Savings plan meltdown

Millions of people face poor returns on their savings but don't know there's a problem. Could you be one of them?

Chris Read, left, faced a stark choice: leave his £100,000 pension fund to languish in a Pearl with-profits policy that wasn't making money, or pay a transfer penalty of almost £4,000 to get out.

Chris weighed up the evidence with his financial adviser. He knew that his Pearl pension fund hadn't made him any money in three years. More importantly, he thought it wasn't likely to in the future. Chris bit the bullet and got out. He made the right move – his new investments are up 11 per cent this year alone, which more than makes up for the Pearl penalty. Chris says: 'The £4,000 transfer penalty is daylight robbery in my opinion, but no more so than getting no returns on a pension fund that's supposed to support me in my old age.'

Up to ten million people with money invested in with-profits funds face a similar decision to Chris – it's just that many don't know it yet. It isn't only pensions that are affected, either. You may be in the same boat if you have an endowment policy or a savings plan. It's important that you find out whether you have money invested in with-profits funds, and check whether they're still right for you.

Is my savings policy affected?

To find out whether you have a with-profits policy, first ask yourself what investments you have and when you bought them. If you took out an endowment policy to back a mortgage in the late 1980s or early 1990s, or started a personal pension at around this time, it's likely that you have money invested in with-profits. You may also have a 'savings plan' or 'savings bond' that isn't a building society-type investment. In this case there's a chance it could be with-profits.

The acid test is whether you get a statement each year with a 'bonus rate' on it. If yes, then it's a with-profits policy. If you're not sure, there's no harm checking with the company that runs the policy.

Jargon buster

Common terms used by with-profits savings plan providers

■ **ANNUAL BONUS** A bonus that is allocated to a policy each year. Once paid, it can't be taken back as long as you keep the policy for its term. It's sometimes called a reversionary bonus.

■ **ASSET ALLOCATION** How the money in a with-profits fund is split between bonds, shares and property investments.

■ **CLOSED FUND** A with-profits savings fund that has been closed to new business or is not being actively marketed by the provider.

■ **MARKET VALUE ADJUSTER (MVA)** Technical name for the penalty that insurers can charge if you cash in your policy early.

■ **MARKET VALUE REDUCTION (MVR)** Another name for market value adjuster.

■ **REVERSIONARY BONUS** Another name for an annual bonus which is allocated to a policy each year.

■ **SMOOTHING** The name for the process in which insurers hold back some of the investment returns earned in good years so they can pay out extra in the bad years.

■ **TERMINAL BONUS** A bonus that is paid when a policy reaches its maturity date. It is based on overall performance over the term of the policy and can be worth up to around two thirds of the total return received.

PHOTOGRAPHY MARC HILL, NEWS TEAM INTERNATIONAL

A NO-WIN SITUATION

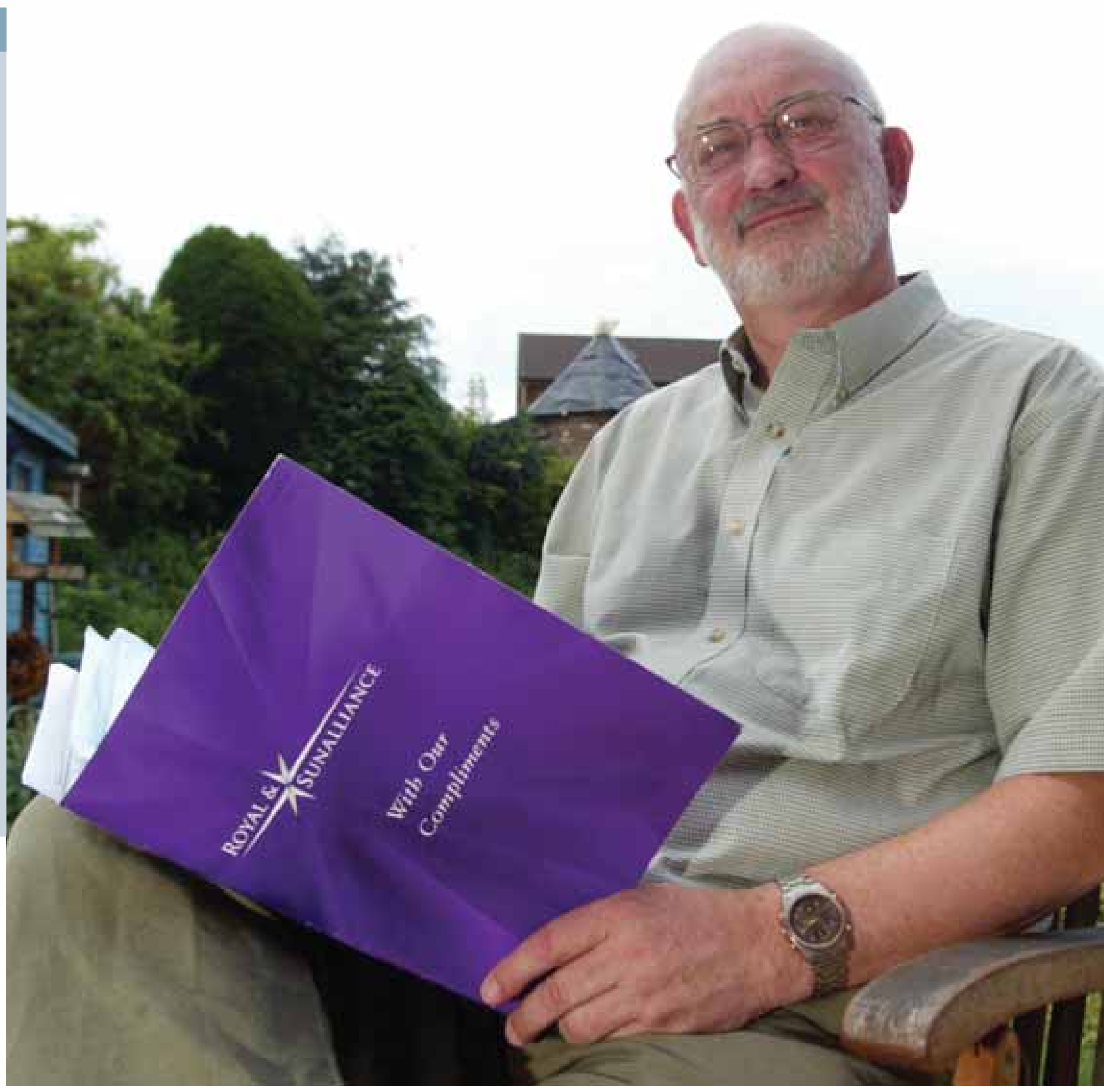
Frank Ledbury

60, retired electrical engineer

In 2000 Frank Ledbury was advised to put the tax-free cash from his pension into with-profits savings bonds. They were sold as safe investments with the potential to grow in future, even if he took an income from them.

But his bonds have been hit by the stock market falls of 2001 and 2002 and he has been trapped by penalties. Frank's £75,000 Royal & SunAlliance bond is now worth £62,000. But if he wanted to cash it in, he'd get only £50,000 after paying a £12,000 penalty.

Frank's new financial adviser has said that if he waits until the bond's tenth anniversary in 2010, he can leave penalty-free. Frank says: 'It isn't much of a choice. Pay £12,000 or wait four years to get my money out.' Frank has made the tough decision to stick with it.



How does with-profits work?

With-profits funds were meant to be the ideal way to invest to get better returns than putting cash in the bank, but without the full risks of investing in stocks and shares.

Your money is invested in a mixture of shares, property, bonds and cash. With-profits funds smooth returns by holding back some of the return in good years to pay more than you earned in bad years.

Your return comes in the form of bonuses. There are two types of bonus – annual and terminal. The annual bonus is added to your policy every year and can't be taken away, provided you keep the policy going for its term. The terminal bonus is added at the end of the life of the policy and is supposed to represent investment returns over the life of the policy.

With-profits policies were sold on the basis that they were steady investments – ideal for an endowment policy linked to your mortgage, or a pension. Up to ten million people have around £400bn invested in with-profits policies for these reasons.

So what went wrong?

The theory of with-profits isn't the problem. It's just that increasingly these policies aren't doing what they originally set out to do. With-profits funds were hit badly by the stock market falls from 2000 to 2002. Annual bonuses were cut, so customers saw slowing growth. Worse still, companies introduced exit penalties for customers who wanted to take their money out. These penalties are set at the company's discretion – it decides whether it wants to charge a penalty and how much it will be. Penalties can be huge. For example, Frank Ledbury (above) has been quoted a 19 per cent penalty to leave his Royal & SunAlliance bond.

The Financial Services Authority (FSA) tightened the regulation of with-profits funds after the Equitable Life scandal which came to a head in 2000, when the insurer couldn't afford to meet the promises it had made in its with-profits fund. The FSA introduced regulations to ensure that with-profits providers should put money aside to meet the commitments made in policies. But to achieve this, many insurers sold shares and moved into safer investments, such as government bonds.

'The £4,000 transfer penalty is daylight robbery in my opinion'

Safer investments are more reliable but it means that many with-profits funds are not doing what they set out to do, which is to provide a reasonably safe way of getting a stock market-linked return. In the long term we'd expect funds with plenty of shares and property in them to do better than those invested mostly in government bonds. Some funds, such as National Provident Life and Alba Life, now contain

You need to find out information on how well your insurer is doing

Badly performing with-profits funds have regularly hit the headlines

little in the way of shares and property. Policyholders in these funds are tied into low returns.

The outlook has improved slightly. The recent three years of stock-market growth is finally feeding through into lower penalties. And not all with-profits policies are doing badly. Legal & General, Prudential and Wesleyan Assurance are among the companies whose funds are performing well because they still have most of their money in shares and property.

Should I stay or should I go?

The decision as to whether you should keep or leave a with-profits policy is often finely balanced so it's important that you take professional advice.

You need to find out the following information on how well your insurer is doing and the specifics of your policy to make the right decision.

The first four facts you should be able to find out yourself, either from information you've already been sent by your insurer or by contacting it. You may need to leave the last two to your adviser.

- **What your with-profits fund is currently invested in** You need to know the current split between shares, property and bonds. The healthiest with-profits funds hold around 70 per cent in shares and property, so use that as a benchmark. If your fund has less than 25 per cent in shares and property, you're almost guaranteed low returns.
- **Whether you would have to pay an exit penalty and, if so, how much** Penalties are likely to be highest in the least healthy funds.
- **The amount of the annual bonus currently being paid** A zero annual bonus rate means your policy isn't growing which means you're reliant for a decent return on whatever your insurer chooses to pay you as a terminal bonus.
- **How long your policy has left to run** If you leave a with-profits plan before the term ends, you'll lose your terminal bonus, which can make up a large part of your return. Think carefully about whether you'd make enough from your new investments to compensate for this.
- **Whether there are any guarantees in your policy** Some policies have valuable guarantees, such as a promise that you can get out penalty-free after ten years, a minimum payout or rate of return on your contributions, or a guaranteed annuity rate for pension policies.
- **Whether the with-profits fund is closed to new business** Closed funds tend to have lower returns on average than those that are taking new business because, on average, they have fewer shares and less property in them. It's not as simple as saying all open funds are good, all closed funds are bad, but it is a factor that you should take into account.

Take whatever you find out along with our checklist, below, to an independent financial adviser (IFA). With-profits contracts are also very confusing, so it's important that an expert scrutinises the small print – especially for any guarantees that may be lurking.

Closed funds tend to have lower returns on average

Checklist

Deciding whether to stick with a with-profits policy is complex, so take independent financial advice

When taking financial advice it pays to be well informed. If you ask your adviser the right questions, or find out some of the answers beforehand, you're likely to make the right decision.

Use these questions to help you decide whether to keep or leave the policy:

- Do I have a with-profits policy?
- Does the policy still meet my needs?
- What percentage of the with-profits fund is invested in shares and property?
- What are the prospects for this fund going forward?
- What costs and penalties would be levied if I transfer?
- Is it worth me leaving the policy in the light of any terminal bonus I'd lose?
- Has the fund been closed to new business?
- Is there any point at which I could get out penalty-free?
- Does the fund have any other useful guarantees?

Finding a good adviser is easier said than done. IFA Promotion offers a useful online search facility on its website www.unbiased.co.uk that allows you to search for an IFA with savings and investment qualifications. Next month we'll be publishing an article on financial advice, which will include help on finding a good financial adviser.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