

OFFSHORE BONDS FOR THE 21st CENTURY

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Introduction

In this, the first of a series of articles for “*International Wealth Management*”, we will be examining many of the products that are available internationally from the offshore life assurance sector as it exists today – most notably from companies operating in the well-developed jurisdictions of the Isle of Man, Channel Islands, Ireland and Luxembourg.

In doing so, we will for the first time be taking the wraps off the all-new *product* past performance simulations that we have developed as actuaries for **LIFEBASE OFFSHORE** (the leading offshore product database and analysis software formerly known as ProBase). More so than is the case in, say, the UK life assurance industry, the offshore life sector offers an amazing diversity of investment funds, with both in-house and external asset management. The tools now available on **LIFEBASE OFFSHORE** enable us for the first time to see the wood for the trees in this veritable forest of product choices.

Investment Bonds

The scope of this article is investment bonds, ie single premium unit-linked bonds which are generally available (ie they are not limited offer tranches) and which offer investment links to a quantifiable number of funds (which may be internally managed or externally managed). This definition therefore also includes some of the more restricted forms of “portfolio” bond offered by one or two offices.

Charges

Comparisons of product charges are hindered by the fact that offshore life companies operating around the world do not have to abide by a single set of rules or standards requiring disclosure or measurement of product charges. Whilst some host country regulatory regimes – most notably UK and Hong Kong – do require a mandatory form and content of disclosure, many others do not. Trade bodies such as the Association of International Life Offices (AILO) have been unable to garner sufficient industry enthusiasm to fill the void. Home country regulators in general are also silent on this matter – which is no bad thing as the prospect of the authorities in Isle of Man, Ireland, Luxembourg, Guernsey and Jersey all agreeing on the same approach is remote to say the least.

The UK regulatory regime is probably the one most familiar to readers. It moved years ago to own-charge projections, in such a way as to place a major emphasis on product charges within the overall disclosure process. (Many readers however might consider that it places undue emphasis on charges.)

Product “cost” takes many potential forms, and these were recently re-examined by the UK Financial Services Authority (FSA) in its proposals for the publication of Comparative Tables. FSA Consultative Paper CP28 and its subsequent Response paper give strong support to the Reduction In Yield (RIY) as the most popular measure of cost. For offshore investment bonds, the RIY is a measure of the extent to which the illustrative investment return assumption – currently set at 7% pa – is reduced by product charges over an initial 10-year policy term. For example, a 1.5% RIY means that a 10-year return of 7% pa before charges would reduce to 5.5% pa after charges.

To assess the relative cost of products, Table 1 (source **LIFEBASE OFFSHORE**) shows RIYs for various investment bonds and product providers. The figures which follow in this and subsequent sections have been prepared assuming a single premium investment of £55,000, which approximates to the average industry figure. For present purposes only, they do not take account of external/underlying fund charges (these will be brought into account later). Where a company offers more than one product of this type or has multiple charging structures, Table 1 shows the cheapest option.

Company	Product	RIY %
Equitable Life Int.	International Investment Plan	0.62%
Canada Life Int.	Delta	0.64%
Friends Provident Int.	International Investment Bond	1.34%
Old Mutual Int.	Maxima	1.47%
Generali Int.	Capital Choice	1.52%
Royal & Sun Alliance IFS	International Investment Account	1.56%
Hansard Eur.	Capital Bond	1.57%
HSBC Life Eur.	International Life Bond	1.61%
Scottish Amicable Eur.	Personal Investment Bond	1.65%
Scottish Equitable Int.	The Investment Bond	1.66%
Sun Life Int.	International Investment Bond	1.67%

Scottish Provident Int.	Capital Investment Portfolio	1.70%
Scottish Mutual Int.	Investment Bond	1.76%
Scottish Widows Int.	International Investment Bond	1.78%
Royal Skandia	Managed Capital Account	1.81%
CMI	Premier Account	1.94%
Irish Life Int.	Performance Bond	1.95%
Eagle Star Int.	Elite International Bond	2.03%
Norwich Union Int.	International Investment Bond	2.10%
Scottish Life Int.	International Secure Investment Portfolio	2.10%
Allied Dunbar Int.	International Investment Bond	2.26%

Source: **LIFEBASE OFFSHORE**

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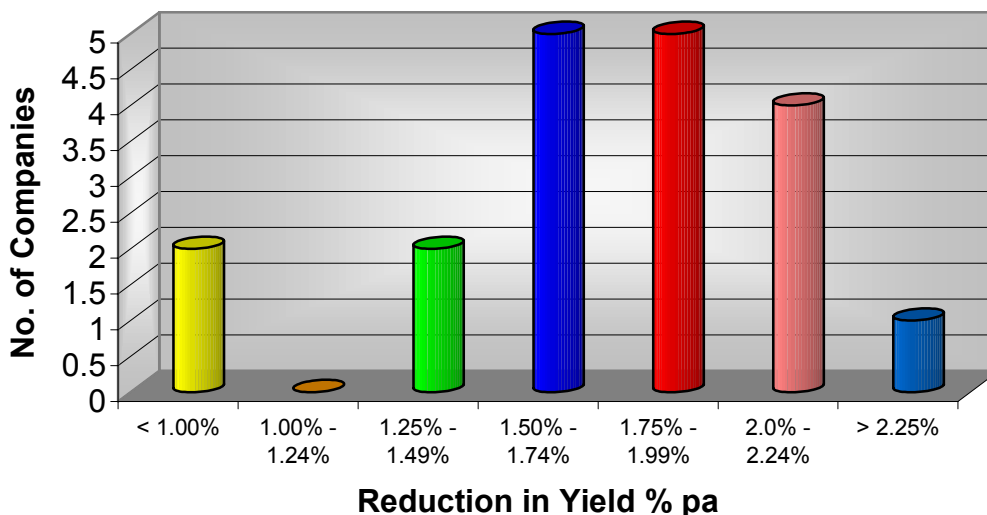
Table 1

Table 1 shows that RIYs range from 0.6% (Equitable Life International and Canada Life International) up to 2.3% (Allied Dunbar). In fact, the average charge is equivalent to an RIY of 1.7%.

For those interested in such things as the difference in charges between onshore and offshore products, the average RIY for UK investment bonds (at their corresponding average case size) is approximately 1.3% (source **LIFEBASE UK**). This confirms that offshore charges are higher, but the difference is probably smaller than many would have assumed.

Further analysis of these figures (Chart 1) shows that, ignoring the extremes of the range, most product charges are clustered in the RIY range 1.3– 2.1%. In other words the difference between one company and the next is of the order of $\frac{3}{4}$ % per annum. As we will see later in this article, charge differences of this magnitude are dwarfed by the corresponding differences in investment performance.

Grouping of RIY %ages

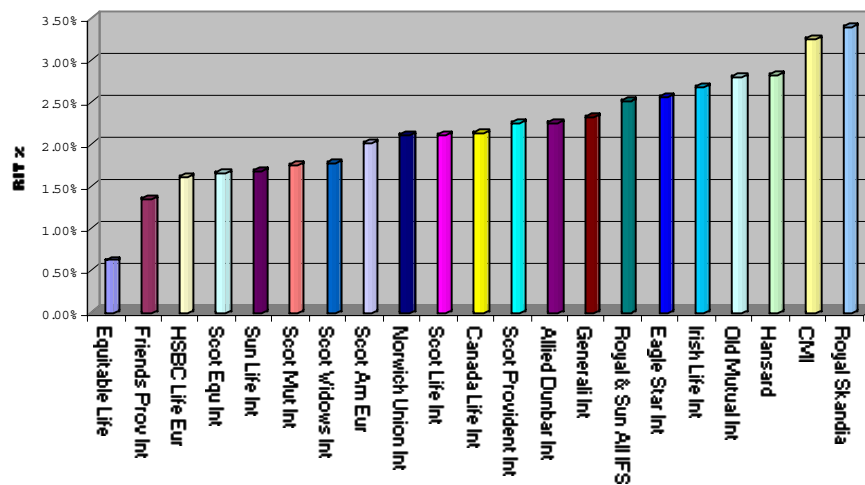


Source: **LIFEBASE Offshore** – www.lifebase.co.uk

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At this stage, we can now bring in the effect of external fund charges. Products in general (although there are exceptions) tend to be polarised into those which offer only in-house funds (and thus have no additional asset management charges) and those which offer mostly external funds (in which case the implied additional management charges can be substantial). Analysis of the latter is made difficult by the fact that the various life companies seemingly have different consciences when it comes to what constitutes a “typical” fund. Some of the numbers in Chart 2 therefore need to be taken with a healthy pinch of salt.

RIY Figures - £55,000 investment, external charges included



Fortunately, the figures available from LifeBase Offshore manage to navigate a safe path around this compliance arbitrage, as will be seen from the Overall Performance (OP)TM measures which follow later in this article.

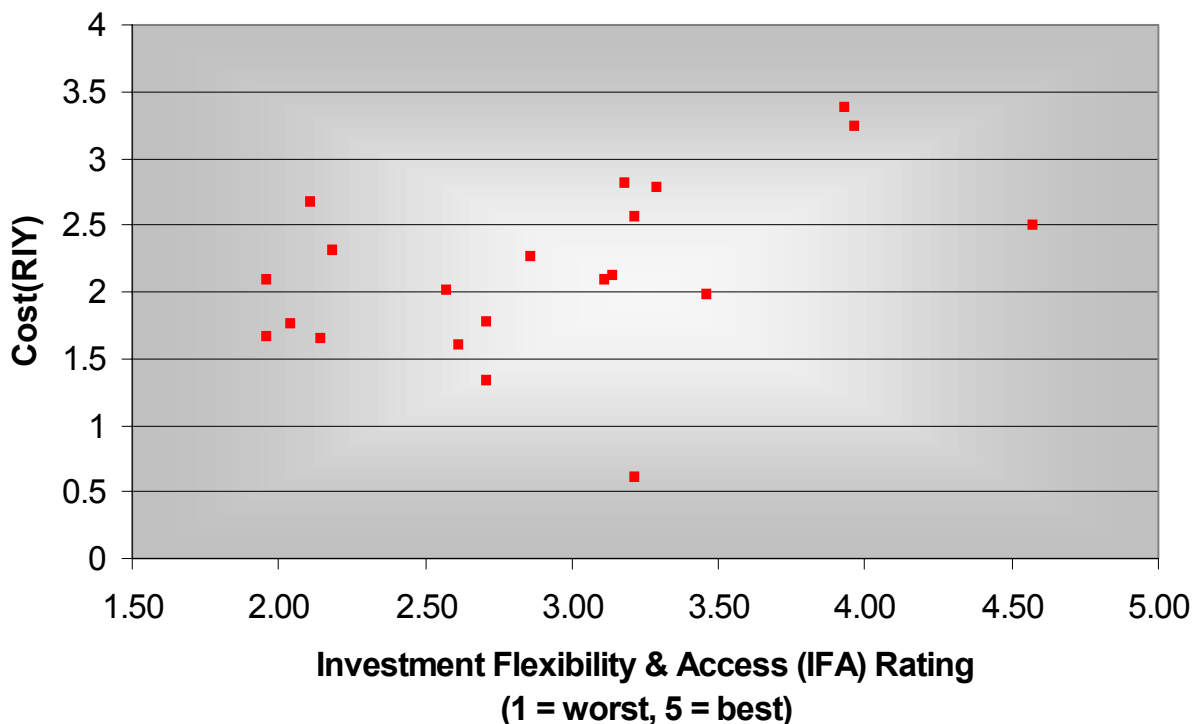
Product Features

As remarked upon before, many offshore bonds offer a wide choice of investment funds, far more so than is typical, for example, of UK life offices. Furthermore, for offshore bonds, free switching is the norm, not the exception. (The reverse applies in the UK.)

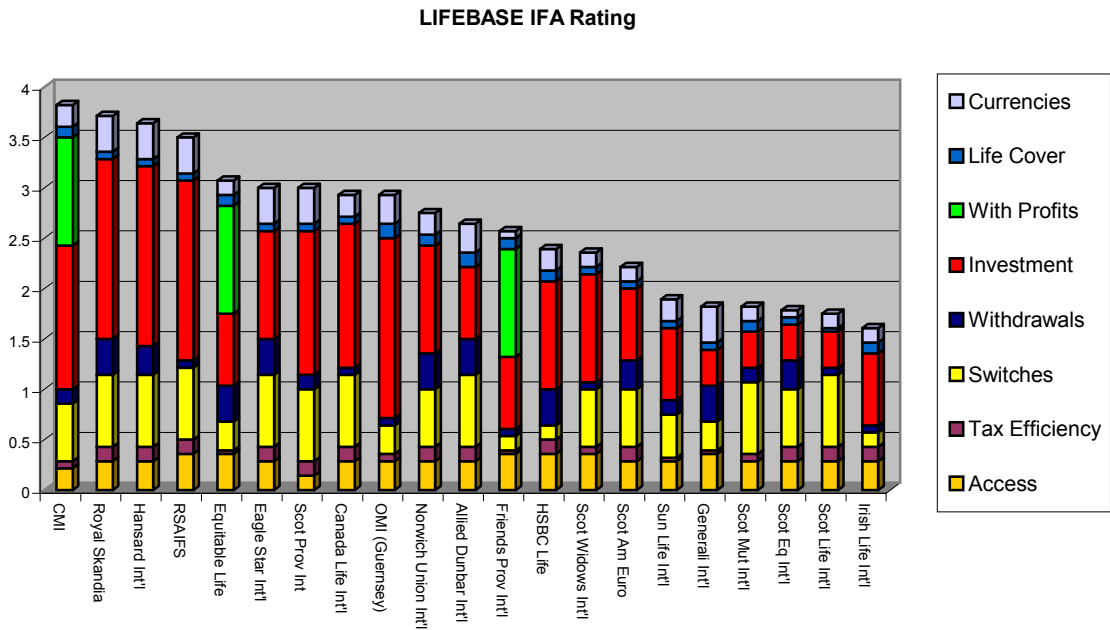
A notable downside however is that unitised with-profits (UWP) funds – which are highly popular with UK products and UK investors – are offered by only a handful of offshore companies. In the UK, UWP business accounts for over £12 billion in single premiums, representing more than 50% of total Life single premiums; yet offshore, only a handful of companies offer a UWP fund! Part of the explanation for this lies with the fact that the largest UK with-profit offices were slow to launch offshore or, if they have done so, have been less aggressive. Part of the situation is also accounted for by the additional complexities of introducing an offshore UWP fund to the range (although these obstacles are not insurmountable).

Other things being equal, one would expect those products which offer more features to be more expensive than those with fewer features. In the offshore world, comparison of Product Features with product cost (RIY) does indeed indicate reveal such a correlation (Chart 3).

Investment Bonds



Hence those products which offer greater flexibility or features (for example, greater fund choice, currency choice etc) do tend to cost more (although there are exceptions). Equally, cheaper products tend to have less features. Chart 4 shows the LifeBase assessment of the flexibility of each product.



Performance – The Missing Link

Whilst cost (charges) and benefits (features) are important parts of any analysis of investment bonds, investment performance is without doubt of much greater import. The principal objective behind an investment bond is, after all, the delivery of a good investment performance. Everything else is subsidiary to this.

That said, however, the term investment performance has to be construed carefully, because traditional measures of investment performance can be misleading. Such measures analyse performance as measured by the increase in a fund's unit price from one period to the next. Whilst these movements are of course influenced by performance, the problem is that they are also affected by anything else which goes into the calculation of the unit price: most notably the annual fund management charge.

At this point some readers may perhaps be questioning what the "problem" is – after all, charges do matter, and hence looking at fund price performance net of charges is surely good?

The problem is that life product charges come in a variety of forms, far more so than is the case for, say, unit trusts (from whence traditional performance systems evolved). In the case of investment bonds, charges (and their opposite - offsetting bonuses) may take the form of some or all of:

- bid/ offer spreads
- establishment charges
- annual management charges
- external asset charges
- surrender penalties
- reduced allocations
- switch charge
- policy fees
- enhanced allocations
- loyalty bonuses.

Furthermore, if one accepts that the totality of charges is relatively standard, then Company X whose product charges are taken mainly via an annual management charge will look poor – on a traditional performance viewpoint – compared to Company Y whose fund charges are low but whose other product charges are high. Clearly, by any measure, this is wrong.

The following real-life example shows just why. Let us (with the help of **LIFEBASE OFFSHORE**) examine the performance of three products, with reference to their international managed funds. (Where a company has more than one international managed fund, the mean performance of all such funds is used.)

Table 2 below compares the normal fund performance with the Modified Performance™ calculated by **LIFEBASE OFFSHORE**. For this purpose, **LIFEBASE** add back on to the performance the effect of the annual management charge implicit in the unit price. In each case, raw underlying performance figures are sourced from Reuters Lipper Hindsight, 3 years to 31st May 2000, sterling, bid to bid.

Company	Ordinary Performance		Modified Performance™	
	Annualised	Rank	Annualised	Rank
Canada Life International	10.75% pa	1	10.75% pa	3
Sun Life international (IoM)	10.16% pa	2	11.84% pa	1
Scottish Equitable International	9.72% pa	3	10.83% pa	2

Source: **LIFEBASE OFFSHORE**

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Table 2

From the raw performance figures one might have concluded that, in this instance, Canada Life was the best of the bunch in performance terms. However, their performance is flattered in this case by the fact that their annual fund management charge (0% pa) is less than that of Scottish Equitable (1% pa) and Sun Life (1.5% pa). In fact, **LIFEBASE** figures prove that it is Sun Life in this example who were the best asset managers, Scottish Equitable second and Canada Life third.

Squaring the Performance Circle

The above example demonstrates very markedly the care and precision which is needed when analysing products and performance. Charges matter (in their totality) and so does performance. What is needed – for product advisers and analysts – is something which brings the two together.

To this end, LifeBase has developed **Overall Performance (OP)TM** – an analytical measure which combines performance and charges to simulate past performance on current charges. To illustrate this, the figures in Table 3 are for the same three products and 3-year performance period as before. The OP measure adjusts the fund performance figures to allow for other product charges, giving the nearest thing to *product* past performance as distinct from fund past performance.

Company	OP TM Measure – International Managed Funds – 3 years
Sun Life Int.	10.09%
Canada Life Int.	10.01%
Scottish Equitable	9.72%

Source: **LIFEBASE OFFSHORE**

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Table 3

The figures in Table 3 show a relatively narrow performance result for all 3 companies, with Overall Performance (OP)TM of the best being only 0.4% pa better than the worst. In this case, the narrow range is in fact associated with a mid-table position for all of these companies. LifeBase figures reveal the top company in the international managed sector to be Eagle Star International and the worst to be CMI. The gap in this case is much larger. Table 5 shows an example of the large range, again focusing on International Managed Funds.

Company	OP TM Measure	
	3 years	5 years
Eagle Star Int.	15.39%	16.67%
Hansard Int.	12.73%	13.33%
Canada Life Int.	10.01%	11.23%
Scottish Amicable Eur.	5.74%	6.78%
CMI	3.07%	4.88%

Source: **LIFEBASE Offshore** – www.lifebase.co.uk

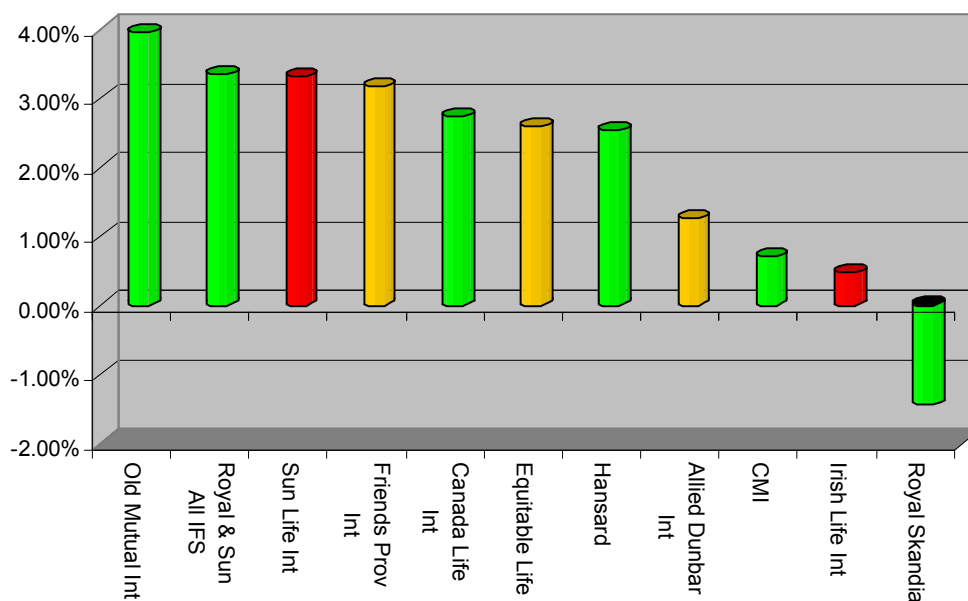
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The same type of Overall Performance™ (OP)™ analysis can of course be extended to other fund sectors. Looking firstly at International Equity funds (and their associated investment bonds) on 3 and 5-year performance view produces the results shown in Table 6.

Company	Product	International Equity			
		3 Years	Rank	5 Years	Rank
Allied Dunbar Int	International Investment Bond	13.99%	5	13.35%	6
Canada Life Int	Delta	21.51%	1	18.55%	1
CMI	Premier Account	9.23%	12	11.14%	10
Eagle Star Int	Elite International Bond	20.45%	2	18.35%	2
Equitable Life	International Investment Plan	12.19%	6	13.42%	5
Friends Prov Int	International Investment Bond	16.78%	3	15.85%	3
Hansard	Capital Builder	10.20%	11	14.23%	4
HSBC Life Eur	International Life Bond	9.06%	13		
Old Mutual Int	Maxima	10.48%	9	11.40%	8
Royal & Sun All IFS	International Investment Account	10.36%	10	11.15%	9
Royal Skandia	Managed Capital Account	11.42%	8	12.39%	7
Scot Am Eur	Personal Investment Bond	7.25%	14	9.48%	11
Scot Equ Int	The Investment Bond	11.84%	7		
Scot Mut Int	Investment Bond	16.44%	4		
Sun Life Int	International Investment Bond	-5.19%	15	-2.01%	12

Extending the analysis now to products linked to international Fixed Interest and UK Equity funds produces the results in Charts 4 and 5.

OP - £55,000 premium, 5 years, Fixed Interest

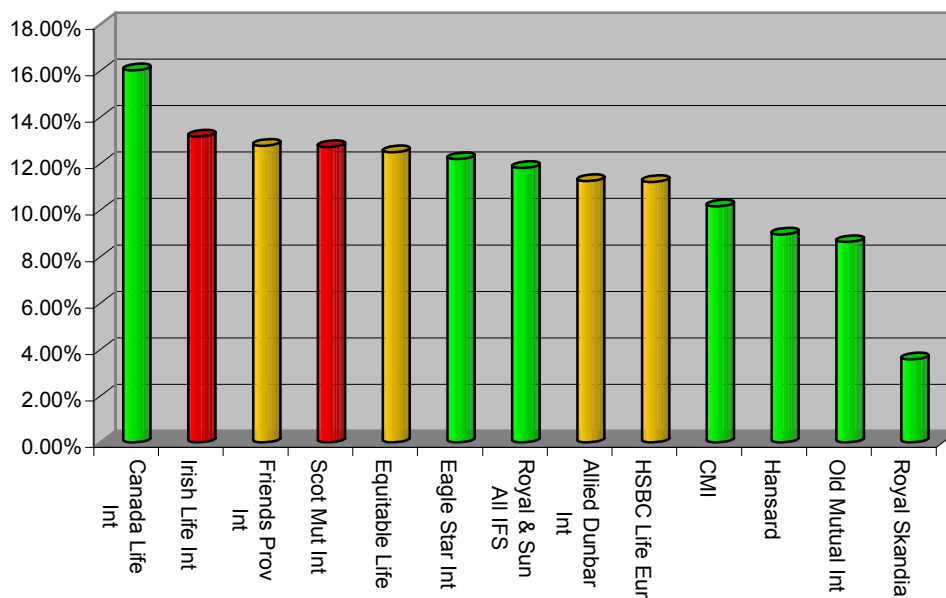


Source: **LIFEBASE OFFSHORE**

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Chart 4

OP - £55,000, 3 Years, UK Equity



Source: **LIFEBASE OFFSHORE**

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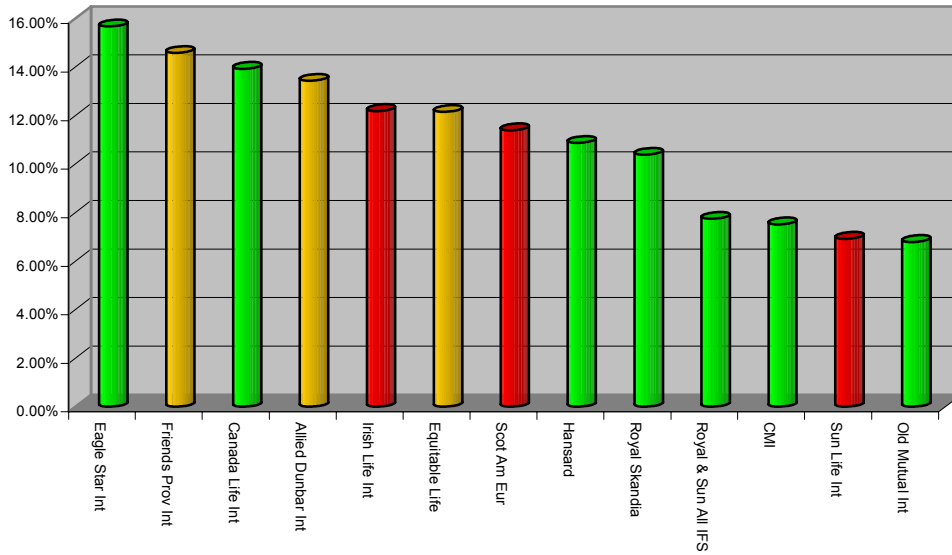
Chart 5

(In the charts above, the colour shadings denote the Investment Flexibility & Access (IFA) Rating assigned to each product by LifeBase to measure the qualitative aspects referred to earlier in this article: Red/Amber/Green denotes poor, average and good respectively.)

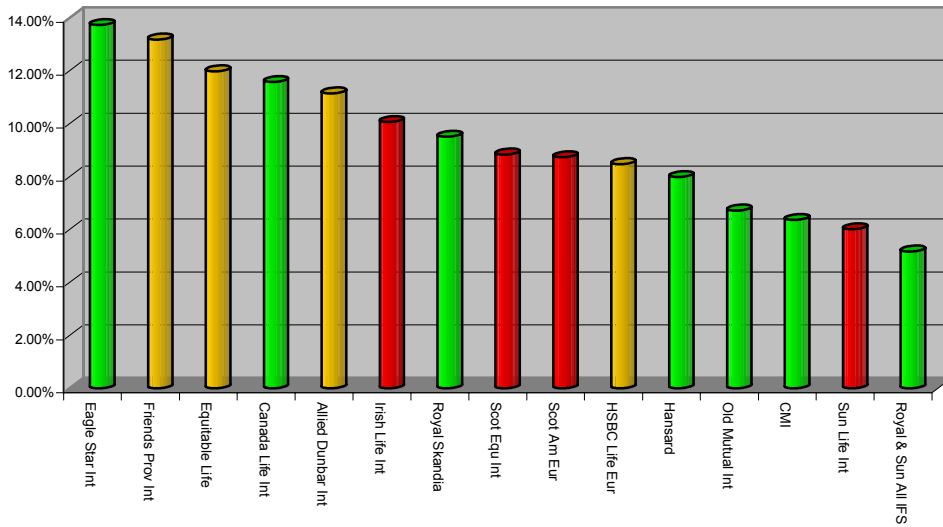
Finally, taking the analysis to the widest extent possible, we can bring in all funds linked to each investment bond and feed these into an average (OP)™ measure per product (see Chart 3).

OP measure – All Funds:

OP - £55,000 premium, 5 Years, All Funds



OP - £55,000 premium, 3 Years, All Funds



Source: **LIFEBASE OFFSHORE**

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Chart 6

Conclusions

Detailed analysis of investment bond products in the manner shown above does offer some striking conclusions:

- **the effects of investment performance – ie the difference between the good, bad and ugly - far outweigh the impact of product charges**
- **the Overall Performance (OP) comparison results do show consistent winners and losers across different time periods**
- **some companies are strong in certain fund sectors, though weak in others – this is where the Overall Performance measure across all funds helps to condense the picture**
- **there is no positive correlation between the number of funds in a company's range (and internal vs. external asset managers) and the overall performance achieved**
- **indeed our observation on the OP measures of those companies offering the largest fund ranges (through mirror funds etc) is that the performance they achieve is far more volatile as a result – for example, the same analysis done two months apart shows these companies leaping up and down the OP ranking to a dramatic extent**
- **we suspect that another explanation is that external fund offices are commonly adding new funds to their range only when such funds have become flavour of the month (or from another viewpoint, possibly be reaching their sell-by date).**

The positions shown above will, of course, move over time and we will, with LifeBase Offshore, be monitoring the evolution with interest.

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