WITH PROFITS FUNDS

APRIL 2025

With Profits funds are a specific type of investment fund, with returns driven by the underlying investments as for a direct investment. However, an artificial "smoothing" process also operates with the aim of reducing the risk of the investment. This means that direct control over the underlying investments are lost, and the operation of the process and the charges involved can be difficult to clarify.

These funds were once very popular, but in recent years the opacity of the concept, and the imposition by life companies of early surrender penalties, has meant their popularity has sharply declined.

Here we look in more detail at these funds to explain how they work.

WITH PROFITS INVESTMENT FUNDS

The fundamental concept behind With Profits funds is “**smoothing**.” This means that in **good** years the insurance company **does not distribute all the fund gains** to policyholders. Rather it retains a certain percentage of gains to be distributed to policyholders in **bad** years. The underlying fund will invest in a combination of equities, bonds, property and cash.

The **financial strength** of the insurance company is important when evaluating With Profits funds. In theory, a life office with greater financial strength should be able to risk investing more heavily in equities and, therefore, over a long period of time should produce superior investment returns for its With Profit policyholders.

A weaker office will have to take care over investment strategy so as not to incur heavy losses and will therefore have less scope to deliver strong equity returns over the long term. This point rests, of course, solely on the long term out-performance of equities over other asset classes, which is in no way guaranteed.

STRUCTURE

With Profits funds are offered by **insurance companies**, both publicly quoted companies and mutual life offices (for which the fund also represents the company's capital). The investor's capital, together with that from the other With Profits policyholders' funds, is invested in a "**pooled**" fund.

The With Profits fund invests in cash, gilts/bonds, property and equities. The management of the With Profits fund is designed to maximise capital growth, and so the fund will ordinarily have a large proportion of the fund invested in equities. However, the actuaries also must take into account any liabilities, which will usually be covered by investment in more risk averse assets such as cash, bonds and property. If liabilities become too large, a higher proportion of the funds may be placed in these risk averse investments, which may reduce longer term investment performance. This occurred with many With Profits funds in previous decades, which had to sell equities at relatively low market levels in order to maintain their **Free Asset Ratios**, and as a result then became heavily invested in bonds.

The investment profits are, in the case of **mutual funds**, added to those derived from **other parts of the company** such as the underwriting of protection business. The **company actuary then decides** what portion of total profits is to be distributed to the investors and how much is retained by the company in the form of reserves. This **annual bonus** is then added to the investor's policy. **Once the bonus is distributed it can never be taken away**. Therefore, in theory, the result is a steady appreciation of the capital over the years.

The reserves can be called upon in future years to maintain the bonus rates, if the investment markets under perform. When the contract comes to an end the **undistributed reserves** are paid in the form of a terminal bonus. The **terminal bonus**, especially for older contracts, has become a **major portion of the eventual pay out**.

Mutual With Profits Fund policyholders are entitled to all the profits of the company, but are also **indirectly liable for the losses**.

METHOD OF INVESTMENT

With Profits funds can be bought through life policies direct from the insurance companies. The most common methods are **pension policies, endowment policies** or **single premium bonds**. There are tax planning aspects of these respective forms of investment that need to be considered carefully; please see our respective Research Notes on each area for further details.

Second hand endowment policies are also traded, which give a potential opportunity to buy at a discount to its "real" value. However, you are dependent upon the maintenance of the current bonus rates, and especially the terminal bonus, to achieve the stated returns. The second-hand endowment is a geared investment, i.e. you are incurring a higher level of risk to secure a higher return. The second-hand endowment policies can be purchased either individually or collectively through investment trusts. However, the market has shrunk markedly in recent years due to legislative changes and an overall reduction in supply.

BENEFITS

The With Profits fund gives you a portfolio of assets whose risk profile is theoretically lower than if you were to purchase those investments directly. However, you have no control over the distribution of investment profits, i.e. the bonus rates. Net returns can therefore be less than managed funds with a similar asset allocation, as the company is also giving you some protection against any investment downturn within the With Profits fund.

DRAWBACKS

The concept of With Profits has been criticised heavily for the following reasons:

- The competition for market share amongst life offices led to some offices taking more risk by way of equity investment than perhaps is justified by the investment mandate.

- In addition, an increasing proportion of the overall investment return on a policy now comes from the terminal bonus, rather than the annual bonuses. Some commentators believe that these terminal bonus figures have been set at a higher level than the overall investment returns warrant, with the aim of increasing the attractiveness of the fund.

- The "smoothing" concept was designed to cope with smaller (single digit percentage) year losses in stock markets if these losses were reversed in the following years. However, many funds could not cope with the sustained and significant losses that were experienced at the start of the 2000s. Under this amount of pressure many supposedly lower risk with profit funds "creaked" at a time when it was hoped they could withstand pressure. Although this did not always cause a fall in policy values, for many policyholders wishing to surrender their policies early, the imposition of Market Value Adjustments was effectively an early surrender penalty – in many ways just the same as a loss, but called something different.

- With Profit funds are opaque. It is very difficult for individuals and even experts to understand what is going on within a fund or what the underlying investments are held in. It is not a simple case of reading a valuation figure from the Financial Times as with Unit Trusts or OEICs. In a period of greater openness in financial services products, such an opaque concept now seems out of date.

- The concept underlying With Profits can be broadly replicated by following a sensible asset allocation policy including exposure to both domestic and international equities, bonds, property and cash, for example through the medium of a balanced managed unit trust or pension fund.

Important information: Our views are based upon our understanding of current legislation in England, unless stated otherwise. Levels and bases of, and reliefs from, taxation are subject to change and their value to you will depend upon your personal circumstances.

Risk Warning: The past is not necessarily a guide to future performance. The value of your investment and the income from it can fall as well as rise and is not guaranteed. You may not get back the full amount invested. This document is provided for information only and does not constitute advice. You should not act on any of the information without seeking professional advice.