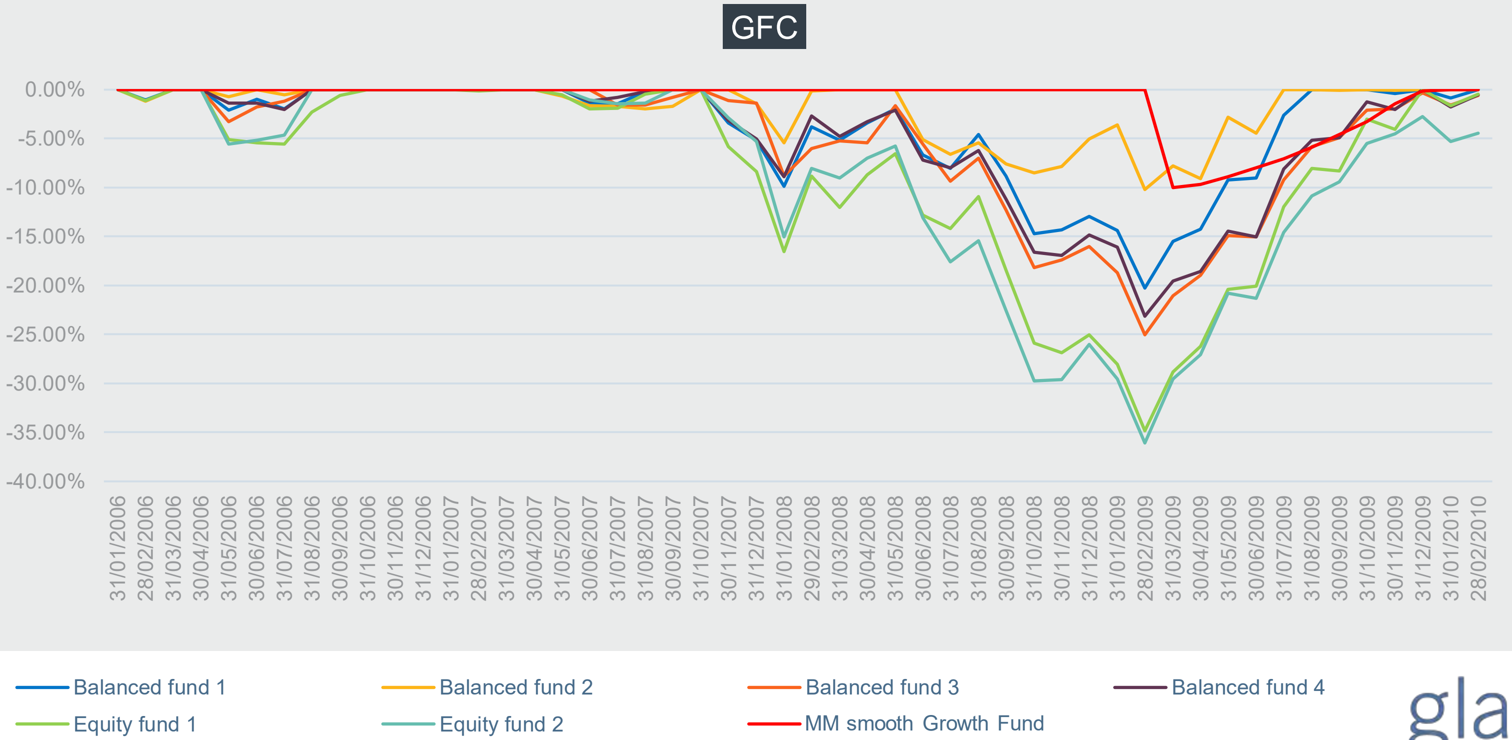
MULTI-MANAGED SMOOTH GROWTH FUND



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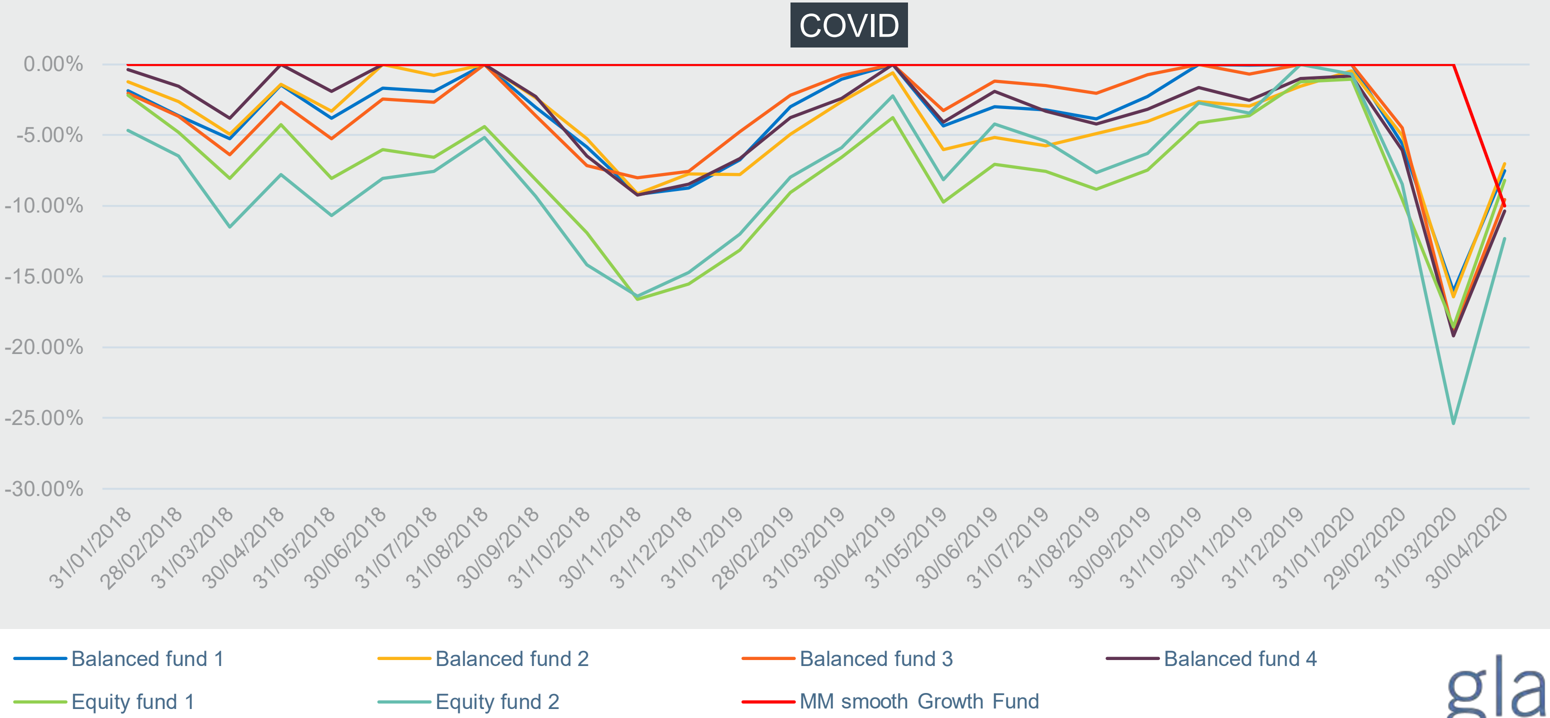
MULTI-MANAGED SMOOTH GROWTH FUND



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MULTI-MANAGED SMOOTH GROWTH FUND

	Balanced fund 1	Balanced fund 2	Balanced fund 3	Balanced fund 4	Equity fund 1	Equity fund 2	MM Smooth Growth Fund
Balanced fund 1	1.00	0.90	0.93	0.96	0.96	0.94	-0.18
Balanced fund 2	0.90	1.00	0.87	0.89	0.82	0.87	-0.17
Balanced fund 3	0.93	0.87	1.00	0.95	0.91	0.96	-0.18
Balanced fund 4	0.96	0.89	0.95	1.00	0.94	0.95	-0.17
Equity fund 1	0.96	0.82	0.91	0.94	1.00	0.95	-0.19
Equity fund 2	0.94	0.87	0.96	0.95	0.95	1.00	-0.23
MM Smooth Growth Fund	0.18	-0.17	-0.18	-0.17	-0.19	-0.23	1.00

	Balanced fund 1	**Balanced fund 2**	**Balanced fund 3**	**Balanced fund 4**	**Equity fund 1**	**Equity fund 2**	MM Smooth Growth Fund
Annualised Return	2.24%	3.97%	2.33%	2.17%	1.55%	0.25%	7.33%
Annualised Std Dev	12.07%	12.58%	13.51%	13.07%	14.97%	19.28%	6.09%

HOW IS THIS POSSIBLE?

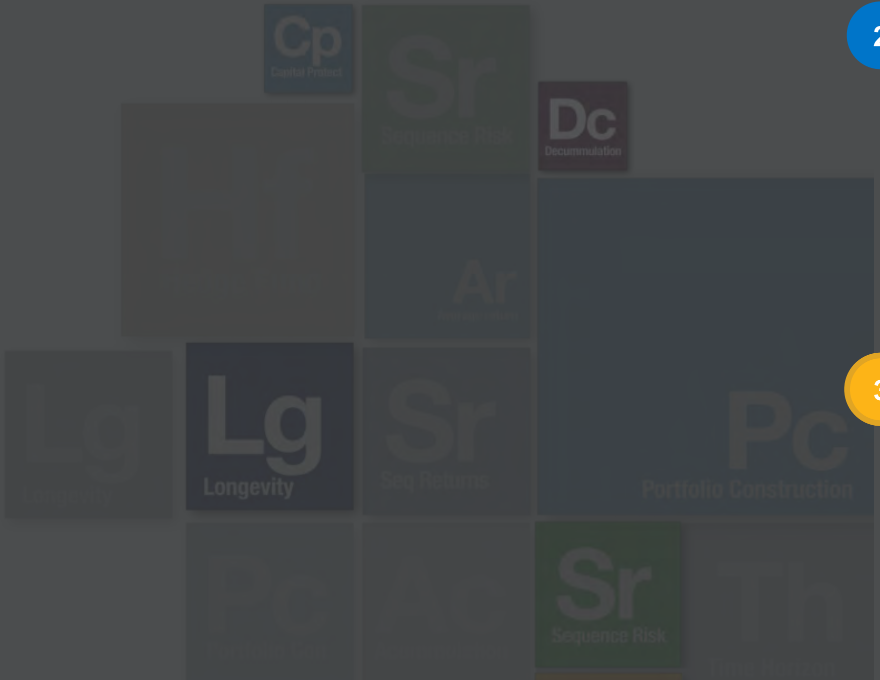
1. Volatility is not removed, necessarily, merely spread out. There is a 20bps smoothing fee involved for managing volatility.

2. Book value only guaranteed in the following instances:

    Income payments

    On death & disability

3. **If you switch, the book value is not guaranteed and you get the lower of book or market value.**



BOOK VALUE VS MARKET VALUE

SWITCH

Pension, Death & Disability

T2

MV = 93.25

-9%

+ 2.47%

BV = 100.65

+ 0.02%

+ 0.63%

MV

BV

T1

MV = 102.47

BV = 100.63

BV

BV

T0

100

Market value = book value

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MULTI-MANAGED SMOOTH GROWTH FUND SUMMARY

MM Smooth Growth Fund underlying multi-managed fund consisting of moderate aggressive funds.

The smoothing effects create a very favourable return and volatility profile that is very different to peers.

Through manager selection, portfolio construction and smoothing, this fund has protected capital well, with lower drawdowns, lower volatility, but higher overall returns.

Good correlation and portfolio construction benefits.

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CONCLUSION

1

Volatility is real when it comes to drawing an income.

2

Sequence of these returns and volatility are actually more important.

3

Smoothing can address both volatility and sequence risk, but without reducing overall growth assets exposure in your portfolio.

4

Great addition to any Living Annuity portfolio.

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Cp
Capital Protect
Sr
Sequence Risk
Dc
Decummulation
Hf
Hedge Fund
Ar
Average return
Th
Time Horizon
Lg
Longevity
Lg
Longevity
Sr
Seq Returns
Pc
Portfolio Construction
Lg
Longevity Risk
Pc
Portfolio Con
Ac
Acummulation
Sr
Sequence Risk
Th
Time Horizon

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