AWFM Fact File

"With Profits Funds"

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For years With Profits had been seen as a safe way of gaining access to Stock Market funds without exposing your investment to the highs and lows associated with investing in shares. Then in 1999 Stock Markets around the world began to slide, and they continued to fall for 3 consecutive years. This was combined with the Equitable Life saga, a company who were arguably the major presence in With Profits investing for decades. Suddenly With Profits funds were hit by:

- MVAs or MVRs. MVA stands for Market Value Adjustment, MVR stands for Market Value Reduction. They mean the same thing but the two different terms are often used.
- Reduction in Reversionary Bonus rates.
- Reduction and in some cases Cancellation of Terminal Bonuses.

This article explains With Profit funds in more detail including the issues to look out for.

How With Profits Works
You can be invested in a With Profits fund through many different investment products such as Pensions, Endowments and Bonds. When you invest into a With Profits Fund a guaranteed sum assured is purchased at the outset. Each year regular bonuses are added to the value of the basic sum assured. These are called Reversionary bonuses. When these bonuses are added to the value of your fund they cannot be taken away (except in certain circumstances*). When the investment is due to mature there would be the possibility of a further Terminal bonus.

Reversionary Bonuses In More Detail
These regular bonuses are calculated annually by the insurance company who determine the bonuses offered based on their assumption of returns over the following 12 months and their performance over the last year, taking into account their future liabilities. As a With Profits Fund is a pooled investment the underlying fund can be invested in Shares, Property, Gilts and Fixed Interest funds etc.

Current Reversionary bonuses are dependent on the company and the fund (as some companies have more than one With Profits fund) but are typically somewhere in the region of **0%** to **3%** per annum. There has been a shift in the way companies distribute their funds, moving away from providing decent levels of Reversionary bonus (which they can't so easily take away) to Terminal Bonuses.

Terminal Bonuses
Terminal Bonuses are usually based on the previous Reversionary bonuses paid and are also paid dependent on the time that the investment has been held with the insurance company. The Terminal Bonus, if paid, could increase the overall annual bonus applied to the value of the With Profits investment quite significantly. Some companies add their Terminal Bonus into the Reversionary Bonus and some companies quote the Terminal Bonus as an accruing figure when a valuation is requested but is only actually applied on maturity of the investment. One very important aspect is that <u>Terminal Bonuses are never guaranteed</u>. Terminal Bonuses will often be used to increase the total pay-out on maturity of a With Profits investment to enhance a company's standing in the With Profits League Tables. It always used to be in a company's interest to get pay outs as high as possible but often Terminal Bonuses have to be paid out of reserves. More recently however, new investors have not been investing so much in With Profits funds, so the incentive for companies to keep their investment returns as high as possible, is not necessarily as important as it used to be.

Financial Strength
Whether or not a company is able to keep their With Profits returns constant usually depends on the reserves that they have. This is why financial strength of insurance companies is a very important aspect when considering With Profits investments. The problem that Equitable Life ran into was that all of their reserves virtually, were earmarked to pay their liabilities following the House of Lords ruling against them. In other words they failed to provide sufficient

reserves to cover all of their future liabilities. Having said this, at the time of writing Equitable Life is still an ongoing company and it has not failed totally – the returns however are very poor from With Profits investments.

MVA/MVR
A With Profits investment means that the value of your fund cannot go down it can only increase except in certain circumstances* (see above). Around 1999 to 2002 the MVR was a very real issue with regard to With Profits investments.

The MVR is the ability for a company to effectively take back some of the Reversionary bonuses if investors wish to withdraw some or all of their money in a time of poor investment conditions or specific problems within the company. MVRs have been applied by many companies for anyone wishing to encash their investment in years gone by. It should be noted that the MVR only applies if you wish to encash your investment and if you otherwise hold your investment to encash in better economic times it is quite possible that when you come to encash no MVR would apply. Also, MVRs don't usually apply at the maturity date of a policy – for a pension this would be the standard retirement age, and for an Endowment this would be the maturity date.

Are With Profits Funds Still Appropriate? What should you do?
Despite all of the problems, With Profits has been an exceptional way to invest for many years. The "smoothing" effect of regular bonuses without the highs and lows of stock-market investing will always make With Profits attractive. In cases where MVAs have not been applied and policies have been running for some time, the returns from With Profits investments have been very good especially when compared with direct Stock Market investments.

In the later years of the plan the reliance on Terminal Bonus which is never guaranteed can significantly increase the risk associated with holding such an investment. The policy-holder simply does not know the true underlying value of their fund until they request a fund or transfer value.

If you are invested in one of these funds you certainly need advice as this is a complicated area of investing, where there is a lack of transparency, which stands in the way of most people being able to make rational and well-informed choices without help.

Alternative to With Profits
As a firm we are not currently recommending With Profits for any new investments.
Our strategy for investment funds for some many years has been to try to match a client and their investment funds with an investment **asset allocation** which is appropriate for them. So someone drawing closer to retirement or seeking to draw funds out for some specific reason would be encouraged to invest in much lower risk investments such as cash and fixed interest funds, which will help to crystallise values, whereas someone with a longer period of investment ahead of them will be directed towards higher risk funds and an investment portfolio made up of mainly equities. If however a client were seeking a flexible drawdown approach with their pension fund, they would probably be encouraged to maintain an overall Medium risk approach right up to and beyond their retirement date.

Our approach is to **review the strategy** with clients on an ongoing basis and to make changes to the asset allocation along the way, or to build in a feature (particularly with pensions) whereby the asset allocation automatically changes and reduces the risk, as the client draws closer to their retirement age.

Asset Allocation & Risk Explained
We have produced a more detailed fact-file on our Investment Management Process which is available on request.

There is no substitute for discussing your own personal financial issues with a qualified adviser who can help you come to the correct decisions, taking all of your circumstances into account.

If you have any questions or need an independent review of your financial planning or pension arrangements, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.

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