



Investment performance and strategy

UK with-profits funds

This is the ninth annual investigation Barnett Waddingham has conducted into the investment strategies of UK with-profits funds.

Analysis as at 31 December 2021





Contents

- 03** Executive Summary
- 06** The data we're reporting on
- 07** Asset allocation – assets backing asset shares
- 11** Asset allocation – other with-profits assets
- 13** Investment returns by asset class
- 15** Fund-level investment returns
- 17** Sustainability

Participating firms

We thank the following firms for participating in this survey.

- AEGON
- Aviva
- Chesnara
- Dentists' Provident
- DG Mutual
- Foresters Friendly
- Forester Life
- Healthy Investment
- LV=
- M&G
- National Friendly
- NFU Mutual
- Royal London
- Scottish Friendly
- Scottish Widows
- Sheffield Mutual
- Shepherds Friendly
- The Oddfellows
- Wesleyan
- Zurich

About the survey

Our aim is to help UK life insurers determine whether their with-profits asset allocations remain appropriate for them, and whether their asset manager has performed well compared to peers.

The data* used in our report is private information that is not in the public domain. We approached the majority of firms who have with-profits funds in the UK, asking for information on asset allocations and investment returns. Our analysis this year covers £201bn of assets spread over 43 funds from 20 insurers.

*We have used the information provided without any independent verification, although we have queried responses where these looked to be outliers.



Executive Summary

Looking back at 2021

2021 saw the successful rollout of Covid-19 vaccines in the UK and across the world. UK and overseas equities have seen a bull run, with most market levels at the end of 2021 above pre-Covid levels. Wholesale energy prices began rising in the second half of 2021, driving an increase in inflation and volatility in markets. Other notable sources of volatility included the Omicron Covid-19 variant and the anticipation of, and actual increase in, the Bank of England base rate.

Investment returns

As might be expected in such a year, this had led to significant variation in returns between different with-profits funds, with a mean return of 5.6% — well in excess of interest and inflation rates but with an observed range of -4.9% to 12.9%.

Our analysis shows that larger funds have performed relatively better than smaller funds on a 1-year, 3-year and 5-year horizon. Of course, the return to the customer is not only affected by the investment return on the fund. Our analysis does not take account of the impact of smoothing, guarantees and additional sources of profits that can benefit holders of with-profits products relative to other investment options.

Asset mixes

Most individual funds have a balanced asset mix backing their asset shares, and the average asset mix has remained relatively stable for many years, demonstrating a long-term investment view. There has been an average decrease in allocation to government bonds and an increase to hold more overseas equity. This is driven by large changes by a small number of funds. We are aware that some funds de-risked investments in 2020 because of the market falls in 2020 and began reverting to target allocations during 2021.

We note that larger funds have a higher equity (including property) backing ratio (58%) compared to smaller funds (39%). The difference in the equity backing ratio between larger and smaller funds exists for open funds and is exacerbated by closed funds.

For the first time this year, we have asked firms about what risks they think are likely to change asset allocation over 2022 and how they anticipate the exposure to each asset class may change over 2022. Firms responded to this survey between April 2022 and June 2022, and their responses are likely to be influenced by known events such as the Russia-Ukraine war and rising inflation.

For each asset class, most funds do not expect the asset allocation to materially change over 2022. For open and closed funds that do expect changes to allocations, the general trends are for an overall decrease in allocations to UK equity, government bonds and cash, and an overall increase in allocations to overseas equity and corporate bonds.

Unsurprisingly, geopolitical risk is viewed by most funds as one of the top three risks to affect asset allocations over 2022. Russia-Ukraine war has likely already affected asset allocations by the time firms responded to this survey. The hope of a conclusion to the Russia-Ukraine war and anticipated geopolitical stability may be the driver to the overall anticipated increased allocations to overseas equity and corporate bonds. For smaller funds, the asset volatility risk is viewed as a key risk driver, and this suggests that they may be seeking to make asset allocation decisions to smooth investment returns over time.

Sustainability

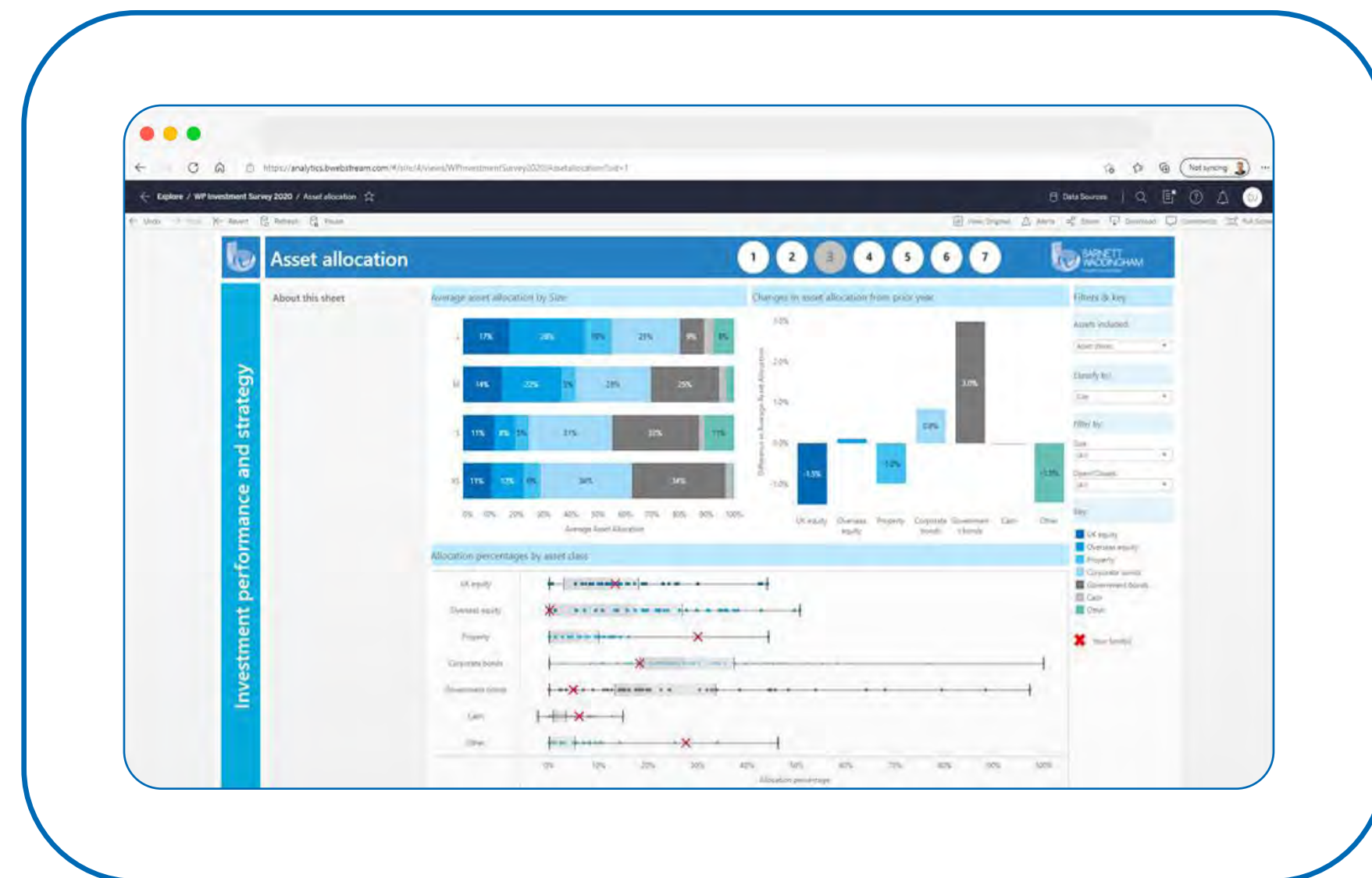
The proportion of funds in our analysis that are using sustainability targets or criteria to manage at least some of their assets has significantly increased since last year. The use of targets and criteria is similar for open and closed funds, which suggests that sustainability is seen as more than just a selling point for new business.



Interactive Tableau dashboard

This report is accompanied by an interactive Tableau dashboard. Participating firms are given secure online access and can use the dashboard to review results in more detail than presented in this report, and to carry out their own bespoke benchmarking analysis.

We hope you find the report informative. Please get in touch with any questions and comments you have.



SCOTT EASON

Partner, Head of Insurance and Longevity Consulting

✉ scott.eason@barnett-waddingham.co.uk

☎ 0207 776 3884



AMIT LAD

Principal, Insurance and Longevity Consulting

✉ amit.lad@barnett-waddingham.co.uk

☎ 0207 776 3876

The data we're reporting on

Grouping of funds

This investigation covers 43 funds across 20 insurers, who provided information on their asset allocations and investment performance to us privately.

We have split the analysis in this investigation by fund, as different funds within an insurer can have materially different risk characteristics.

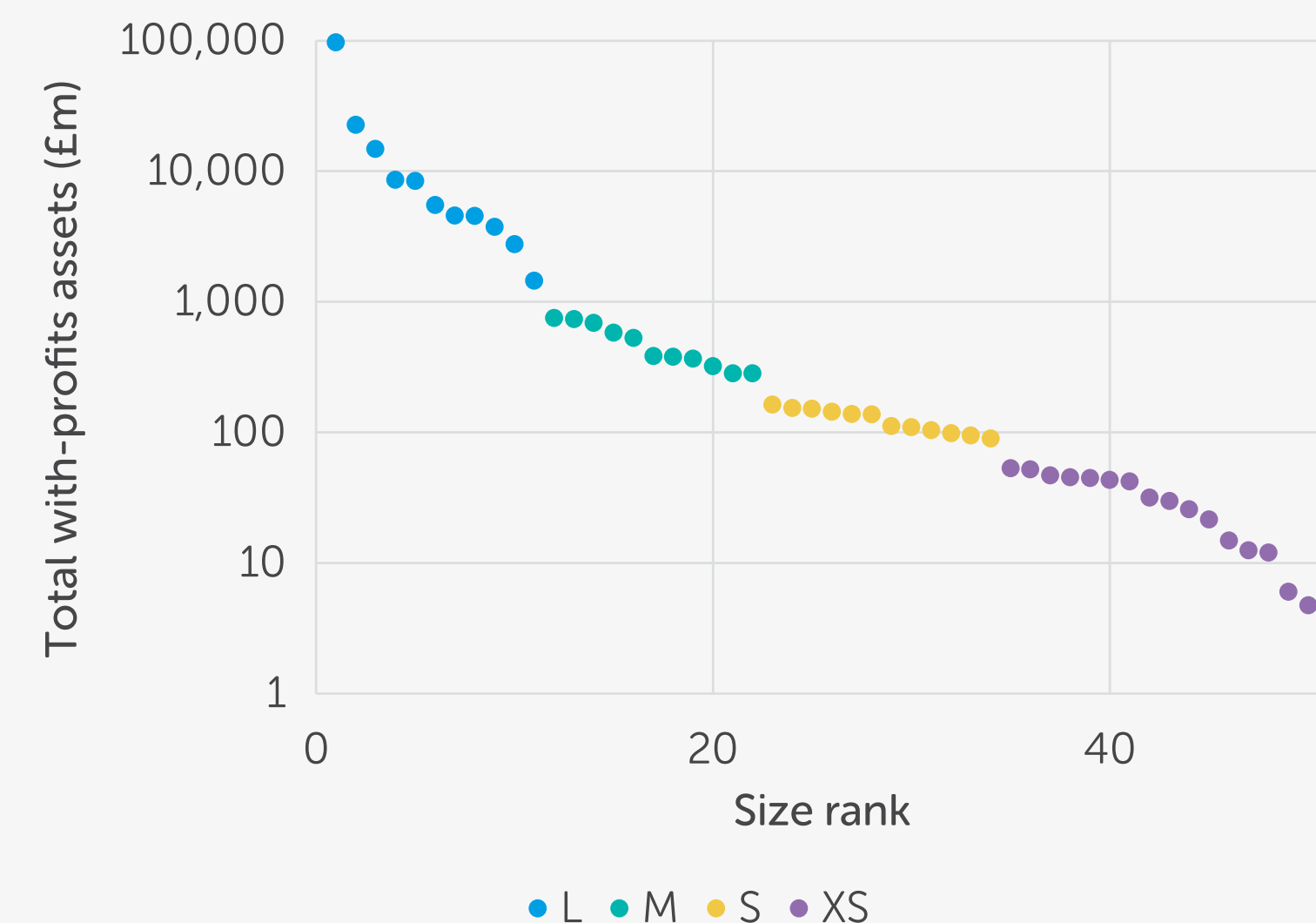
We have grouped funds by fund size and whether the fund is open to new business as set out in Table 1.

Table 1: Fund classifications used in this investigation

Classification	Fund size (£m)	Number of open funds	Number of closed funds	Total number of funds
L	> 1,000	5	6	11
M	250 – 1,000	5	5	10
S	75 – 250	7	5	12
XS	< 75	7	3	10

The distribution of funds by size of total with-profits assets as at 31 December 2021 is illustrated on a logarithmic scale in Figure 1 below.

Figure 1: Total with-profits assets by fund (ranked)



Asset allocation – assets backing asset shares

Figure 2 shows the average asset allocation for assets backing asset shares split by size classification. Figure 3 shows how the average asset allocation across all funds has changed from 31 December 2020 to 31 December 2021.

This year, for the first time, we have asked firms what risks they think are likely to change asset allocation over 2022, and how they anticipate the exposure to each asset class may change over 2022.

Figure 4 shows how fund allocations to each asset class are expected to change over 2022. Figure 5 shows what firms view as the key risks that would influence asset allocation over 2022.

Figure 2: Asset allocation for assets backing asset shares as at 31 December 2021

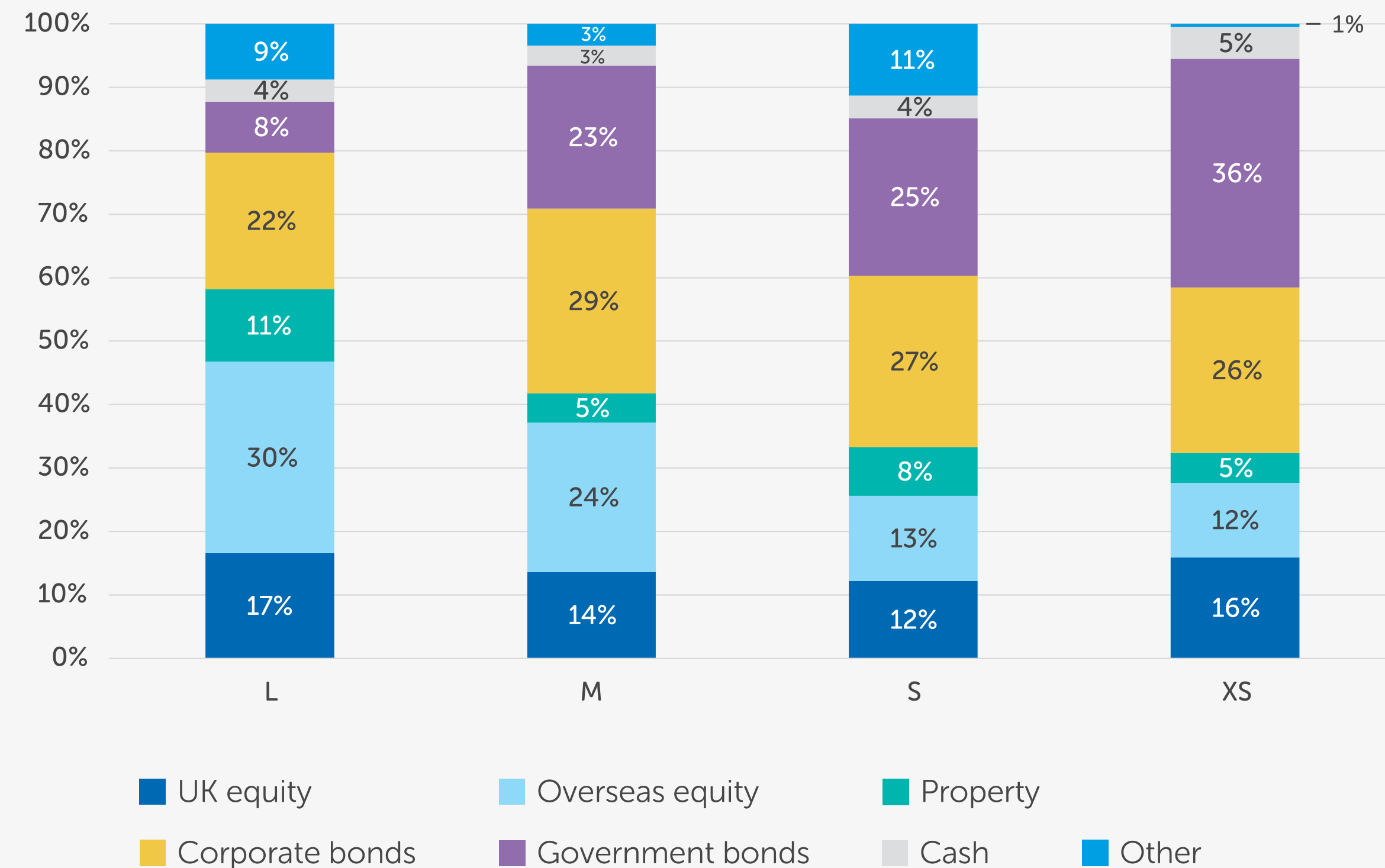


Figure 3: Changes in asset allocations from 31 December 2020 to 31 December 2021

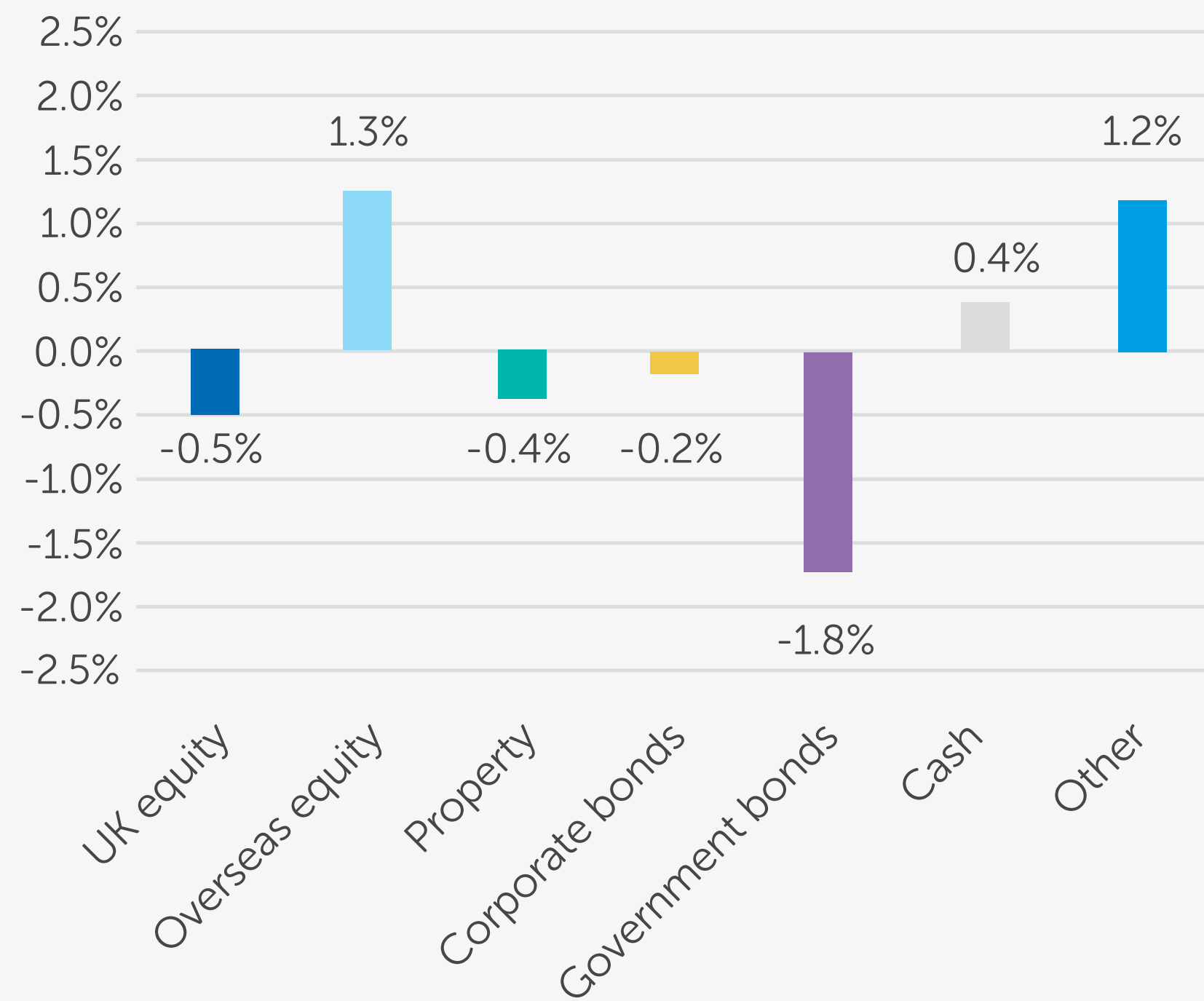


Figure 4: Anticipated changes to asset allocations over 2022

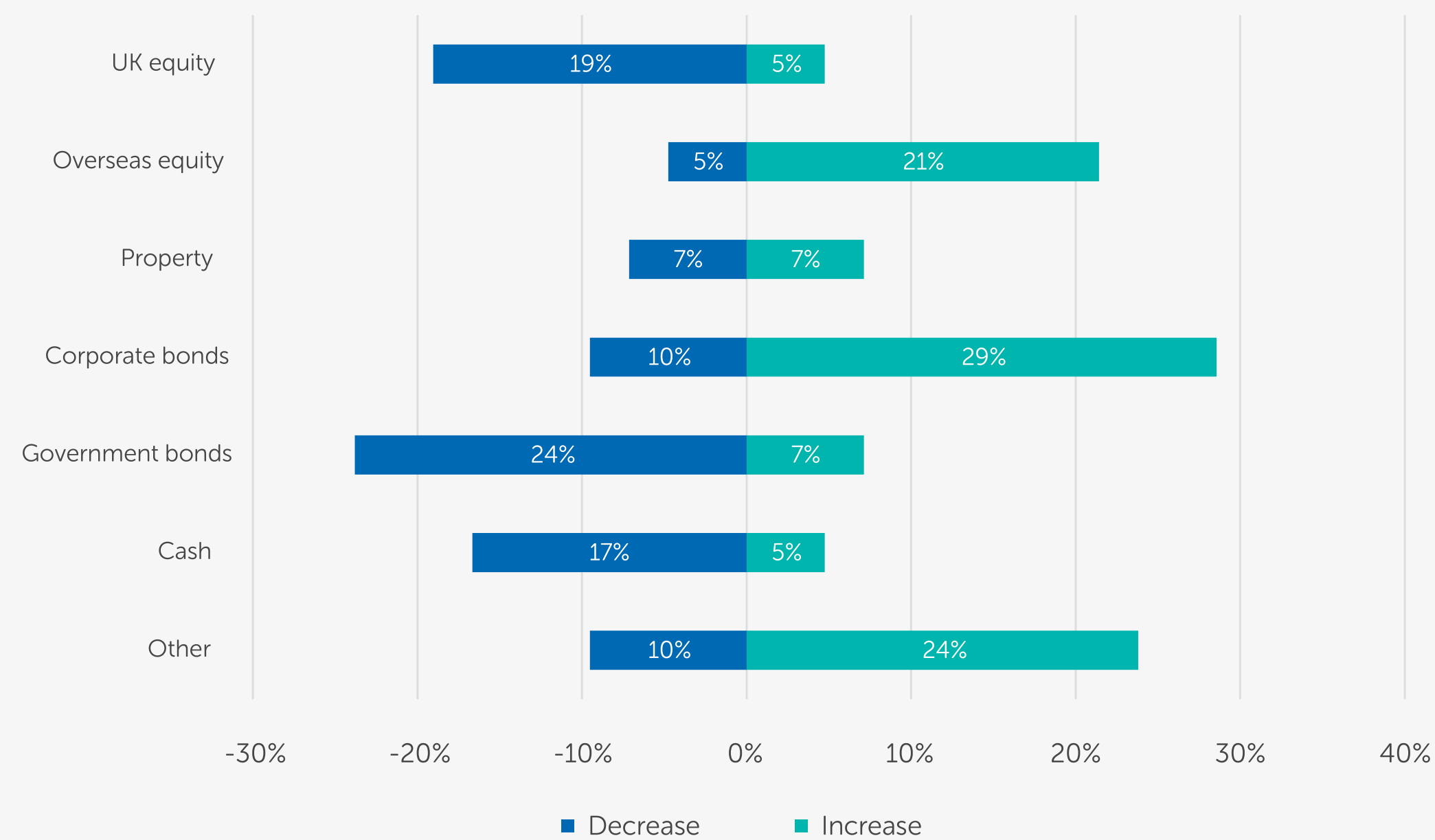
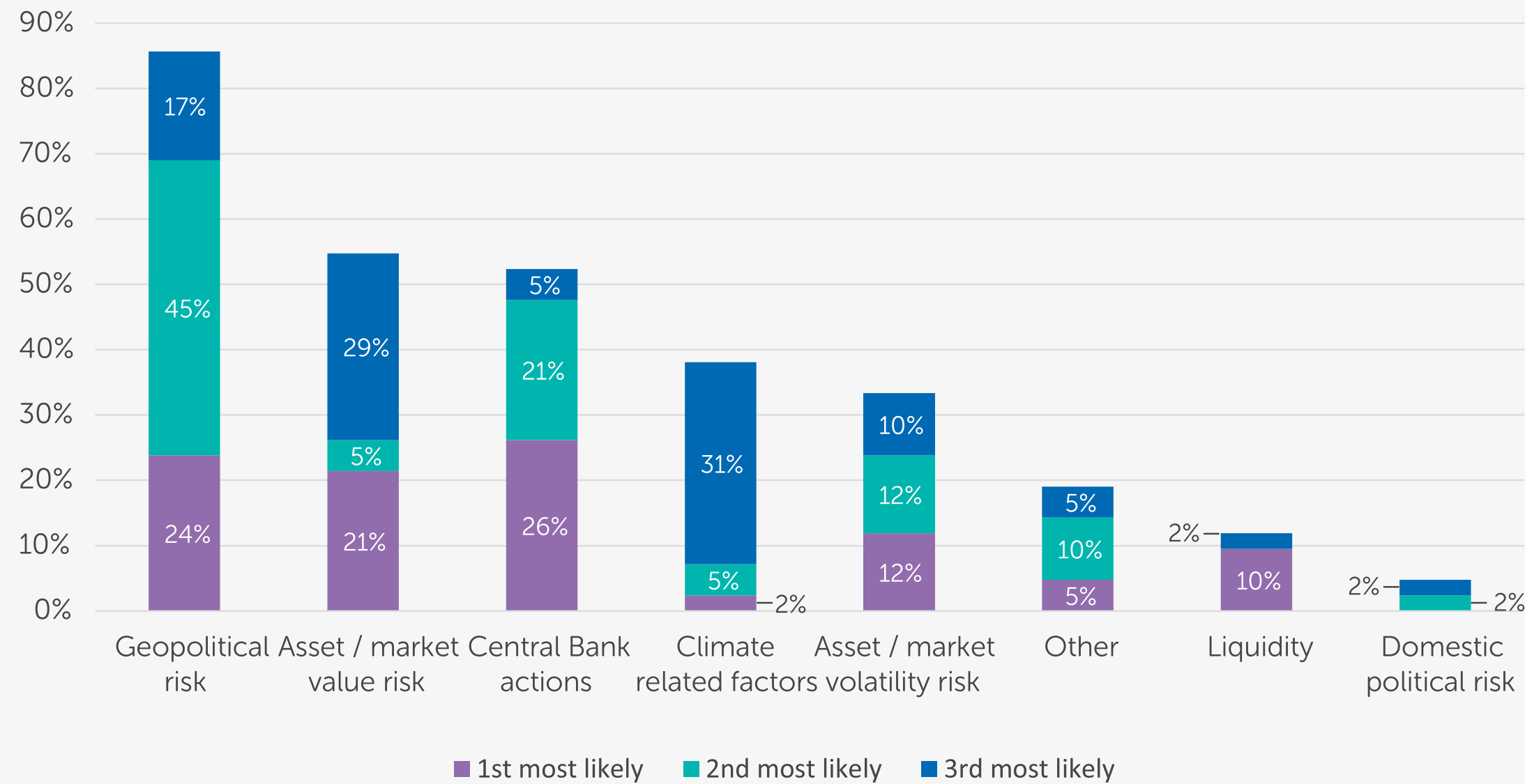


Figure 5: Top risks likely to influence asset allocation over 2022



Our insight

Different funds have a wide range of different asset allocations, although most could be described as balanced funds with a mix of all the major asset classes.

A wide variety of different types of assets were included under “other”. For the larger funds, this includes private equity, private debt, overseas bonds, loans, and holdings in subsidiaries. For the smaller funds, this primarily represents holdings in collective investments that cannot easily be split into their component asset classes.

On average, larger funds tend to hold a higher proportion of riskier assets such as equities, whereas smaller funds tend to hold more fixed interest assets. The allocation in large open funds is relatively similar to the allocation in large closed funds. For smaller funds, the relative allocation of fixed interest assets is higher for closed funds.

Overall, the change in asset allocation has been small. The most notable change during 2021 has been an increase in holdings of overseas equities, and a decrease in holdings of government bonds. This is driven by a small number of funds (across all sizes) that have significantly increased their allocations to overseas equities and government bonds rather than being a feature across most funds across the whole market. We are aware that some firms that de-risked in 2020 because of the market falls in 2020 had begun reverting to their target allocations during 2021.

For each asset class, most funds do not expect the asset allocation to materially change over 2022. For open and closed funds that do expect changes to allocations, the general trends are for:

- Overall decreases in allocations of UK equity, government bonds, and cash
- Overall increases in allocations to overseas equity, corporate bonds and other

Unsurprisingly, the majority of funds of all sizes viewed geopolitical risk as one of the top three risks to affect asset allocations over 2022. The Russia-Ukraine war began before

firms responded to this survey, and this event would have already affected their asset allocations. The hope of a conclusion of this war, and anticipated geopolitical stability, may be the driver to the overall anticipated increased allocations to overseas equity and corporate bonds.

For smaller funds, the asset volatility risk is viewed as a bigger risk driver to asset allocations than asset value. The opposite is true for larger funds. This suggests that smaller funds may be seeking to make asset allocation decisions to smooth investment returns over time, whereas larger funds are investing more in growth assets in an attempt to maximise returns over the medium term.



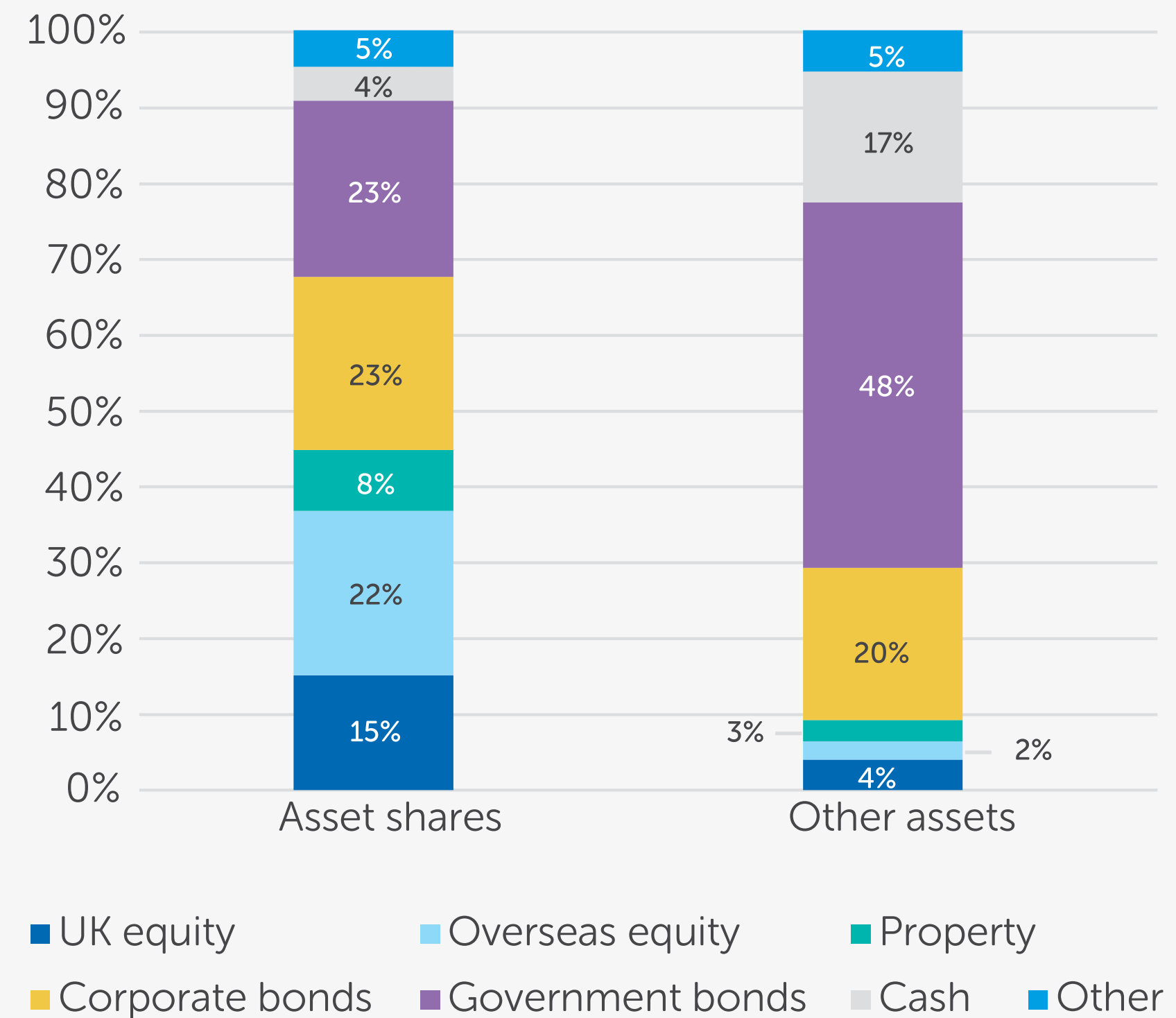
Asset allocation – other with-profits assets

Figure 6 shows the average asset mix for those funds that provided a separate asset mix for their other with-profits assets, compared with the average asset mix for the assets backing asset shares for those funds.

All but one of the large funds reported a separate pool of with-profits assets not backing asset shares, although just under half of medium and smaller funds did so. This implies that smaller funds are more likely to be managed with a single investment strategy covering all assets in the fund. As expected, the other with-profits assets were invested predominantly in fixed interest assets and cash.



Figure 6: Asset allocation for other with-profits assets compared with asset shares as at 31 December 2020



Our insight

There is a stark difference in the investment mix between the two pools of assets, reflecting their different purposes. The purpose of the assets backing asset shares is to deliver a return for policyholders in line with their reasonable expectations and attitude to risk. The purpose of the other with-profits assets might vary slightly from firm to firm, but typically it is to provide the capital of the fund, to absorb losses under stress and (for open funds) to finance the capital strain on new business. The other with-profits assets are predominantly invested in safer assets such as fixed interest assets and cash.

Interestingly, we saw no significant variation in the propensity for closed funds to adopt a separate asset mix when compared with open funds. However, we did note that for closed funds, the amount of other with-profits assets allocated to cash was double the allocation in open funds.



Investment returns by asset class

Figure 7 shows the average return on each asset class across all funds in the survey, in comparison to an appropriate index. The indices used are set out in Table 2. Note that no index return is shown for “other”, due to the diverse nature of this asset class.

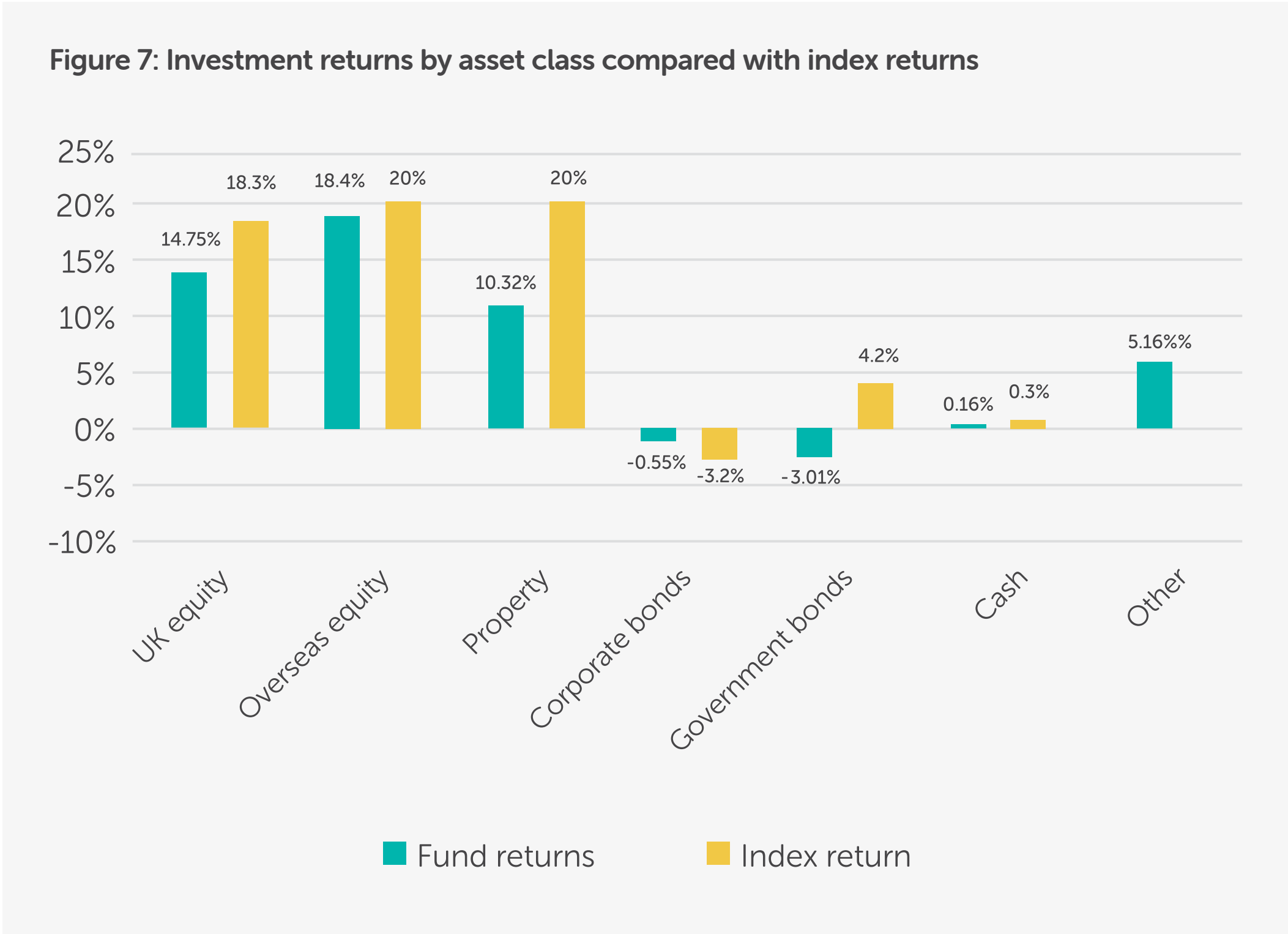


Table 2: Indices used by asset class

Asset class	Index
UK equity	FTSE All Share Index
Overseas equity	FTSE All World (exc. UK) Index
Property	IPD UK All Property Index
Corporate bonds	iBoxx Non-Gilts All Stocks Index
Government bonds	FTSE Gilts All Stocks Fixed Interest Index
Cash	Bank of England Base Rate
Other	N/A

Our insight

Overall, the benchmarks used achieved a positive return on all asset classes, with the exception of corporate bonds. Equity returns have been less volatile than they were during 2020, and market levels have largely recovered to pre-pandemic levels. UK Gilt yields have been volatile over 2021 as the market responded to the Omicron variant of Covid-19 and the Bank of England base rate changes.

It is disappointing to note that the average returns on with-profits assets have lagged the benchmarks chosen for all asset classes, with the exception of corporate bonds. This is a trend we have seen over the recent years that we intend to explore further next year when we will have five years of granular performance data, as we recognise it is important to consider performance over the medium term.

It is also important to note that the benchmark shown is chosen by us, and funds may be managing to a different benchmark. There may be valid reasons for the average performance being different to the benchmarks shown. Here are some examples.

- For overseas equity, it may reflect a different portfolio composition between different overseas markets relative to the index, as there was considerable variation between different markets over the year.
- For fixed interest assets, it may reflect that the assets held may be of a different duration than the average duration in the index.



Fund-level investment returns

Figure 8 shows the investment returns achieved in 2021 on assets backing asset shares by fund, ordered from highest return to lowest return. Figure 9 shows the average investment return achieved in each of the last five years by size classification and Figure 10 then shows how this translates in relative performance over a five-year period.

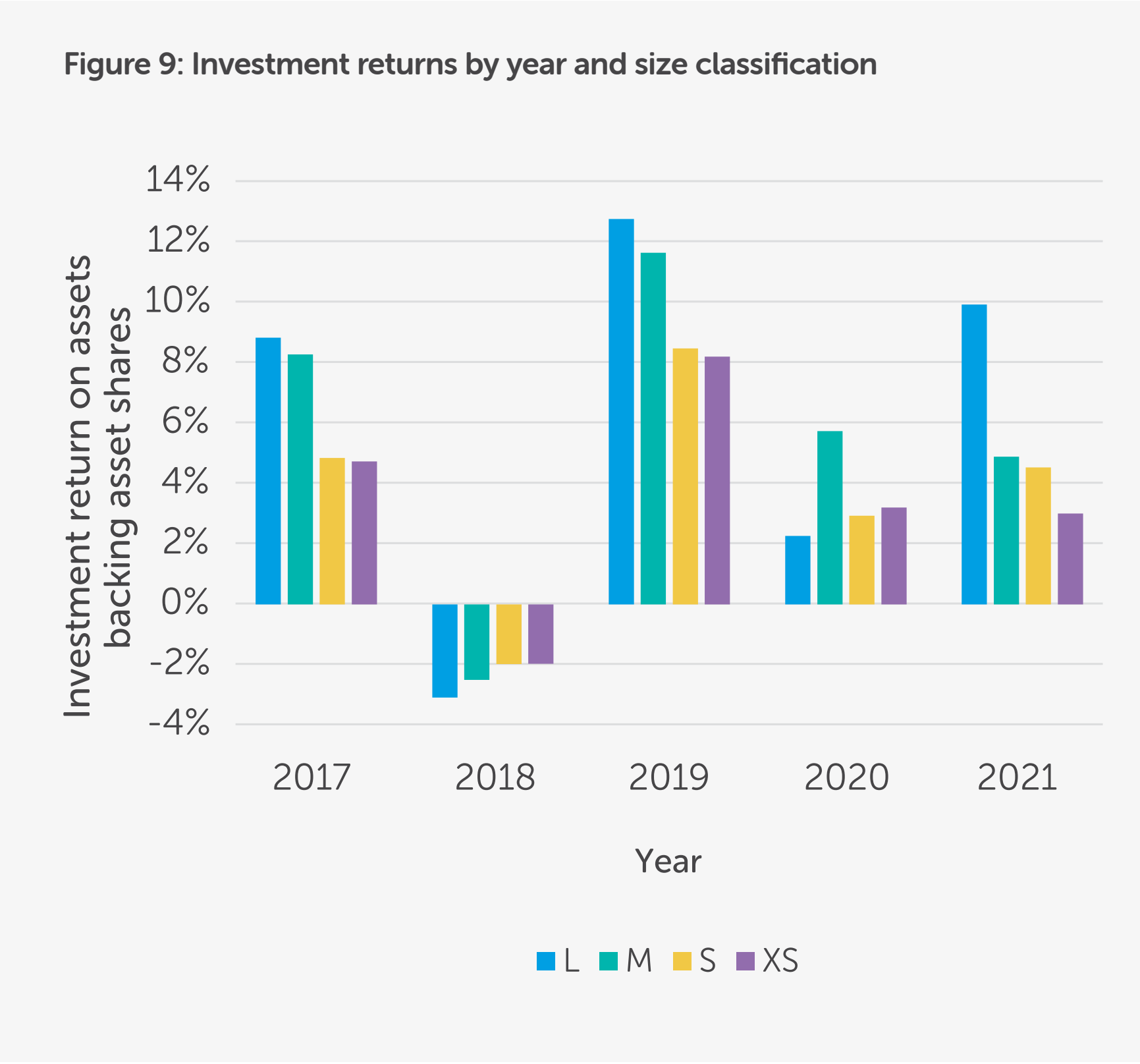
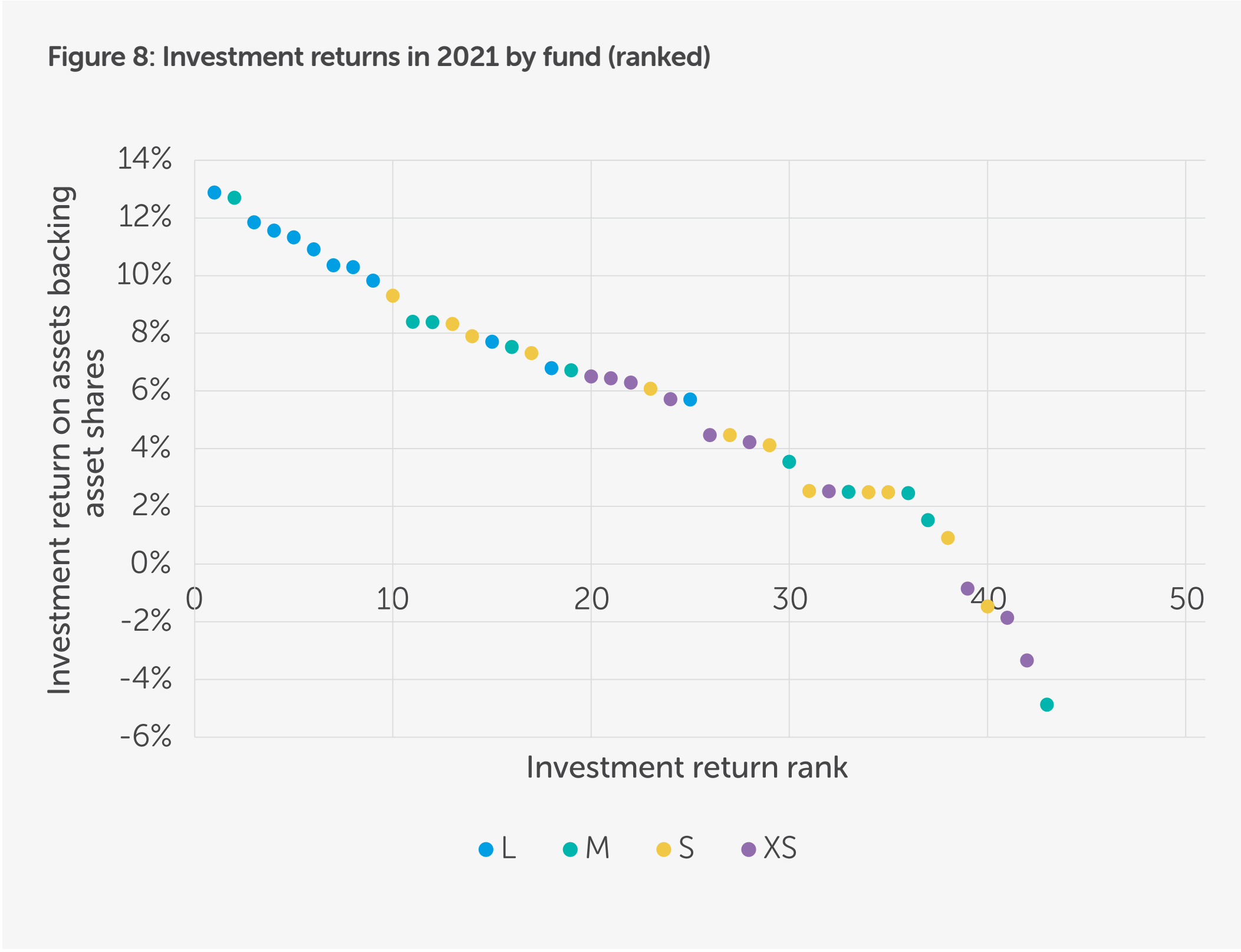
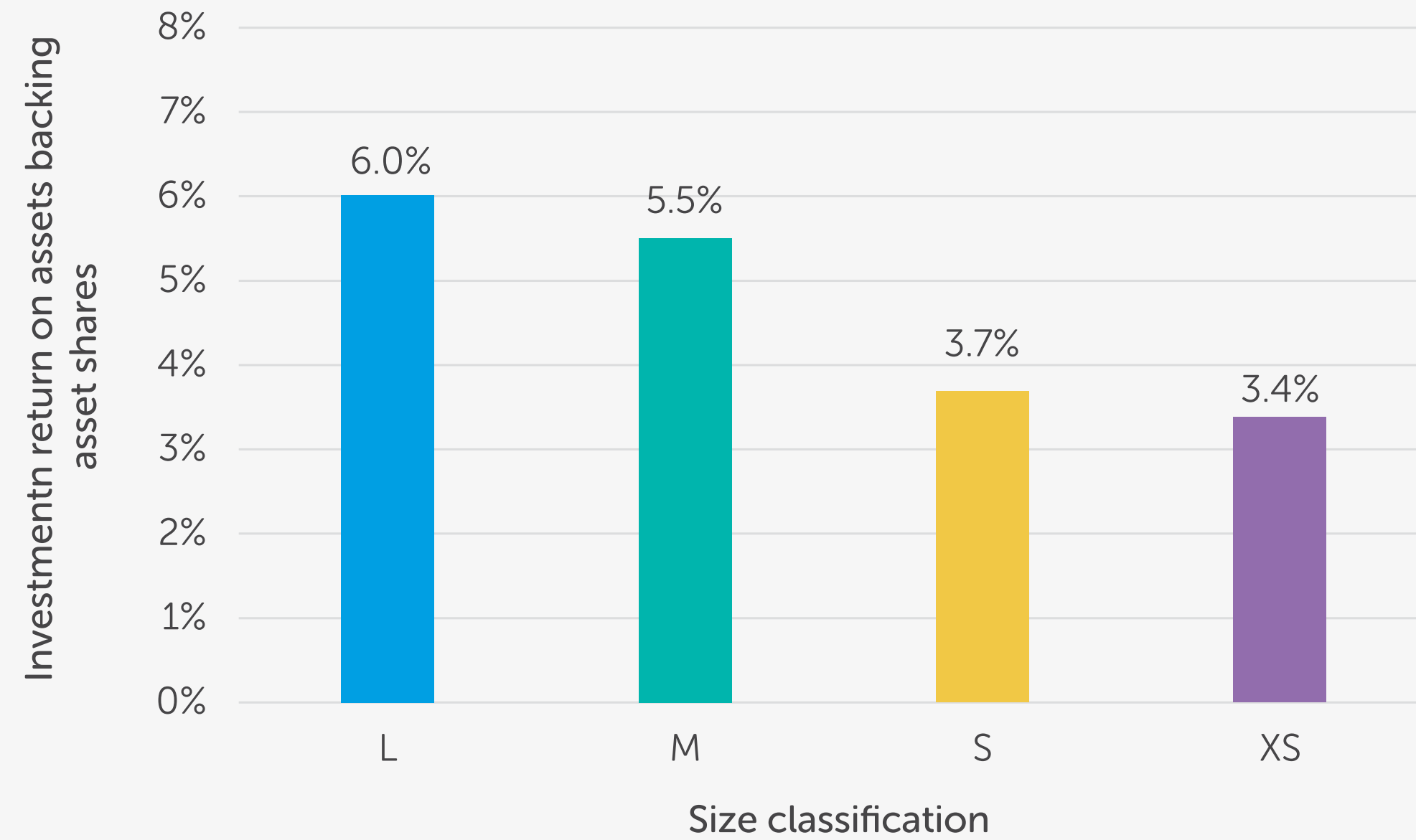


Figure 10: Investment returns by size classification over five years



Our insight

The funds included in the survey achieved a wide range of investment returns over 2021. Larger funds tended to perform better than smaller funds, and eight of the top ten performing funds in 2021 had more than £1bn assets. This is attributable to larger funds having a higher allocation to UK and overseas equities, which performed well in the year.

Figure 9 shows that smaller funds have, on average, performed better than large funds in more challenging and volatile markets, like we saw in 2018 and 2020. This is attributable to their larger allocation to fixed interest and cash assets.

Overall, Figure 10 illustrates that larger funds enjoyed a relative advantage over the most recent five-year period.

Every fund in our analysis achieved a positive investment return over a period of five years.

Sustainability

Sustainability considerations (also referred to as “Economic, Social and Governance” or “ESG”) are becoming increasingly important in investment management, in response to both regulatory pressure and consumer demand.

Figure 11 shows, at a high level, how much of a fund’s assets are subject to sustainability targets or criteria. Table 3 sets out several approaches that could be used to set sustainability targets and criteria. Figure 12 shows a breakdown of the proportion of funds using each of these approaches. Funds can use multiple approaches.

Table 3: Possible approaches to sustainable investment

Approach	Description
Screening	Certain sectors are excluded from the portfolio (e.g. coal)
Tilting	Certain assets are favoured, using metrics such as ESG ratings
Carbon reduction	Carbon emissions data is used to exclude heavy polluters
Climate aware	Portfolio is selected to align to specific climate targets

Figure 11: Proportion of funds that apply a specific sustainability target or criteria to all, some or none of their assets

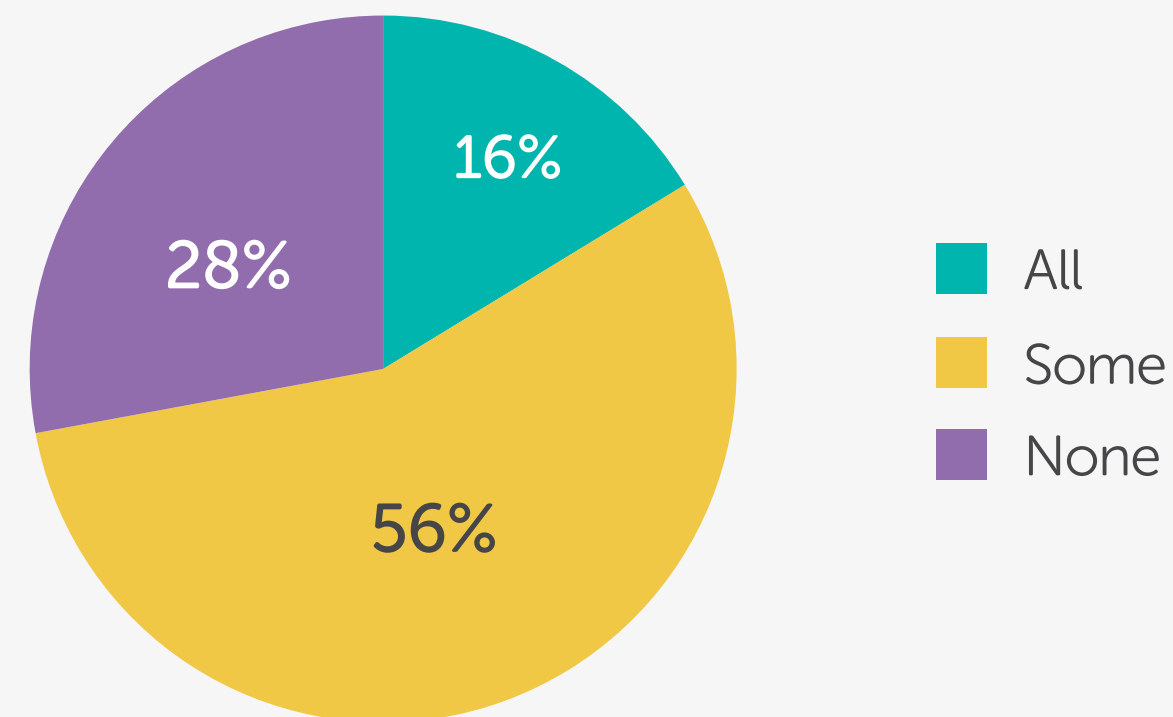
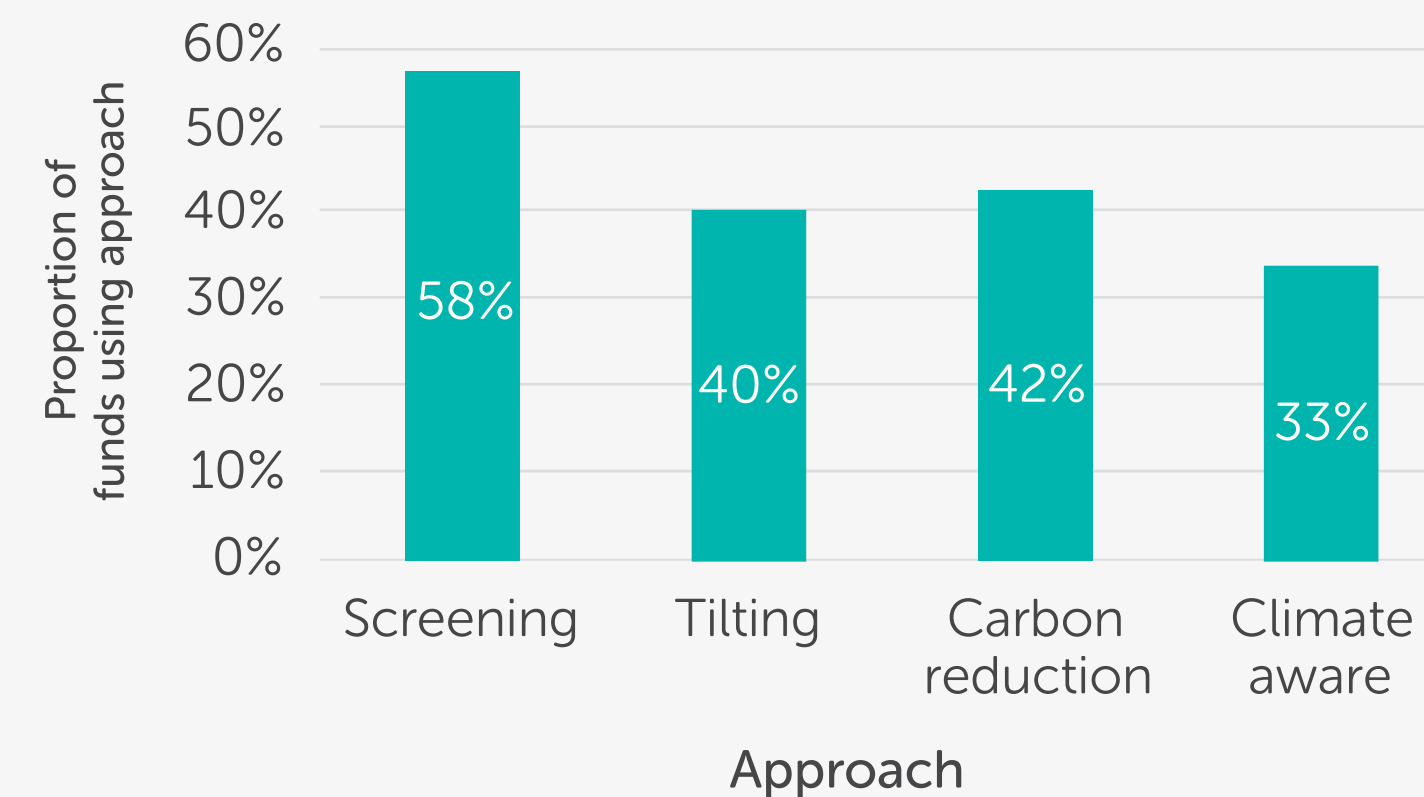


Figure 12: Proportion of funds using each approach



Our insight

71% of funds are managed with at least some of their assets having a specific sustainability target or criteria (2020: 47%).

These targets and criteria are more prevalent amongst the larger funds. The proportion of funds that apply sustainability targets or criteria to at least some of their funds was similar for open and closed funds, which suggests that sustainability is seen as more than just a selling point for new business.

Of the different possible approaches to sustainable investment, screening is the most common, used by 58% of all funds and 81% of funds that have a sustainability target or criteria. The climate-aware approach is the most sophisticated approach, and it is the Prudential Regulation Authority's (PRA's) metric of choice. It is becoming more widely used, with 33% of funds in our analysis using it this year, compared to 16% last year.

For more information on sustainable investment, please visit the [ESG Investing hub](#) on our website.





Our services for insurers

Our insurance experts provide market-leading advice and support on actuarial, investment, longevity and risk management projects on either a consultancy or a secondment basis. Employing a personal and partner-led approach, we build bespoke teams to ensure we can meet the exact requirements of our clients. Our growing client base covers a broad range of life and general insurance firms, from captive insurers and friendly societies to FTSE 100 companies and Lloyd's syndicates.

Our areas of expertise are:

Actuarial function services

Our team of experienced practitioners are on hand to provide all of your actuarial outsourcing or peer review needs.

Risk management

Whether you are looking to outsource your CRO function or to design and implement elements of your risk framework and ORSA process, our experts can assist you.

Strategy and transactional support

From mergers and acquisitions, and product development to transformations and capital optimisation, we work alongside you to develop a strategy that enables you to achieve your goals.

Investment consulting

By enhancing mandates and establishing governance frameworks, we assist in driving performance improvement across your business.

Data and analytics

We provide a comprehensive and practical analytics and visualisation service – using data management, modelling and communication expertise to reach solutions that are tailored to your business.

With-profits

Our team has wide experience of acting as With-Profits Actuary and advising on with-profits issues such as bonus policy, investment strategy, capital management and the fair treatment of customers.

Unit-linked services

Our specialist knowledge covers all aspects of unit-linked insurance management: unit-pricing governance and methodology reviews; independent advice on discretionary practice; error investigation and rectification; and product development and policyholder disclosures.

Bulk annuities

Working with our pensions and longevity consulting teams, we provide pricing, new entrant strategy, modelling and investment advice to existing and prospective market participants.

Audit support

We provide actuarial expertise to support internal and external audit teams.



For professional use only. This report is for information and should not be construed as investment advice.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact Scott Eason, Head of Insurance and Longevity Consulting, via the following:

✉ scott.eason@barnett-waddingham.co.uk

☎ 020 7776 3884

www.barnett-waddingham.co.uk

Barnett Waddingham LLP is a body corporate with members to whom we refer as "partners". A list of members can be inspected at the registered office. Barnett Waddingham LLP (OC307678), BW SIPP LLP (OC322417), and Barnett Waddingham Actuaries and Consultants Limited (06498431) are registered in England and Wales with their registered office at 2 London Wall Place, London, EC2Y 5AU. Barnett Waddingham LLP is authorised and regulated by the Financial Conduct Authority.

August 2022