canada life

Canlife Index Managed (80% Protected)

A protected investment solution

The Canlife Index Managed (80% Protected) fund offers protection against the ups and downs of the investment markets. The fund is designed to overcome two major problems associated with investing in retirement:

- **The threat of market downturns** - especially the catastrophic damage that can be done to a portfolio if sharp falls occur in the early years of retirement, and
- **Volatility** - which can act as a drag on long-term performance.

There are **3 important features**:

1 The unit price can never fall below 80% of the highest unit price the fund has ever achieved

2 It has a built-in volatility control mechanism to smooth returns across retirement

3 It won't suffer from 'cash-lock' like most protected funds

For adviser use only

Canlife Index Managed (80% Protected) Fund at a glance

The Canlife Index Managed (80% Protected) is an investment fund developed by Canada Life in partnership with Morgan Stanley. The fund invests in an OEIC run by Morgan Stanley, made up of the following three components.

1

A basket of index funds (the risk asset)

The risk asset provides the growth and invests in **a multi-asset passively managed portfolio of exchange traded funds** provided by two leading fund managers:

Vanguard is one of the world's largest asset managers of passive funds with around $6.2 trillion under management (source: Vanguard as at 31.01.2020)

Black Rock (iShares) is the world's biggest asset manager with over $7.4 trillion under management (source: Black Rock as at 30.09.2019)

Advice on asset allocation is provided by **Canada Life Asset Management**.

Vanguard®

iShares®

canada life
Asset Management

2

A volatility control mechanism automatically set at 8%

In volatile markets, the fund reduces its exposure to volatile assets like equities and moves into more stable assets like cash.

3

Capital protection at 80% of the highest ever unit price, via a 'put' option

A 'put' option provided by Morgan Stanley, one of the world's largest financial institutions, is used to ensure that the fund's unit price can never fall below 80% of the highest ever price attained (apart from in the event that Morgan Stanley fail in which circumstances the 80% guarantee would not apply). 'Put' options allow a fund manager to sell an asset for a set price at an agreed time in the future. Using this method of protection, rather than simply moving assets into cash, means that the fund cannot 'cash lock' like other protected funds.

Combining these three components means that the fund can play a valuable role in a drawdown portfolio and is an ideal source of income to fund important expenses.

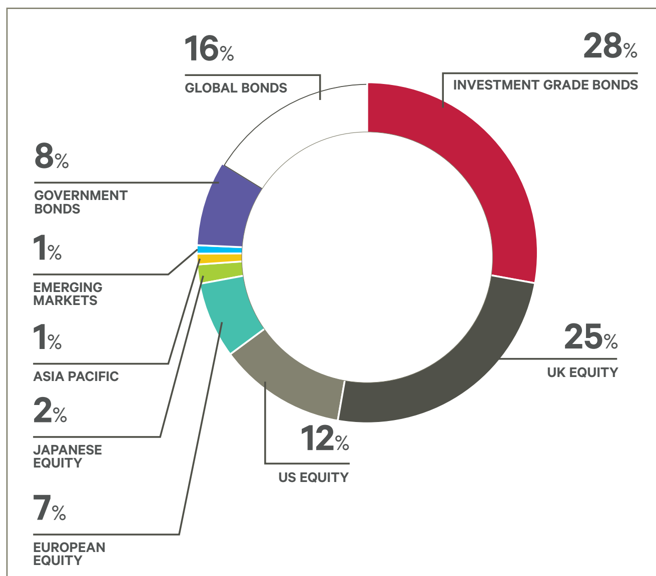
Basket of index funds from Vanguard and BlackRock (iShares) Volatility control at 8% 'Put' option to provide protection **Canlife Index Managed (80% Protected)**

The fund in depth

1. Asset allocation

The pie chart below shows the typical strategic asset allocation of the fund (as at 30 Apr 2020). In addition, a proportion of the fund will be used to provide the 80% protection ('put' option).

The percentage of the overall investment used to provide the protection will vary depending on market performance, and is therefore not shown in the pie chart.



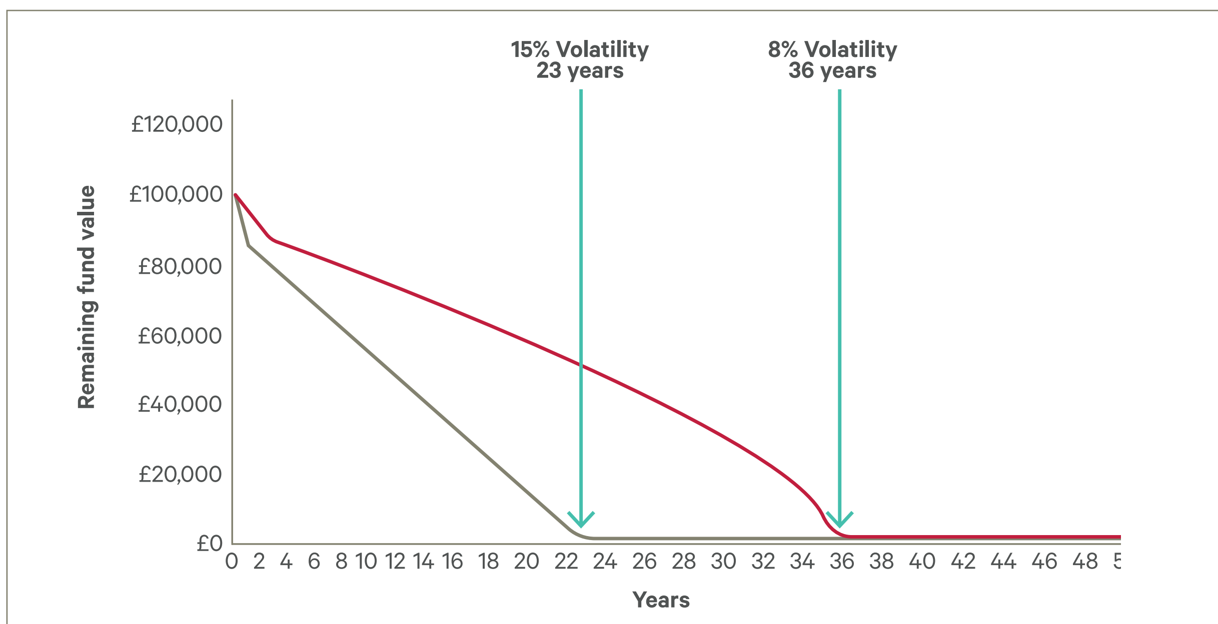
All investments are held within passively managed funds, keeping charges low. There is an annual management charge of 0.75% and an ongoing charge figure (OCF) of 0.86% (inclusive of AMC).

Advice on asset allocation is provided by Canada Life Asset Management.

2. Volatility control mechanism

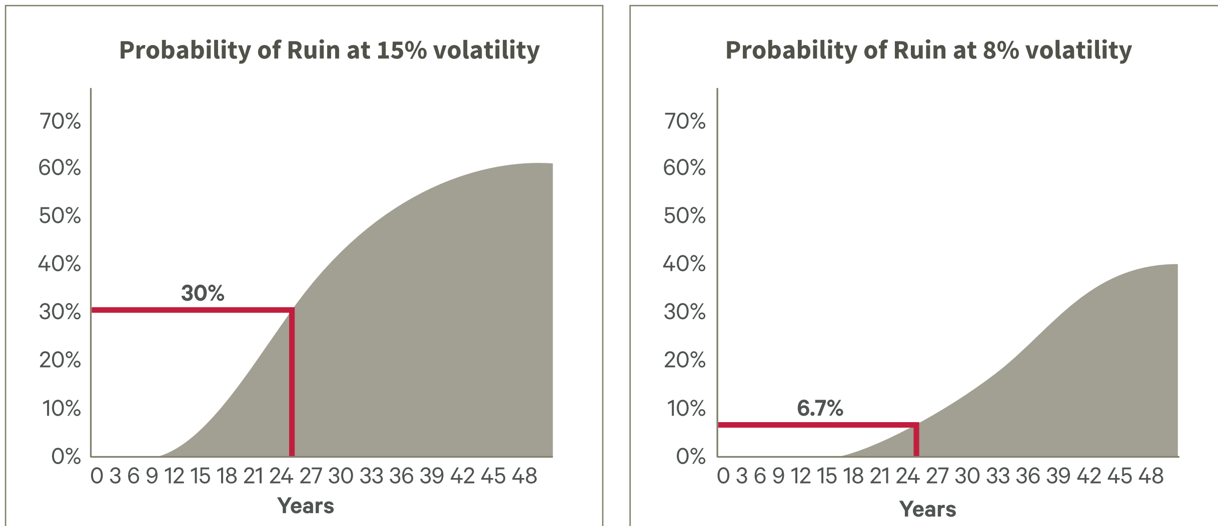
The danger of volatility

Volatility means the amount of variation of market prices compared with the average return over a given period (the 'standard deviation'). For clients taking a regular income during retirement, high market volatility can significantly reduce returns and erode capital. The chart below, modelled by Morgan Stanley, shows the impact of volatility at an average of 15% and 8% on a £100,000 fund, from which income is drawn at £5,000 per annum.



The green lines represent a 1 in 4 chance of running out of money. At 15% volatility (grey), there is a 1 in 4 probability of running out after 23 years, but at 8% volatility (red), this would extend to 36 years.

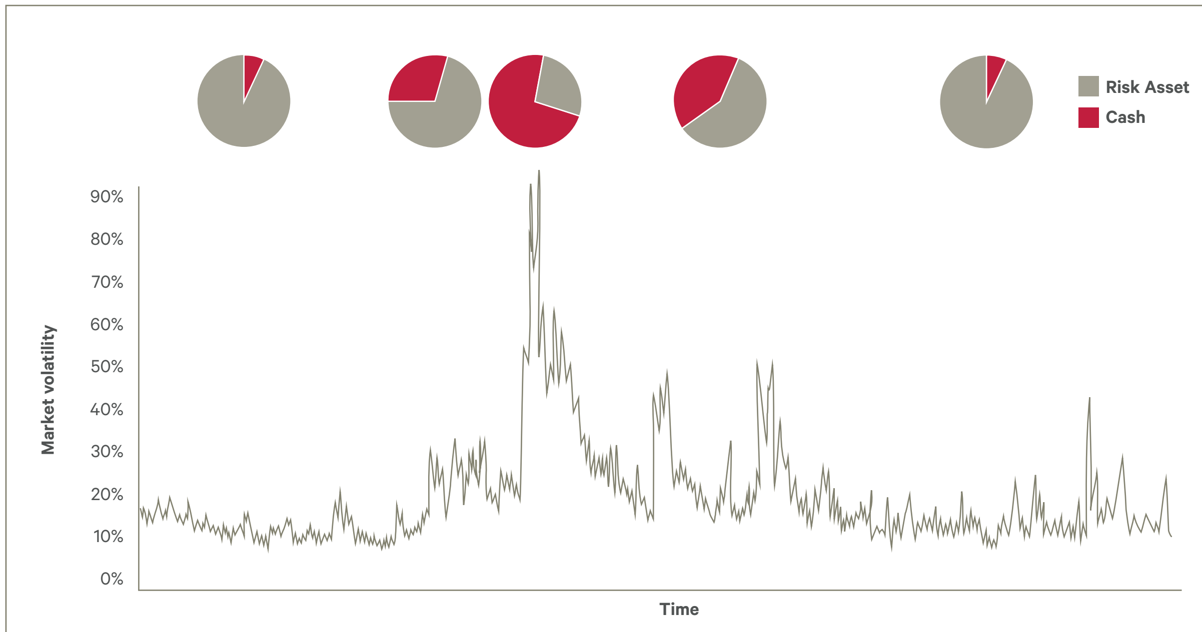
Looking at this another way (below), with volatility at 15% there is 30% chance of running out of money by year 25, whereas at 8% volatility the odds of running out of money would be only 6.7%.



Graph(s) source: Morgan Stanley modelling based on previous market trends. £100,000 fund, £5,000 income taken at the start of each year.

Volatility control

The fund incorporates automated volatility control set at 8% (roughly the same as UK gilts[1]). This works by decreasing exposure to the risk asset and increasing the amount allocated to cash in volatile markets, and vice versa. The chart below[2] illustrates how the cash component increases with volatility, protecting clients from extreme price movements.



This chart is for illustration purposes only.

1 Source: Chicago Board of Trade, volatility of the S&P 500, 2004 to 2016. The Canlife Index Managed (80% Protected) Fund was not available during this period, therefore this is an illustration of how the volatility in the works in principle, rather than historical data.

2 Source: Canada Life. These figures are for illustrative purposes only and do not provide a guide to future or past performance.

3. The protection mechanism

The need for protection

The table below[3] shows how an investment portfolio can be depleted in extreme market conditions if a client is drawing an income. It assumes an initial investment of £100,000 in a FTSE 100 tracker, with £5,000 income taken at the start of each year between 2000-2003.

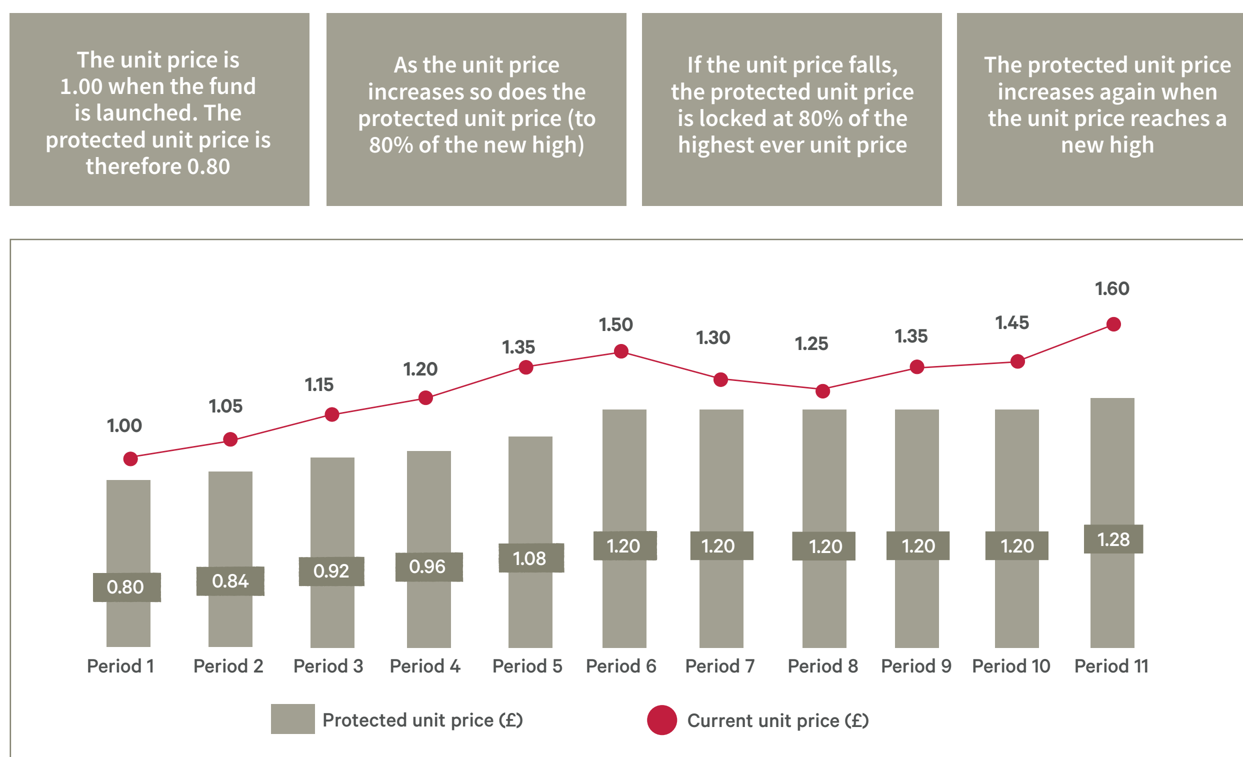
	2000	2001	2002
Fund (£)	100,000	87,182	70,602
Income (£)	5,000	5,000	5,000
FTSE 100 fund remaining (£)	95,000	82,182	65,602
FTSE 100 return (%)	-8.23	-14.09	-22.17
FTSE 100 balance (£)	87,182	70,602	**51,058**

After three years the investment portfolio would have roughly halved in value, making life very stressful for a client in the early years of retirement. This is why the Canlife Index Managed (80% Protected) Fund has been designed with a protection level of 80%.

3 Source: Canada Life. These figures are for illustrative purposes only and do not provide a guide to future or past performance. The FTSE 100 figures are based on total return. Figures exclude fees and charges and ignores dividend income. Assumes income taken at the start of each year.

How does the protection work?

The fund aims to provide a minimum level of protection at 80% of the highest unit price ever achieved. The chart below shows how both the unit price and the protected unit price move over time.



Three important benefits arise from this:

a. **The protection level can rise, but never fall.** The unit price of the fund can move up and down like any other tracker, but the protection level never falls. Once a new high is reached, it is locked in forever. Imagine an initial investment of £10,000 which doubles in value to £20,000. The protection would rise to 80% of £20,000 which means the new protected level would be £16,000. So the client's investment going forward will never drop below £16,000 (ignoring charges and assuming no income is taken).

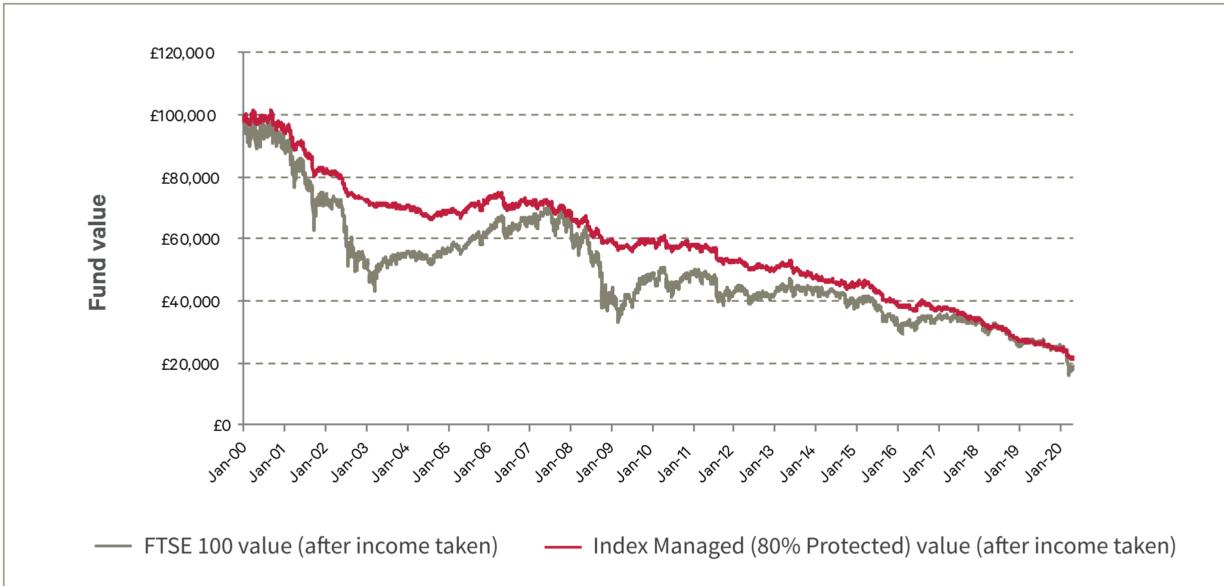
b. **Protection may be even higher than 80% in practice.** Protection is based on the highest ever unit price of the fund since launch, not the price when the client invested. If a client invests when the unit price has fallen from a previous high, the protected unit price is still 80% of that previous high. If the highest ever unit price is £2.00, then the protected unit price is £1.60 (80% of £2.00). If a client invests when the price has fallen to, say £1.80, they still benefit from the £1.60 protected price, which means their 'effective' protection level when they invest is £1.60 divided by £1.80, or 89%. In practice the 'effective' protection could be anywhere between 80% and 100% at the point a client invests. Canada Life publishes daily figures showing the current unit price and effective protection level.

c. **The fund cannot 'cash lock'.** Most other protected funds work by reallocating investments into cash with a small 'insurance' element when markets fall. This is called CPPI (constant proportion portfolio insurance). However if markets fall too far, the bulk of the fund has to be switched into cash, making it almost impossible to recover when markets improve. This is known as 'cash locking'. Because this protected fund uses a 'put' option for its protection mechanism, rather than CPPI, it will not cash lock. When markets fall, the 'put' option increases in value to offset the decrease in value of the risk asset, and when markets rise again, the 'put' decreases in value as the risk asset recovers. This allows the fund to keep a higher proportion of funds in the risk asset, so it can respond positively when markets recover.

4. Backtested fund performance

The Canlife Index Managed (80% Protected) Fund was launched in March 2016, but how would it have performed in the long-term when compared with the stockmarket? The chart below tracks the movement of the FTSE 100 (total return) since the year 2000 against the simulated performance of Canlife Index Managed (80% Protected) Fund, based on 5% per annum income being taken.

Performance vs FTSE 100 with income taken - a smoother path and a similar outcome



Graph source: Morgan Stanley & Canada Life. The protected fund was not available back to 2000 so for the purposes of the charts Morgan Stanley has attempted to construct a portfolio for it by using various indices in different asset classes, modelled the impact of the volatility strategy, cost of derivative protection, and deducted the 0.75% AMC. The FTSE 100 figures have assumed a 0.15% charge per year is applied.

When retirees draw an income, and unit prices fall, more units must be sold to achieve the same income, leaving fewer units to benefit from a recovery. This is known as 'pound cost ravaging'. Over the period the protected fund would have kept pace with the FTSE 100 if a level monthly income was taken, because the 'put' protection and volatility control prevent big drops in value, reducing 'pound cost ravaging'.

The protected fund performance is much smoother, and would have provided a more comfortable ride for clients.

Risks

- The fund offers 80% capital protection, therefore in extreme market conditions the value of the investment could go down by 20%.
- Investment returns may be below that required to fund future income payments.
- The 80% protection is not guaranteed, because Morgan Stanley could fail.
- The fund performance may lag unprotected funds without protection when markets are rising or in times of market recovery.
- After continued poor investment returns (over a number of years) the cost of providing the protection may become too expensive, or impossible to achieve going forward. In the worst case scenario the fund may no longer be able to continue. At this stage, keeping the fund open may not be in the client's best interest so the fund may close. However even in this extreme eventuality it is important to remember that you would still benefit from 80% protection.

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