

A safer bet?

If you want to invest, just how reliable are 'With Profits' investments? Or is it worth taking more risk, asks financial planner Ray Prince

If you bought an investment policy, such as an endowment or pension, in the 1980 or 1990s, it is possible your money was invested in a 'with profits' fund.

The concept of the 'with profits' policy was legitimate. Your money would not be directly exposed to the stock market. Instead, your plan would earn a bonus each year. This would be largely based on the returns that your provider had achieved and the prospects for future years.

The pension or endowment provider would attach the bonus to your plan (known as a reversionary bonus), which could not be removed. At the same time, in years of good fund growth, they would retain a portion of the profits, which could be used in future years to pay a bonus when performance was poor, or even negative.

This 'smoothing' effect attracted a lot of investors as it was a way in which they could benefit from investing in the stock market without directly taking the risks.

When the policy matured the provider would usually pay a loyalty bonus (known as a terminal bonus). Although not guaranteed, this bonus often had the effect of increasing the returns by a considerable amount, especially late in the 1980s (many endowment companies were paying annual bonuses of up to nine per cent, with the overall return being 15 per cent when the terminal bonuses was included).

How it works

It's important to understand how the funds work. Even though the provider may pay you an annual bonus, it's highly unlikely that the fund itself will be achieving the same amount

of return, as it will usually be higher or lower. Your money is invested across different 'asset classes':

- equities (shares)
- bonds
- property
- cash.

Since 2000, many companies have reduced their exposure to equities, therefore reducing their growth prospects. The typical fund has gone from 65 per cent equities exposure to 30 per cent. In 2005 the equities percentages were (for pension funds):

- Clerical Medical, 34.4 per cent
- Friends Provident, 29.1 per cent
- Standard Life, 19.5 per cent
- Equitable Life, four per cent.

Also, let's consider the fall in the bonus rates. We mentioned earlier the nine per cent bonus rates. What you also have to consider is the real rate of return. In 1990, the rate of inflation reached 9.5 per cent, so with an overall return of 13 per cent the real rate is the difference, being 3.5 per cent.

'With profits' companies are now paying annual bonuses of zero to four per cent. There's also been a fall in terminal bonuses. We believe that a number of 'with profits' funds are not satisfying the objectives they were originally designed for.

So what's next?

Step 1

Find out what bonuses your provider is paying, along with the percentage exposure they have to equities. Also check what the charges are on the plan. If they are paying a bonus of four per cent, but the overall annual charges are four per cent (which is possible when

you factor in all the charges), then you are losing money in real terms.

Step 2

Ask for a transfer value (for a pension) or cash in value. You also need to check if the provider will apply a 'Market Value Reduction', which is applied to protect the existing investors in the fund. If they do apply one, it will mean you will be offered a lower amount than its current value.

Step 3

Assess your attitude to risk. There's a number of tools that you can use for this. The results will help you decide what exposure to shares you will be comfortable with.

Step 4

Choose the most suitable investment portfolio in line with your attitude to risk. Let's look

at some examples with their annual returns from 1988 to 2005:

- 100 per cent Fixed Interest, 7.1 per cent pa
- 20 per cent Equity 80 per cent FI, 8.0 per cent
- 40 per cent Equity, 60 per cent FI, 8.9 per cent
- 60 per cent Equity, 40 per cent FI, 9.6 per cent
- 80 per cent Equity, 20 per cent FI, 10.3 per cent
- 100 per cent Equity, 10.8 per cent.

(Source: *Dimensional Matrix 2006 Year Book.*)

The FTSE All-Share, which covers 97 per cent of the market, has returned 10.8 per cent pa during this period. As you can see, increasing exposure to risk brings higher returns (and more risk), but the main advantage is that you will benefit from the returns immediately as none of them will be carried forward, as is the case with 'with profits'.

Time for action

Reviewing your investments should be a priority. Many people make the mistake of thinking that the tax wrapper they have (such as a pension) is the investment. The funds your money is invested into is key to ensuring you achieve the returns you desire.

Take the time to go through your investment portfolio, especially if you have money in 'with profits' funds. Don't underestimate the importance of doing this, as it will be too late when the policy matures or you are due to receive the proceeds. But take note. Past performance

is not a guide to future performance. The value of your investments may fall as well as rise.

Finding out more

To learn more about how to invest into your pension planning, you can request a free copy of Rutherford Wilkinson's latest CD: *How To Avoid The Three Most Common Retirement Planning Mistakes*. Just call Catherine Lowes on 0191 217 3340 quoting reference DT and a copy will be posted to you. [DT](#)

About the author



Ray Prince

is an Independent Financial Planner with Rutherford Wilkinson plc, and helps dentists get the best deals on mortgages, protection and investments, as well as helping them achieve their financial objectives. Rutherford Wilkinson plc is authorised and regulated by the Financial Services Authority (FSA).

You can contact him on 0191 2173340 or on email ray.prince@rwplc.co.uk

