This article first appeared in the December 2006 issue of FORUM magazine and is reprinted courtesy of Advocis

SIZING UP S

Segregated funds have held a steady place in many retirement portfolios, offering security and guarantees in turbulent investing times. But, as **JUNE YEE** explores, many are asking if the value of these increasingly complex products justifies the high price tag

This article first appeared in the December 2006 issue of FORUM magazine and is reprinted courtesy of Advocis

SEG FUNDS

It's been almost 10 years since investment companies first partnered with insurers to bundle brand-name mutual funds into segregated funds. Ever since, there has been ongoing debate over the merits of segregated funds. The crucial question: are the security and other benefits they offer worth the higher costs?

But seg funds appear to be taking the criticisms in stride. In fact, they are attracting new money at a time when uninsured mutual funds are being shunned by investors. Despite a slowdown in sales in September, investors bought approximately $2.5 billion of seg funds in the nine months ended September 30, 2006 — nearly identical to net sales over the same period in 2005. Sales of regular mutual funds, by comparison, fell by 17.8 per cent versus the first nine months of 2005.

The growing appeal of seg funds may be part of a "hangover" from the most recent bear market, says Geraldo Ferreira, vice-president, investment products marketing and development at Transamerica Life Canada. As well, seg funds are filling a need that is increasing as Canada's population ages and our concerns with capital preservation and estate planning grow, he says.

"There's a demographic shift and, as you get older, your priorities change," Ferreira notes. "People are looking for investment options that provide some downside protection."

That protection in the form of investment guarantees comes at a significant price. Research from Morningstar Canada shows the three most expensive seg funds currently available are sector funds offered by TD Asset Management Inc. TD Science & Technology GIF II, TD Health Sciences GIF II and TD Entertainment & Communication GIF II carry management expense ratios (MERs) of 5.97 per cent, 5.91 per cent and 5.81 per cent respectively. By comparison, each underlying fund has a MER of 2.79 per cent.

Meanwhile, at 2.91 per cent, the average MER for a mainstream Canadian equity segregated fund is nearly a percentage point higher than the 1.96 per cent average cost for its mutual fund counterpart, according to Morningstar. In the more volatile international equity category, cost differences can be even greater. While international equity mutual funds charge an average of 1.89 per cent for management, the average MER for segregated fund in this asset class is 3.16 per cent. Sales charges and other commissions are usually also payable on seg funds.

Even though they are at the heart of the cost debate, investment guarantees have been central to the marketing of seg funds since 1997, when Manulife Canada's Guaranteed Investment Funds (GIFs) pioneered the concept of insurance-wrapped mutual funds and put seg funds in the limelight.

In the push to attract investors, many companies were quick to exceed the regulated minimum guarantee of 75 per cent to offer 100 per cent guarantees of principal to maturity (usually 10 years) as well as fully guaranteed death benefits. These features were often enhanced by reset provisions that allowed investors to lock in market gains at set times, thereby ratcheting up the guarantee level on their funds.

"From an issuer point of view, on a straight 10-year guarantee with a very volatile fund, the cost of providing that guarantee would be exorbitant," says Roy Firth, executive vice-president of Manulife Investments.

Indeed, even as seg funds went mainstream in the late 1990s, concerns over the potential risks to issuers from those investment-related guarantees prompted regulators to mandate higher capital reserve requirements. The new rules, which took full effect in 2001, caused some companies to retract or reduce some features on their funds and even forced two firms out of business, says Transamerica's Geraldo Ferreira.

With more than 2,000 seg funds now on the market, issuers have adapted to the new capital requirements. Some have pared down the guarantees while others have diversified their lineups with more asset classes and by giving investors the option of full or 75 per cent maturity and death benefit guarantees. Reset provisions remain, with ages 75 and 80 being the most common age limitations for resetting the guarantees.

For its part, Transamerica Life Canada now offers three guarantee levels with tiered costs on some of its funds. The highest fees belong to the 100/100 products, which fully guarantee the principal investment on maturity and death benefit payouts. The most popular option combines a full death benefit guarantee with a 75 per cent maturity guarantee at mid-point pricing.

"The 100/75 guarantee really appeals to investors who are considering estate planning," says Ferreira. "They've accumulated a significant amount of wealth and now they're looking to preserve that wealth for their beneficiaries."

Costs can vary significantly when it comes to the different levels of guarantees. For example, AIC Ltd., a seg fund player with mutual fund roots, currently offers two levels of maturity guarantees on segregated versions of some of its most popular mutual funds. While the MER on AIC American Advantage Fund is 2.7 per cent, management expenses on the comparable seg fund with a 75 per cent maturity guarantee total 4.26 per cent. Choose the 100 per cent maturity guarantee and the MER jumps to 5.33 per cent, nearly double the cost of the underlying fund.

"I'm not a big fan of the maturity guarantee," says David Phipps, a senior financial

This article first appeared in the December 2006 issue of FORUM magazine and is reprinted courtesy of Advocis

advisor with Assante Capital Management Ltd. in Ottawa. Like many critics, Phipps points out that, at the end of any 10-year period, an investment in almost any market is unlikely to be worth less than it was at the time of purchase.

Ultimately, whether the investment-related guarantees are necessary and the additional cost for these features justifiable will depend on the individual investor and on the market: more conservative investors may want, even need, the security of full capital protection while the guarantees and reset provisions may be more useful in volatile markets than in asset classes with little risk of negative returns.

"If someone is 85 years old and they buy it and the market is down 30 per cent, that client's heirs are going to feel the product is necessary," says Phipps. "If someone is sued and they happen to have RSPs in a seg fund that gives them the creditor protection they need, they would suggest that product was very necessary. It's like any form of insurance. It's not necessary until it's needed."

So, despite the ongoing discussion of the cost, there's little doubt that seg funds can offer valuable estate planning features and important potential benefits to small business owners and professionals. "We did focus groups with financial advisors before we launched our products," says Transamerica's Ferreira. "The majority of the response was that the death benefit was most important."

To be sure, says advisor David Phipps, some of his clients have been well served by the death benefit guarantee, which pays out the full value of the principal investment to a named beneficiary even if the market value of the investment has declined. He tells of one elderly client who passed away at a time when his original investment of $60,000 in an equity fund was worth $10,000 less in the market. "[His beneficiaries] received $60,000 at the height of the bear market," recalls Phipps.

In addition, similar to life insurance policies, seg fund assets may be protected from creditor claims and can avoid estate-related costs. By naming a beneficiary, for example, death benefits may bypass the probate process and allow the proceeds of the seg fund contract to flow directly to one's heirs.

Though new to Canada, GMWBs have been around in the U.S. for about four years

As well, because they're legally structured as insurance contracts, seg funds may be shielded from creditors in the event of bankruptcy, unpaid debts or a lawsuit. Creditor protection may be especially important to people who are self-employed or who work in professions where they are at high risk of being sued, says Phipps, who estimates that seg funds comprise roughly five per cent of his business.

However, the creditor protection of seg funds is not perfect, cautions Phipps. For example, moving assets into seg funds when one is already insolvent and for the purpose of avoiding creditors could lead to the creditor protection being disallowed. "It's always a bit of a question mark," says Phipps. "You have to couch your language to make sure [clients] are aware that there's a measure of creditor protection."

FUND CATEGORY	AVERAGE MER (%): UNINSURED MUTUAL FUND	AVERAGE MER (%): SEGREGATED FUNDS
Canadian Equity	1.96	2.91
Canadian Core Fixed Income	1.37	2.19
Canadian Money Market	0.89	1.33
Canadian Portfolio	1.93	2.87
European Equity	2.26	3.16
Global Portfolio	2.10	2.93
Global Equity	2.36	3.33
Global Fixed Income	1.77	2.36
International Equity	1.89	3.16
U.S. Equity	2.06	3.16

Source: Morningstar Canada

Investors and their advisors should also be aware that the creditor-proof status of seg funds may be susceptible to regulatory developments, cautions Geraldo Ferreira. He notes that the current proposals to make RSPs creditor proof contain weaker protections for RSPs than currently exist for seg funds. That could have implications for the creditor protection on seg funds.

Over the past decade, the estate planning capabilities and potential for limiting risk have helped increase the popularity of segregated funds, particularly among older Canadians and business owners.

Now, product design is evolving to meet growing demands from Canada's largest demographic group, says Manulife's Roy Firth. "No one has really spent a lot of time on what happens when people, particularly the big bubble of baby boomers, get to the point when they want to start spending the money," he notes.

His company's newest seg fund-based initiative focuses directly on just that demographic segment. IncomePlus was introduced in October and uses well-known fund managers, including AIM Trimark Investments, CI Funds, Fidelity Investments, MFC Global Investment Management and Mackenzie Financial. The new product rolls the downside protection for which regular seg funds are known into a payout scheme that is meant to address the risk that investors will outlive their retirement income. In particular, the guarantee that an investor will get at least his or her principal back over 20 years is aimed at removing fears of a shortfall if the years leading up to retirement or the early years of retirement coincide with a market downturn.

Going by the name of "guaranteed minimum withdrawal benefits (GMWBs)," guaranteed payouts from IncomePlus over a 20-year period are based on a formula that includes deposits, market performance and withdrawals. The guaranteed amount is reset every third year on the contract anniversary date if the market value at that time is greater than the guaranteed value. The payout levels may also be bumped up according to a bonus scheme when payouts are deferred.

Though new to Canada, GMWBs have been around in the U.S. for about four years and have been available there through

This article first appeared in the December 2006 issue of FORUM magazine and is reprinted courtesy of Advocis

Manulife subsidiary John Hancock for nearly three years. Although it has no immediate plans to launch a similar product, Transamerica Life Canada is taking notice of its competitor's latest foray. "We're watching very closely," says Transamerica's Ferreira. "If there is a demand for this type of product, I don't think Manulife will be alone." He notes that Transamerica's sister company, AEGON U.K., launched the same product in Britain in September.

According to the Canadian Life and Health Insurance Association (CLHIA), segregated fund assets total $133 billion, less than a quarter of the $610 billion currently held in mutual funds. Roy Firth, who joined Manulife in 1998 as president of fund manager Elliott & Page Limited, believes this product will help Manulife transcend the limited market for seg funds to garner a healthy share of the estimated $1.3 trillion that comprise stocks, bonds, GICs and other savings presently.

"It's something that's going to become a normal part, 25 per cent to 50 per cent, of every person's retirement portfolio," says Firth. "We don't look at this at playing merely in the segregated fund market. There's going to be an awful lot of money flowing into this type of product over the next five, 10, 15 years."

According to the Canadian Life and Health Insurance Association (CLHIA), segregated fund assets total $133 billion, less than a quarter of the $610 billion currently held in mutual funds.

To this end, Manulife has dedicated extensive resources to promoting this product, including a big push on advisor education. Firth also notes that Manulife plans to introduce further variations to IncomePlus over the coming years.

For his part, advisor David Phipps acknowledges that the increasing complexity of the products over the 13 years he has worked in the industry makes it challenging to market seg funds, including the latest offerings.

"The different options allow the advisor who's willing to invest the time to probably do a better job than we did in the past of meeting a client's unique needs. But it does put additional demands on the advisor," says Phipps. "I do think the level of complexity is going to be a hurdle."

JUNE YEE is a researcher, writer and editor specializing in investment funds. She is a regular contributor to Morningstar Canada and is a co-author of the managed funds sections of the Canadian Securities Course. She has written articles for numerous media and research organizations, including the Toronto Star, National Post, 50Plus *magazine and BellCharts Inc., and is a founding member of the Canadian Investment Funds Standards Committee. June can be reached at june.yee@sympatico.ca.*