LWM Consultants Ltd

Meeting the Fund Manager

Schroder Secure Distribution 2032 Fund

In our travels we are occasionally introduced to funds which don't necessarily fit the normal pattern of investing and actually can be difficult to place. This doesn't necessarily mean they are not good funds but more that they are specialised and possibly do not fit into a portfolio mould. The Schroder Secure Distribution 2032 Fund is one of those funds.

Before I provide an overview of the fund there are two things to consider. Firstly this is not about capital preservation but about distribution preservation. Effectively by this we mean at the end of the term you may not receive back the full value of your capital however you should have received capital distribution payments which, when added together may exceed your original capital investment (see examples in overview). Secondly the target market, this has been pitched at the retirement market but equally it could work well with school fee planning or even a foundation stone for pension funds where the distribution payments are re-invested.

In the overview we will unpack this further. The fund is the brainchild of John McLaughlin at Schroders who has been developing this idea for a number of years. We were fortunate to meet with John who explained this fund. His experience is clear having worked for Schroders since 1993, where he was transferred to Head of Structured Investments in 2000, Head of Japan in 2004, head of Multi Asset in 2008 and now Head of Investment Solutions.

Overview

The proposition is firstly a fund which is daily traded but it has a 20 year life span. At the end of the twenty years it will be wound up and any remaining fund will be paid to the policyholders. At any time during this period the investor can sell their units so they are not locked in.

It was originally designed as an alternative retirement product. The idea is that for ten years the fund focuses on growth and then for ten years it distributes capital. When you consider this you can see that this could work equally well for school fees - so say for a child who was 10 and providing university fees in 10 years' time. The other interesting angle is that the distribution of capital is seen as a return of capital so subject to CGT.

So how does this work in practice. The fund was launched in July and is now embarking on what is called a 10 year accumulation strategy. The focus is towards growth assets and no distributions. So for example the unit price starts at 100p. During this period the fund is constantly locking into what it calls the high water mark (HWM).

This is important because in year 10 the fund will pay a distribution of 7.5% p.a. of the HWM. So what does this mean?

So say the price was 100p and during the 10 year growth period the price went up to 166p at its highest point and then at the end of the growth period it was 150p, the fund would distribute capital at 7.5% of 166p i.e. 12.50p per unit for a period of ten years. So this would be 125p.

At the end of the ten year distribution period any remaining capital is paid out to the client – so say this worked out at 99.60p. So effectively over 20 years the client put in 100p, received 125p in distribution payments and 99.60p return of capital. A total return of £224.60.

On the reverse in a worst case scenario if the starting price was 100p and during the 10 year growth period the price dropped so that the highest was 100p, the fund would distribute capital at 7.5% of 100p i.e. 7.50p per unit for a period of ten years. So this would be 75.

At the end of the ten year distribution period any remaining capital is paid out to the client – so assuming there was no final capital payment this would be nil. So effectively over 20 years the client put in 100p, received 75p in distribution payments and no return of capital. A total return of £75.

This idea reverses the way many of us think because at the end of the investment term we would like to get some capital return so it has to be considered as a distribution product.

So how does this work in practice. Ultimately the fund has a focus on growth assets and I will cover this separately but it also needs to hold some back in cash to protect the future distribution payments. This was explained as follows.

Say the HWM on any given day is 100p then the future distribution payment is effectively 75p for ten years. If the price of the fund is 90p then the difference between the distribution and "growth" is 15p. The rule of the fund is that it can invest four times that difference, in this case 4 times 15 which is 60p. So 60p is invested and 30p is in cash. Obviously the gap widens if the price is higher. So say the distribution was 8.25p and the price was 110 then in theory the fund could be 100% invested in equities.

So effectively the aim is to invest the maximum possible for growth whilst ensuring that all future capital drawdowns will be honoured.

One of my concerns was that as the fund is actively managed with the movement in share prices you could see a lot of trading between cash and equities and back to ensure the capital distribution side is protected. One of the main killers of performance is fees so I wanted to explore this further. Schroders have a large institutional multi-asset team who manage circa £37 billion of assets. To some extent this is similar to the Standard Life GARS Fund but doesn't focus on absolute return. The aim is to track or beat the equities index with 2/3 of the downside risk. Since this strategy was developed by Schroders in June 2006 it has outperformed global equities by 8.7%.

The key to keeping charges down is that the fund uses passive instruments to invest in which reduces the costs. The fund is actively managed even though it uses these instruments so for example if the team are unhappy with the situation in Europe then they will have zero holdings in Europe.

The next question is around timescales, if I invest at any time during the ten year accumulation period what happens. Effectively this doesn't matter because everyone during this period will get the lock in distribution payment. The point is after ten years no new investors can come in but investors could come out if they wanted. Of course investors can come out before the distribution period. The key to the price is to protect the distribution payment i.e. the price is made up of the distribution payment plus the growth and if this is high then some may consider to coming out early.

Conclusion

Of course as a fund this doesn't sit naturally within a portfolio but as a tool to invest for school fees, or some form or retirement income it may work well. Assuming this fund is successful it is likely there will be tranches of new products, so a 2033 fund, 2034 fund etc. In a world where longevity is a challenge to retirement I think there will be some interesting funds or propositions introduced to the market. Clearly this has come from an investment management house with a great deal of experience in this area and it is one that we will continue to watch and monitor. It will not suit every client and that is where careful planning will be required.

Special note:

What could go wrong with the investment strategy:

1. Cash lock risk – if we experience a severe or prolonged bear market (i.e. where the markets fall), it is possible that the growth allocation gets reduced close to zero, in which case there would be no subsequent participation in any market recovery and the fund will then return the capital drawdowns but no final capital payment
2. Bank default risk – the fund uses BNP Paribas for the operation of this fund. If they were to default on their obligations; and if the value of the collateral was then to fall during the time taken to replace the contract; the net asset value of the fund would have to be reduced accordingly. This will ultimately impact the final capital payment from the fund, It may not also be possible for the fund to deliver the capital drawdowns in full, if the reduced net asset value were to fall below the floor level
3. Performance risk – the main risk for this fund is simply that the growth assets fail to deliver the expected return over time. In the worst case up to 25% of capital invested can be lost. This is not taking into account any bank default
4. Early termination risk – if you redeem prior to the final maturity date, the amount you receive back will be the prevailing market value of the assets of the fund, which may be less than the total value of the future expected capital drawdowns