



fresh
perspectives
on
with-profits



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Miles Hendy offers his views on the key points to consider
when reviewing with-profits policies.
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The Great Wall of China cannot be seen from the moon. Apparently it's the equivalent to looking at a hair from two miles away. But the urban legend that it can be seen is so widely repeated that many readers may well be surprised to learn that it's not true.

Similarly there are assumptions relating to with-profits policies that are repeatedly stated as facts by journalists and media-connected IFAs that are either misleading or just plain wrong.

With-profits has a veneer of complexity that has led to this widespread misunderstanding. I think the confusion relates to people mistakenly believing that the policy is worth what it states on paper. However every policy has two values, the most important being the true value of the savings plan known as the policy's 'asset share'. This figure represents the actual investment return experienced on the money invested in the fund. The other value, the one that appears on the annual statement, is only worth this amount on a guarantee date if the asset share is equal to or less than the statement value. If the asset share is worth more than the policy value a terminal bonus will be paid and if the asset share is worth less than a Market Value Reduction (MVR) will reduce the pay-out to the asset share (unless it's cashed in on a guarantee date). Understanding the role of the asset share and challenging some firmly held assumptions is the key to understanding with-profits.

Assumption 1: Market Value Reductions are an exit penalty

Reality: The MVR is simply a mechanism of giving the policyholder his asset share. It works on the basis that if you want your money back at any time other than a policy guarantee date, you should not expect to get back a figure that is more than your investment has made in the fund.

Policyholders should not be led to believe that getting their asset share is somehow penalising them. They instead need to be encouraged to evaluate the guaranteed value on the guarantee date and how this might represent a significant windfall.

Assumption 2: You should wait for a Market Value Reduction to be removed before moving money out

Reality: If the guaranteed value is, for example, 5% higher than the asset share but the policyholder has to wait 10 years before

they can actually get this guaranteed value, what is the opportunity cost of staying in the fund for a further 10 years compared to investing the money in an alternative strategy?

Assumption 3: A 0% bonus rate is a worse return than cash

Reality: It might be the case that the value already guaranteed on the guarantee date through bonuses already added is worth much more than you could hope to achieve if you reinvested your asset share elsewhere. If the policy already has a guaranteed value on maturity or on an MVR-free date that is greater than the policyholder's anticipated asset share, why should the insurance company increase the guaranteed value further by adding more bonuses?

Assumption 4: Investors should exit their with-profits fund if the life office is financially weak.

Reality: The financial weakness of the company may be tolerable if the policyholder is enjoying a guarantee on their policy, the value of which made the company weak in the first place.

Assumption 5: You should always keep a policy with a Guaranteed Annuity Rate

Reality: The Guaranteed Annuity Rate has to be applied against a fund value which may be significantly lower than the policyholder might otherwise expect if they transferred. This could happen through the company adding no bonuses and investing heavily in gilts and cash over a long period. It's important to compare the guaranteed pension payable based on the guaranteed fund against a projected return in an alternative plan using a stochastic modelling tool and reach an informed view on the value of the guarantee.

Assumption 6: With-profits funds are managed to maximise returns

Reality: Where guarantees have been generous historically investment returns can be compromised by the actuary moving money into cautious assets. This risk management process can lead to insurance companies selling equities at the bottom of the market and buying them back later at a more expensive price. The lost value of this process is implied by the low return of many with-profits funds in 2009 compared to the average cautious managed unit trust. If the

policyholder has guarantees of negligible value but has investment prospects restricted due to this process, even cautious policyholders should consider alternatives.

Assumption 7: A with-profits bond MVR-free date is a 'get out of jail free card'

Reality: The with-profits bond policyholder may be in a decent fund and may not feel 'imprisoned' by it. I prefer the analogy of the MVR-free date being like a lottery ticket worth potentially thousands of pounds which will be lost if you don't claim on the ticket. Regardless of the quality of the fund and the policyholder's fondness for the investment, any investor whose asset share is less than the guaranteed value can enjoy a windfall by cashing in on this date.

Assumption 8: Insurance companies will adequately explain guarantees to policyholders

Reality: In May 2007 the FSA issued an Insurance Sector Briefing telling insurance companies to improve the way they communicated to policyholders on with-profits guarantees. Some of the 'Examples of Less Good Features' (sic) have been seen on statements issued in 2010. The value of MVR-free dates to policyholders often runs into thousands of pounds per policy and as this value can only be claimed by cashing in it's understandable that insurance companies are not making it easy for policyholders to understand. We've written to the FSA asking them to issue a directive to insurance companies on how to communicate these guarantees more clearly. Meanwhile it requires IFAs to be proactive in checking policy conditions.

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