

Introduction

With Profit Bonds were a very popular form of investment and over the last three decades many hundreds of millions of pounds were invested with the various life offices that offered such bonds.

Their popularity has **not only waned but has turned into reverse**, however, as the long bear market of 2000 to 2003 took its toll and product providers were forced to slash bonus payments, introduce Large Market Value Reductions and, in many cases, withdraw from the market and close their funds.

Many investors in With Profit Bonds now find themselves in the **unenviable position of holding an investment that is not growing in value**, with no real prospect that the situation will change, and yet they will suffer a heavy penalty if they attempt to move their investment elsewhere.

Holders of existing With Profit Bonds are encouraged to go to their advisers **to ask for a review of their bonds** to see if they are still a suitable investment for them or whether their money should be reinvested elsewhere.

Some With Profit Bonds, however, continue to perform well and the predictions of the complete death of such bonds have been exaggerated. There is **now a small but noticeable increase in the number of new investments being made** into such bonds with a small number of product providers who have shown that they can manage their With Profit funds successfully.

After what can only be described as a dark age for with profits bonuses, the latest announcements are at least something to rekindle interest.

Guy Vanner, AKG Actuaries & Consultants Ltd
writing in *New Model Adviser* 26 February 2007

Far from the with profits process being completely discredited, **one of the fastest growing types of annuity** is now the with profits annuity.

The Tax Treatment

A With Profit Bond is a **form of life assurance bond** and the tax treatment of these is dealt with in some detail in our Guide: *Life Assurance Bonds*.

The Underlying Investments

A With Profit Bond invests in a wide range of assets such as UK and overseas company shares, gilts and other fixed interest securities, index-linked stocks and commercial property.

In view of this the bond **should outperform deposit-based investments over the longer term**.

Such a portfolio of investments would normally be considered as a moderate risk investment, depending on the percentage held in equities (ie stocks and shares).

However, the main attraction of a With Profit Bond is that **the value of the investment should grow steadily each year** rather than exhibit the volatility of many investments. This is because the growth is achieved by means of bonuses which the life office declares each year rather than being related directly to stocks and shares etc.

This feature changes the nature of a With Profit Bond to a **cautious to moderate risk investment**.

The widespread use of Market Value Reductions in exceptionally difficult market conditions has shown, however, that **the value of such bonds can fall** and that this can create great difficulty for people who need to access their capital at such times.

The Bonuses Which Are Added

There are two forms of bonus payments that can be added to a With Profit Bond. All With Profit Bonds will have an annual bonus that is declared by the life office.

Currently a **typical annual bonus would be around 1.50% to 3.5%** but clients need to be aware that future bonus levels are not guaranteed.

The initial bonus level quoted by the life office, whilst a factor to be considered, has also to be viewed in conjunction with the general level of performance that the life office has achieved over many years with its With Profit Fund.

The general strength of the life office is another very important factor in making sure that future bonus levels can remain competitive.

In addition to the annual bonus **some life offices also give a terminal bonus**. Any figures quoted for such terminal bonuses should be largely ignored as they are much more susceptible to current market conditions.

Nevertheless, if a good performing life office is chosen this could be an additional benefit to receive on final encashment of the bond.

Taking an 'Income' From the Bond

Automatic regular withdrawals of capital can be set up on a monthly, half yearly or annual basis. If these are within the level of growth that is being achieved on the bond, **these regular withdrawals of capital will effectively provide 'income'**.

At present we would not recommend that regular withdrawals be set up in excess of 3.0% pa.

You can **amend the level of such withdrawals at any time**, to suit current income needs irrespective of the actual growth of the bond. There is therefore a known 'income' at any time, the level of which is fully controlled by you.

Provided that the amount of capital withdrawn is less than the bonuses which have been added to the bond the capital value will remain intact, so long as a Market Value Adjustment is not imposed.

It is for this reason that **'income' should, where possible, be delayed until any initial charges on the bond have been covered by the addition of bonuses** or the capital value may suffer.

The With Profit Bond is particularly useful for clients who have some years to go before retirement and **can build up bonus values before taking a regular income in retirement**.

Where They Fit In

A With Profit Bond **cannot guarantee a particular level of return**, as bonuses paid by life offices are dependent on the returns which they receive on their investments. Unlike a unit trust or other unit linked investment, however, the bonuses once added cannot be taken away (except by the imposition of a Market Value Reduction).

A With Profit Bond is therefore **higher risk than a deposit account** but is **lower risk than a typical equity investment** and should be considered as a cautious to moderate risk investment. It is not a replacement for a building society or bank deposit account, or a National Savings account, but **it has the potential to provide a higher return than such accounts** over the longer term.

As with any long term investment, a period of at least five years should be envisaged for a With Profit Bond before any large planned capital withdrawals are required. It is possible to access your money in an emergency but **withdrawals in the early years should be expected to result in a loss of part of the capital**.

It is, however, possible to set up regular withdrawals of capital (usually up to a maximum of 5% pa) from the bond once the initial charge is covered. **Such withdrawals will effectively provide an 'income' so long as they are realistic** bearing in mind current bonus levels.

The Security of Your Bond


As life assurance companies issue such bonds, there is usually **no question of there being any difficulty in realising the investment**. Most bonds do, however, have redemption penalties during the first five years, although these do not normally apply on death.


On your death, the current value of the bond is available to your estate.

Investments into With Profit Bonds taken out via independent financial advisers (IFAs) are **protected by the Financial Services Compensation Scheme (FSCS)**, which provides compensation of 100% of losses up to £30,000 and for 90% of the next £20,000 making a maximum payment of £48,000. Investors in UK authorised insurance companies are **further covered by the Policyholders Protection Act**, which gives 90% compensation without limit.

The Most Competitive Bonds

We recommend the most competitive With Profit Bonds to our clients based on a number of tools at our disposal together with ongoing research.

 We use **Defaqto's research software Aequos Engage**. This is product research and analysis software which is built on the latest technology and updated daily with real-time data. Established in 1994, Defaqto uses the analytical skills and industry expertise of its dedicated research team, to provide innovative solutions designed to assist us as we strive to select the most effective products for our clients. Defaqto offers respected expert commentary via monthly market reports and is the data collection agent for the FSA's Comparative Tables Service.

 One of the most important factors when choosing a With Profit Bond is **the underlying strength of the product provider** and we rely on agencies such as the internationally recognised Standard & Poor's to provide such information to us. The strength of the product provider is far **more important than the current bonus level**, or the bonus history of the product provider, as this can be manipulated, particularly in the short term.

Market Value Reduction

You need to be aware that when you wish to encash part, or all, of your investment in a With Profit Bond the product provider may apply a Market Value Reduction (MVR). **The usual reason for applying an MVR is if the actual investment performance of the fund has not matched the bonuses declared**. The application of an MVR is done in order to prevent medium to long-term investors remaining within the fund from being disadvantaged by other investors who encash their investments when the underlying securities would have to be sold at a loss.

Each product provider will have their own rules for applying an MVR. In practice **most product providers guarantee not to apply an MVR on death, or on automatic withdrawals within certain limits.** This is particularly of benefit to retired people who wish to use their With Profit Bond to produce retirement 'income'.

Some product providers guarantee that no MVR will be applied if the bond is fully encashed on a certain policy anniversary, usually after 10 years.

With Profit Bond Reviews

The Financial Services Authority (FSA) has compiled 10 questions that we, as advisers, should consider when reviewing the suitability of existing With Profits investments.

We produce **a written review which seeks to answer these questions.** If you **would like a review** of your With Profit Bond please contact us and we will be pleased to inform you of the cost of providing such a review.

The review covers the following questions:

- A** **Type of policy** - What particular With Profit Fund are you invested in and is this an 'open' or 'closed' fund? Not all closed funds provide poor future prospects but some have reduced the equity (ie stocks and shares) content too much and future growth prospects are extremely limited.
- A** **Product Provider** – What is our view of the product provider and particularly their strength as measured by outside agencies?
- A** **Investment objective** - Does the investment still serve the purpose it was taken out for, or has your investment objective changed since then? How has the policy performed to date? What has been the actual increase in surrender value in the last 12 months? What has been the 'internal rate of return' that the bond has achieved since you have held it?
- A** **Timescale** - How long is left before you want to cash-in the investment? Are you looking to invest over the short, medium or long term?
- A** **Attitude to risk** - Does the asset allocation (ie how much is invested in equities, bonds, that is fixed interest investments, property and cash) match your risk profile? Is this likely to be the case in the foreseeable future? For example, you may be a very cautious person but may find that your With profit Bond is no longer a cautious investment due to having a high terminal bonus that could be reduced or removed at any time.
- A** **Tax position** - If the investment performance indicates encashment of the fund should be considered, would this lead to a chargeable gain to income tax now or at some point in the future? Is it possible to avoid this in any way?

If encashment of the bond is likely to involve you in a charge to higher rate tax there may be ways of reducing the tax charge or putting it into the next tax year if that would be to your benefit.

It would be important to know whether you are using the bond to provide 'income', that is making monthly withdrawals as these are not taxable at the time up to 5% pa. If you are 65 or over there is also the question of the Age Allowance income cap to be considered.

- A** **Guarantees and options lost on surrender** - What is included in the policy which would be lost on surrender? What life assurance benefits would be lost if the policy is cancelled? How important are these benefits to you? For example, some With Profit Bond holders may receive a demutualisation windfall at a future date.
- A** **MVR-free exit points** - Are there any MVR-free dates at which it will be possible to leave without penalty? Could you drip money out of the fund instead, perhaps by taking MVR-free regular withdrawals? This may not currently be an issue for you as your product provider may not currently be applying an MVR.
- A** **Asset mix** - Would the asset mix on a replacement policy better match your risk profile and investment objectives both now and in the future? How important is it for you to have control over the asset mix?
- A** **Future performance potential** - What are the prospects for the fund moving forward, taking into account any known changes to the ownership of the fund? To what extent are the prospects for investing in equities restricted? For example, what returns is the bond provider actually making on the With Profits Fund as these have to be fed through into bonuses (either annual but more likely terminal) at some stage.
- A** **Cost of surrender** - What penalties and MVR's would be levied on surrender?
- A** **Cost of the replacement policy** - What set-up costs would be incurred by taking out a new policy? Is it possible to simply effect a free switch to a different fund(s) with the same bond provider? Where we do recommend the termination of an existing With Profit Bond we will offer to set up any replacement investment on advantageous terms.

Risk Factors

An investment into a With Profit Bond is intended as a long-term investment. Where past performance is mentioned please note that the past is not necessarily a guide to future performance.

The return on a With Profit Bond depends on the profits made by the life office and on its policy as to their distribution (whether on early encashment or in adverse market conditions or other circumstances).

Bonuses come from profits which are yet to be earned, there is therefore no guarantee that current rates will be maintained beyond any special offer period.

If you surrender the contract, especially during the early years, you may get back less than the amount originally invested.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether an investment in commodities is suitable for you, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For Further Info

If you would like to receive a With Profit Bond Review for an existing bond that you already own, or receive advice on whether a With Profit Bond would be a suitable investment for you, please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**

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