

The AC Financial 2005 'With Profit' Report

Published by AC Financial Ltd

With Profit Bonds have had a difficult few years – Bonus rates have fallen drastically and in some cases have disappeared altogether!

In addition:-

- Many funds have closed to new business – how will this affect the investor?
- Reserves have fallen drastically – limiting the ability to pay bonuses
- Many funds have been forced to invest more cautiously into fixed interest securities, bonds and cash. Consequently, having suffered from the past stock market falls (when they may have held a high exposure), these funds may not fully benefit from any future stock market recovery.
- Investors wishing to withdraw their capital are often faced with a Market Value Reduction (MVR) that reduces the value of their investment and deters them from leaving.

If you have investments in this sector we believe that this document will help you to decide whether you should remain with your investment or seek an alternative.

Also included - how the effects of the MVR may be reduced.

AC Financial Ltd

2 Caxton Street, Westminster, London SW1H 0QE

Telephone 0800 731 3080 Fax 020 7593 5621 www.ac-financial.com

Registered Office – Devonshire House, 60 Goswell Rd, London EC1N 7AD

Registered in England No 3895570

AC Financial Ltd is authorised and regulated by the Financial Services Authority

The AC Financial 2005 'With Profit' Report

Background

Having been amongst the cautious investors favourite investments during the 1990's With Profit Bonds have had a difficult time of late. Investors, have seen withering annual bonus rates, and, in many cases, huge Market Value Reductions (MVR's) that have acted as a deterrent against encashing and investing elsewhere. In the worst case scenario's, funds have closed to new business and reduced bonuses considerably, or stopped payment altogether!

The question is?..... What should investors do? - Should they ignore the present position in the hope that things will improve?..... Would they be better off switching investment and accepting an MVR?..... What do other lower risk alternative investments offer?

The answer as usual is in many parts and depends on the reason you invested into this type of investment in the first place. It might be helpful to look at the history of these funds and consider the up to date position before contemplating other actions.

History

In the early nineties there were a few providers offering lump sum investors access to their 'With Profit Funds' that had traditionally serviced their longer term endowment policy investors. This was a novel approach as the longer-term endowment policyholders were, in effect enabling potentially shorter- term investors to benefit from investment returns that were smoothed. This meant that investors were able to enjoy the growth benefits of stock market investment whilst not suffering from the almost daily gyrations associated with this type of investment.

In the late nineties many With Profit funds were asset rich with bulging free asset ratios (a measure of the excess capital over liabilities) enabling them to pay attractive bonuses and attract even higher numbers of new investors. In 2001 a record £14.9Billion of new investors money went into With Profit Bonds- Source: Association of British Assurers 2002.

2000-2002 'Bear' Stock Market

The stock market bear market started in 2000, and unprecedented in recent history, carried on to 2001 and 2002 – three continuous years of losses! These losses, added to the high bonuses being paid out by many WP Funds, provided a huge drain on reserves. The Financial Services Authority (FSA) were showing concern and tightened the rules

relating to Life Company assets and reserves ratio's in an attempt to halt another 'Equitable Life' situation. This meant that liabilities would be more closely covered by assets and that when reserves were low the assets acting as cover should be high quality low risk investments such as government gilts or other fixed interest instruments.

These lower risk investments have not traditionally provided the same scope for long term growth as equities have, and thus, investors in these financially weaker funds may not now be achieving the returns that they might expect.

The AC Financial 2005 'With Profit' Report

The problems facing With Profit Bonds today

- **Low fund reserves** – if this is the case the fund will be invested more cautiously with perhaps a higher exposure to cash and bonds than is appropriate for long-term growth potential. This could lead to poor investment returns as in the longer term, equities and property tend to perform better.
- **Low bonus rates** – this is usually associated with low reserves and/or poor returns. The worry is, that when associated with low reserves, the return is likely to be lower in the future for the reasons stated in the previous point.
- **Market Value Reductions** – In the past these were used as a quick fix to deter investors selling at a figure that was actually higher than their share of the fund. Once markets bounced back the MVR was reduced and eventually completely removed. Unfortunately, the recent bear market has continued longer than in recent history and our fear is that the MVR values now being quoted are in fact the true fund values. We say this because we have noticed a marked difference in MVR levels between investors that had invested quite close to each other chronologically, but at significantly different stock market levels. **In this case the whole point of investing in a With Profit Fund is lost, and this type of investment now provides the worst of all worlds – a true reflection of a lower value in a market downturn, but potentially without the benefit of the full value of any market upturn.** A clear case of heads you lose and tails the reserves wins! With this background the investor must consider whether this type of investment is likely to provide a competitive return compared to funds that are more transparent but with a similar underlying investment spread.
- **Closed Funds** – This has to be the greatest concern as investors may be virtually locked in to a sinking ship! Because the fund is not accepting new business it will generally be invested to closely match liabilities and assets in the most efficient way. This generally involves a high level of Bonds/Cash and other low risk/reward investments. As these funds are not competing for new investors, the bonuses tend to be lower than their contemporaries, and in the worst cases funds have completely stopped paying bonuses. Investors are often deterred from selling because of high MVR's.

Summary

Many With Profit investors are concerned about the lack of transparency surrounding the investment and payout policy of their providers. The fact that the investor cannot know for sure, what the current true value of their investment is, also causes concern. We are often asked when the MVR's will be removed – our view now is that the MVR, or lack of it, is representative of the actual fund value from the time the commenced investment. This would perhaps explain providers now saying that MVR's are on a case-by-case basis. **This is not how WP Bonds were meant to work, or how they were promoted.**

4 The AC Financial 2005 'With Profit' Report

What should you do?

This will depend upon your own circumstances, the current make up of your fund, and your investment period. There are two circumstances that deserve special comment, where in many cases investors may consider staying put.

1. If your Bond has a guaranteed MVR free anniversary date – these were often 5 – 10 years after the investment start date. Providing the date is not too far away, you may wish to consider holding on. Obviously, you must weight up the current bonuses being paid against the MVR currently being applied to ascertain the value of remaining in the fund. You should be aware that some providers will reduce the annual bonus or increase the annual charge where there is a guarantee of future return.
2. If you are in an older age group, and/or are in ill health, your estate may well be better off with your holding on, as most Bonds pay out the full value on death and do not impose an MVR. In fact, on death most providers pay out 101% of your funds value.

In any event the future will be determined by one of the following circumstances and we provide our prediction as to what might result.

Equity investment markets substantially recover

Two possible concerns exist here :1) Is your fund currently sufficiently invested in equities to take advantage of this? and 2) If it is, how much of the gain will be retained to bolster reserves for future generations of With Profits investors. The FTSE100 Index rise in the tax year ending April 5th 2004 was a substantial 22.5% :Source of raw data Standard & Poor's Micropal. As most WP Funds had some exposure to this gain, the bonuses paid out for the year ending 2004 should indicate the level of retention to reserves your fund is making. We would expect lower bonus trends to continue until reserves are adequately replenished.

Equity Investment Markets fall

In this result the fund behaviour will depend on the exposure to equities and the residual fund bond exposure investment. Often, bonds can perform well against equities particularly if the Bank of England is forced into reducing interest rates to bolster a failing economy. Thus, a fund that has been forced into holding an overweight exposure to bonds might benefit. If however the fund falls in value then what little bonuses are currently available will be threatened further.

Equity Investment Markets remain flat

This is possibly the worst of all scenario's as in these circumstances a listless fund would have no reason to increase bonuses and the fund will remain static with little prospect of any MVR's being removed.

The AC Financial 2005 'With Profit' Report

Reasons for remaining in a WP Bond

- A guaranteed MVR free anniversary should definitely be considered as amongst the best reasons for remaining in a fund. However, consideration should also be given to bonuses payable, future fund prospects, and the level being repaid at the anniversary. You should also enquire as to whether you are being disadvantaged by a higher fund charge, or a lower bonus rate than other investors who do not enjoy an MVR free guarantee. It makes little sense hanging on for a return that is less than is available elsewhere.
- Ill health is also a factor for remaining in a fund that has an MVR, particularly if you have a terminal illness. Many providers will pay out benefits of 101% of the fund value on death and will not impose an MVR.
- Your provider is amongst the most financially strong funds with a good record and a reasonable bonus rate. We would however, caution against having too high a % of your overall portfolio in with profit bonds as there are other more transparent funds available with a similar underlying investment strategy where you will be credited with 100% of the growth and income.

Reasons for selling

- **You belong to a closed fund and where bonuses are not being paid.** You should check the Free Asset Ratio and the current asset allocation. If these are unpromising you might seriously consider selling. If, for example, you need income, then it should be possible to obtain around 5% per annum net of tax from a distribution bond that has a similar asset mix to a well financed With Profit Fund. After 5 years this income could amount to 20-25% of your investment which should more than make up the MVR currently being applied. There will also be further potential for capital appreciation above the income.
- In our reasons for remaining in a WP Fund we point out that certain investors have a 5 or 10 year guarantee of a nil MVR. Also, investors escape the MVR on death and both of these type of investors will receive payouts far higher than the true worth of their investments. If neither of these apply to you then you should be aware that it is you, the investor remaining in the fund, that is paying for these attractive solutions for other investors.
- If your fund is now heavily invested into bonds and cash with little in equities and property this might not suit your investment profile. This might be particularly poignant for investors with a long time frame say 5-10 years or more, as in the longer term equities and property tends to out perform bonds and cash.

6 The AC Financial 2005 'With Profit' Report

How can AC Financial Help?

If you are considering replacing your existing investment with one with a similar underlying investment spread, but without the inherent problems that WP Funds are facing, we believe that 'Distribution Bonds' may well fit the bill.

In place of a bonus they currently pay a 'transparent' dividend of around 4-5% per annum net of basic rate tax. This is not subject to manipulation by the fund, as this dividend is the actual sum of the underlying dividends and interest earned by the portfolio. This income may be more, or less, than this in the future, and is not guaranteed. In the longer term however this dividend has been more stable than deposit rates. If income is not required, this dividend may be automatically reinvested to boost capital growth. In addition to the dividend, the fund has the potential for capital appreciation.

Reducing the effects of an MVR

For example, an investor who wishes to withdraw from a WP bond may be hesitant because an MVR of, say 12%, is being imposed. Our reinvestment terms will usually provide for a special extra allocation of around 4% to 7.50% immediately, depending upon the bond selected and the amount to be invested. When you add this to the annual dividend yield you may well find that any MVR is eradicated over the year. You would then be in a fund that has a diversified investment spread but is totally transparent, and where the return from your investment is not dependent upon arbitrary factors, as is now the case. Distribution bonds are significantly less volatile than equities as the following chart attests:

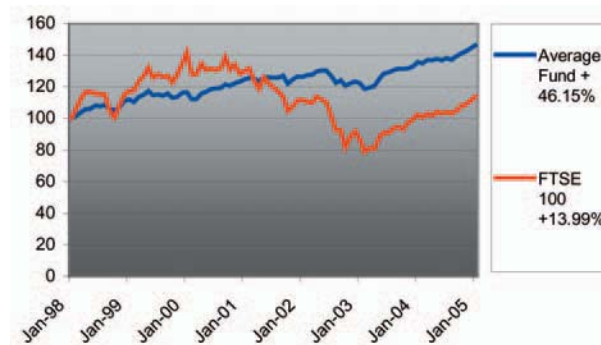


Chart illustrates the average of 3 distribution bonds. Basis is £100 invested over 7 years to 3/1/2005 with income reinvested - offer to offer. **Source: The AC Financial Distribution Bond Guide edition 4 – January 2005** Past performance is not necessarily a guide to future performance. Fund values and the income derived from them can fall as well as rise and accordingly you may not get back the full amount invested.

The AC Financial Distribution Guide is regularly published and includes special advantageous dealing terms. This can be accessed on the Internet at www.ac-financial.com alternatively, investors may telephone us on 020 7593 5620.

© AC Financial Ltd 2005 This document is subject to the laws of copyright and as such no part of this publication may be reproduced, or stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the express permission of AC Financial Ltd. This copyright will be vigorously enforced to the full extent of the law.