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With Profits Conundrum

With profits investments have traditionally been the route for many investors looking for returns higher than bank and building society accounts, but without the risk and volatility associated with investments such as shares.

With-profit funds are supposed to protect investors from falls in the stock market by 'smoothing' investment returns. The money paid into the policy is pooled with other policyholders' premiums and invested into a mixture of equities (shares), property, and lower-risk investments such as government securities (gilts). The 'smoothing' effect is achieved by holding back some of the investment returns on the fund in good years (known as the reserve), to be able to continue to pay out a bonus in years markets do not do so well.

For example, the investment manager might decide that the returns are likely to be 7% in the coming year, and so might then decide to distribute 5% to policyholders, keeping 2% in reserve. Next year, if returns are only 3%, they could use the 2% in reserve to still pay a 5% bonus. This should in theory, protect the policyholders from the short term volatility of the insurance company's fluctuating assets.

In addition, the insurance company holds back some of the investment gains, and then adds it to the policy at the maturity. At the conclusion of the policy, the company can then give an additional bonus called a terminal bonus.

In theory, this seems like a sound investment philosophy, and anybody who held a With Profits investment that matured prior to 2001 would agree with you. However, With Profits investments have hit the headlines over the last few years. When the markets fell in the wake of the technology boom in 2000, many of these funds had been holding a larger proportion of the fund in stocks and shares. They then had to switch to lower risk investments, to ensure the financial strength of the insurance company and to meet regulatory requirements. This change of strategy brought lower returns, so lower bonuses were applied to investors funds.

With Profits has received criticism - not only due to performance, but due to a mysterious investment practice and charging structure. How is the bonus calculated? How much of the returns will be held back in the reserve? What are the charges applying to a With Profits fund? These are questions that can be difficult to answer.

The misery was also compounded for policy holders thanks to the potential application of exit penalties for investors wishing to crystallise their holdings, called a Market Value Reduction (MVR). This is actually designed to ensure that investors receive a fair share of the fund if they leave with-profits funds early and to protect the interests of the continuing investors; but it has not helped the case for these investments.

Cases such as Equitable Life, who continued paying strong bonuses on their With Profits fund, whilst not ensuring they had retained enough capital in reserve to pay liabilities, have added to the bad press.

For many people, the questions remains – should I stay or should I go?

Investors who decide to cut and take their losses may feel this as a tempting option. However, there may be tax implications. Check to see if an MVR will be applied, and consider if there is an alternative investment which might offer inducements to make up the penalty. Also balance the potential for returns over your own attitude to investment risk. As ever, professional advice should be sought.

Penalties can be lower when policyholders have had their cash invested in the fund for less than a year or two, than for longer periods of, say, over 10 to 15 years.

Importantly, some funds have a penalty free date anniversary, often 5 years, when the funds can be cashed in without penalty. It would be prudent for anyone with a With Profits investment to enquire when this date occurred or if this applies to them.

You may decide to stick with your investment, in which case it would be prudent to check the level of equities held within the fund. If the proportion is low (perhaps less than 30%), then your potential for returns could be relatively low.

If all else fails you could always opt for a mix of the above strategy of staying with a proportion of the fund and drawing income from it. Many investment bonds allow for a free annual withdrawal of up to 7.5 per cent, but you should be careful that this does not trigger an income tax liability.

In general, it's really about individual choice, and no one strategy fits all. However the first stage for any investor is to enquire if they have an anniversary free date on the plan. Ultimately though, it is likely to be each person's own tax position, attitude to investment risk, the impact of the penalties on the plan and whether you have invested for income or growth that will guide your decision.

This article is for general information only. Remember past performance is not a guide to future performance and investments can go up as well as down. If you have any doubts in respect of your own personal circumstances you should a full review

with an independent financial adviser to get their help and remember, don't leave it to the last minute next year!

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