

A UNIQUE INTERNATIONAL INVESTMENT With Profits Bonds

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With the creation of the European Union (“EU”), a large, unified, economic unit was established. The economic climate of the US and the EU effect each other but the two marketplaces do not move in lockstep.² The economic health of the global economy is interdependent, however, economic effects are not felt the same way or to the same extent in all markets. Certainly global investment diversification can assist offset the effects of one particular economy on a portfolio. Unfortunately because of the U.S. securities regulatory environment, Americans are generally only aware of investment opportunities approved for sale in the U.S.

The purpose of this article is to introduce the reader to a unique investment opportunity, virtually unheard of and unavailable in the U.S. That investment opportunity is a guaranteed equity investment with “smoothing”, an investment which will appreciate faster than a bond in a down equity market, and in an up market will, unlike a bond, share in market appreciation.³

Prerequisite to European Investing

Although, the Security and Exchange Commission’s (“SEC”) authority only applies within the U.S., depending on how an American investor learned of or invested into a particular non registered investment (“NRI”) the SEC may have obtained jurisdiction. Because of this concern many issuers of NRI’s will not sell to Americans. To invest, an American must first set up a foreign vehicle and that foreign vehicle may then invest in the NRI. The vehicle we will discuss herein is the foreign asset protection trust (“FAPT”).

Numerous articles have been written about the FAPT. These articles have analyzed their asset protection benefits, as well as the different burdens of proof a creditor must meet to prove fraudulent transfer (and by so doing seize the assets of the debtor). It is rare that FAPT benefits other than asset protection are discussed.

Herein we will utilize an FAPT primarily for its ability to purchase NRIs. An American settlor can set up a foreign trust and appoint a trustee located in that foreign jurisdiction. The foreign trustee on behalf of the trust can purchase the NRI.⁴

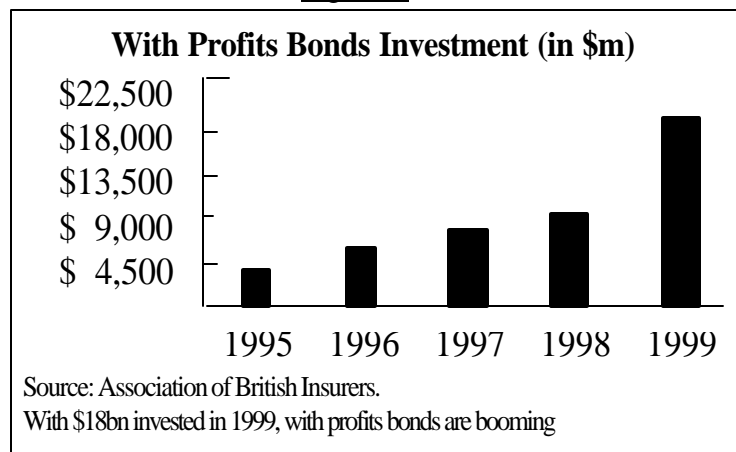
Note that the investment use of an FAPT may prove to be quite beneficial to the settlor seeking asset protection. Some jurisdictions provide that creditors use of a fraudulent transfer argument is only available if they can prove the settlor/debtor's "primary" or "predominant" motivation in settling the trust was asset protection. Herein the settlor can argue that investing into an NRI, was his or her primary motivation for placing assets into the trust. However, by so doing, the investment itself is asset protected.

With Profit Bonds

The NRI discussed herein is the With Profits bond. With Profits bonds are offered by many of the major insurance companies in the United Kingdom ("UK") (See Table 1), with investments usually denominated in US Dollars, Sterling, and Euros. With Profit bonds have been around for over a century. Sales have increased steadily over the last five years (see Figure 1) and reached £12bn (about \$18bn) in 1999.⁵

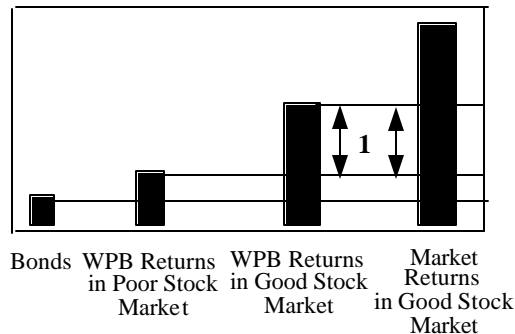
With Profit bonds are life insurance policies that invest in the With Profit fund of an insurance company. An investor in a With Profits bond benefits from the profits made by the With Profits fund. Profits are distributed to policyholders in the form of Annual bonuses which once added to the policy cannot be taken away.⁶ In addition, a Terminal bonus is also paid.⁷ When setting its bonus rates the insurance company's actuary seeks to smooth out the fluctuations of the stock market to produce steady growth. Simply put, With Profits are guaranteed bonds that indirectly profit (but cannot lose) by the stock market's performance.⁸

Figure 1⁹



The Case for With Profits Investing.¹⁰

Figure 2
With Profits Bonds (“WPB”)



1. Yields on With Profits bonds are less than available in favorable stockmarkets but better than bonds and better than yields obtainable from a poor stock market.

The stock market declines of October '87, Autumn '98 and the fall 2000 and continuing decline, are but three recent events to press home the raison d'être of the With Profits market: steady growth, stability and investment security.¹¹ Nervous investors seeking safety from stock market swings have the option of placing their money into With Profit funds. These funds act as a middle point between direct investment in volatile equities and the low returns offered on conventional bonds. Figure 2 above illustrates that With Profits yield are greater than that of bonds in every case and do better than a down stock market, but do not produce the type of returns available in a bullmarket.

Table 1¹²:
Insurance Companies Issuing With Profits Bonds
Past Performance of a £10,000 Onshore (UK) Investment at 1 September 2000³

Invested:	1 year ago			2 years ago			3 years ago			4 years ago			5 years ago		
	Current value	Cash in val	Yield %pa	Current value	Cash in val	Yield %pa	Current value	Cash in val	Yield %pa	Current value	Cash in val	Yield %pa	Current value	Cash in val	Yield %pa
Company	£	£		£	£		£	£		£	£		£	£	
1 Axa Sun Life	--	--	--	--	--	--	11,707	11,771	5.6	13,326	13,329	7.4	15,227	15,227	8.8
2 Britannic Ass	10,127	10,127	1.3	11,059	10,937	4.6	12,742	12,330	7.2	14,966	14,237	9.2	16,301	16,301	10.3
- IFA version	10,127	9,471	-5.3	11,059	10,326	1.6	12,743	11,867	5.9	14,966	13,967	8.7	16,301	16,301	10.3
3 Clerical Med ¹⁴ Clas	10,315	9,902	-1.0	11,768	11,057	5.2	12,954	12,306	7.2	14,630	14,191	9.1	16,564	16,564	10.6
- Sovereign wpb	10,662	9,916	-0.8	11,768	11,057	5.2	12,954	12,306	7.2	14,630	14,191	9.1	16,564	16,564	10.6
4 Co-operative Ins	10,280	10,280	2.8	11,701	11,701	8.2	-	-	-	-	-	-	-	-	-
5 Eagle Star Maxibond	-	-	-	-	-	-	13,255	13,255	9.8	15,156	15,156	11.0	16,396	16,396	10.4
- With profit bond	-	-	-	-	-	-	12,842	12,457	7.6	14,765	14,470	9.7	16,081	16,081	10.0
- Investment bond	-	-	-	-	-	-	12,777	12,777	8.5	14,610	14,610	9.9	15,796	15,796	9.6
6 Equitable Life	Unable to specify due to MVA currently being applied to with profit funds.														
7 Friends Provident ¹⁵	10,594	9,852	-1.5	11,129	10,573	2.8	11,450	12,131	6.7	12,198	13,839	8.5	12,992	16,045	9.9
8 Legal & General	10,376	9,960	-0.4	11,172	10,837	4.1	12,029	11,788	5.6	12,335	12,211	5.1	15,365	15,365	9.0
9 Liverpool Victoria	11,201	10,529	5.3	11,754	11,754	8.4	13,402	13,402	10.3	15,702	15,702	11.9	17,562	17,562	11.9
10 London Life	10,531	10,531	5.3	11,480	11,480	7.1	12,902	12,902	8.9	14,249	14,249	9.3	16,004	16,004	9.9
11 MGM	10,562	10,245	2.5	11,657	11,424	6.9	12,980	12,850	8.7	14,282	14,282	9.3	15,898	15,898	9.7

12 NFU Mutual	10,289	10,289	2.9	11,490	11,490	7.2	13,081	13,081	9.4	14,499	14,499	9.7	15,935	15,935	9.8
13 NPI	10,851	10,091	0.9	11,788	11,199	5.8	13,469	13,065	9.3	14,588	14,442	9.6	15,126	15,126	8.6
14 Norwich Union	10,865	10,322	3.2	11,785	11,196	5.8	13,228	12,831	8.7	14,645	14,499	9.7	16,135	16,135	10.0
15 Pearl	10,608	9,808	-1.9	11,599	10,999	4.9	12,617	12,217	6.9	13,517	13,317	7.4	-	-	-
16 Prudential	10,466	10,048	0.5	11,461	11,117	5.4	12,723	12,469	7.6	14,198	14,057	8.9	15,871	15,871	9.7
17 Red Rose Ass	10,500	10,200	2.0	11,025	10,815	4.0	11,576	11,466	4.7	-	-	-	-	-	-
18 Royal Liver	-	10,197	2.0	-	10,580	2.9	-	11,047	3.4	-	11,650	3.9	-	12,567	4.7
19 Royal London	-	-	-	-	-	-	-	-	-	-	-	-	14,120	14,120	7.1
20 Royal & Sun ¹⁶	10,874	10,221	2.2	11,778	11,248	6.1	13,565	13,158	9.6	15,333	15,103	10.9	-	-	-
21 Scottish Eq	10,874	10,188	1.9	11,932	11,417	6.9	13,074	13,074	9.3	14,208	14,208	9.2	-	-	-
22 Scottish Friendly	10,236	10,236	2.4	10,937	10,937	4.6	-	-	-	-	-	-	-	-	-
23Scottish Mutual ¹⁷	10,878	10,116	1.2	11,867	11,274	6.2	13,793	13,379	10.2	14,650	14,611	9.9	16,758	16,753	10.9
24Scottish Widows	10,475	10,077	0.8	11,471	11,159	5.6	12,995	12,770	8.5	14,483	14,361	9.5	-	-	-
25Tunbridge Wells	10,142	9,736	-2.6	-	-	-	-	-	-	-	-	-	-	-	-
26 United Friendly	10,142	9,838	-1.6	11,284	11,171	5.7	13,202	13,202	9.7	14,621	14,621	10.0	17,170	17,170	11.4
27 Wesleyan Ass	10,200	-	-	11,014	-	-	12,064	-	-	13,955	-	-	16,277	16,277	10.2
Best	11,201	10,531	5.3	11,932	11,754	8.4	13,793	13,402	10.3	15,702	15,702	11.9	17,562	17,562	11.9
Average	10,507	10,091	0.9	11,477	11,120	5.4	12,805	12,556	7.9	14,355	14,158	9.1	15,926	15,912	9.7
Worst	10,127	9,471	-5.3	10,937	10,326	1.6	11,450	11,047	3.4	12,198	11,650	3.9	12,992	12,567	4.7

Components of a With Profits Investment

With Profits participate in the managed fund of a life insurance company, and have no fixed maturity date.¹⁸ The fund consists of U.K. and overseas equities, property and corporate bonds (see Table 2).

Market profits are distributed to policyholders in the form of bonuses. The up and down swings of equity investments are mitigated by “smoothing”. When setting its bonus rates the insurance company seeks to smooth out the fluctuations of the stock market to produce steady growth. Therefore investors in With Profits receive back their initial investment, plus an Annual bonus, plus by way of a final or Terminal bonus participate in the long-term growth in the equity marketplace irrespective of its current gyrations. The prominent features of With Profits are as follows:

1. Guaranteed Fund. “Each policy will have a guaranteed amount of benefit. The ultimate proceeds cannot fall below that amount.”¹⁹
2. Annual (or Reversionary) Bonuses. Each year Annual bonuses are added to both the net sum invested and (usually) the bonuses previously declared, based on the underlying performance of the fund.²⁰ Once added Annual bonuses cannot be taken away, they constitute guarantees. Therefore the with-profits *fund can never go down in value*. “[Annual]... bonuses have to be large enough to make the investment attractive, but not so large that there is little left to pay an attractive [T]erminal bonus.”²¹ In this way the bond achieves steady growth, without the large fluctuations that can be the case with direct stock market investments.

Even if the stock market declines around the time the investor desires to encash his or her investment, the locked in gains will be paid.²² This can be quite comforting to the investor seeking security and growth.

Table 2
With Profits Funds
Asset allocation as at 1 January 2000²³

	<u>Percentage of assets in</u>					
	<u>U.K</u> <u>Equities</u>	<u>Overseas</u> <u>Equities</u>	<u>Total</u> <u>Equities</u>	<u>Property</u>	<u>Fixed</u> <u>Interest</u>	<u>Other</u>
1 Axa Sun Life	59	20	79	7	10	2
2 Britannic	66	9	75	0	15	10
3 CGU	54	16	70	9	16	5
4 Clerical Medical	46	24	70	10	14	7
5 Equitable Life	50	15	65	8	23	4
6 Friends Provident	40	12	52	11	35	2
7 Legal & General	49	14	63	14	21	2
8 L'pool Victoria	57	15	72	11	13	4
9 NFU Mutual	55	15	70	8	19	3
10 Norwich Union	51	14	65	11	22	2
11 Pearl	51	14	65	11	22	2
12 Prudential	58	14	72	12	13	3
13 Royal Sun Alliance	60	13	73	8	17	2
14 Royal London	56	13	69	12	15	5
15 Scottish Amicable	58	16	73	12	12	3
16 Scottish Equitable	37	13	50	0	47	3
17 Scottish Friendly	57	3	60	6	27	7
18 Scottish Life	30	17	47	12	40	1
19 Scottish Mutual	51	25	76	2	18	4
20 Scottish Provident	46	12	58	11	27	2
21 Scottish Widows	45	10	55	7	28	11
22 Standard Life	60	17	77	10	10	3
23 Teachers Prov't	63	11	74	5	15	7
24 Tunbridge Wells	37	7	44	2	44	10
25 Wesleyan	67	3	70	11	4	15
Average	52	14	66	8	21	5

3. Terminal or Final Bonus. Over long periods of time, the fund reserves increase compared to the Annual bonuses declared. A supplementary bonus is needed for the investor to profit by the market's performance. This bonus, called a "Terminal" or "Final" bonus", is applied to a plan when it terminates by way of death or surrender.²⁴

Terminal bonuses vary based on the underlying return the fund has generated over the period an investor has been with the fund. The Terminal bonus can account for over half of the investment's total return. This represents a final "topping up" of benefits in respect of investment earnings not already passed on via the Annual bonuses. Terminal bonuses may be more volatile than Annual bonuses, although the issuers expect over time to avoid severe and frequent fluctuations.²⁵ Terminal bonuses are not guaranteed.

4. Smoothing. “Smoothing is the process by which actuaries hold back a proportion of the investment return in the good years to boost returns in the bad ones.”²⁶ Investment return is allocated to investors by means of the Annual and Terminal bonus. The “bonus systems are arranged to give a degree of stability of results by some smoothing and averaging of the investment return that reflects the mutual pooling of investment which is one of the distinguishing features of the with profits business.”²⁷

Where the stock market has produced high returns and an insurer's fund has done well, the company will not necessarily pay particularly large bonuses, but instead will store up some profit to cover years when the markets perform less well. The aim is to keep Annual bonus payments fairly steady and consistent, regardless of the movement of the stock markets. Over time, however, bonus trends will follow the long-term movement of the stock markets, whether up or down.

As shown above in Table 2 With Profits funds invest in a diverse range of investments just as conventional “managed” funds do. While the non-equity mix of assets produce a steady growth in value, the equity portion rises and falls in value. Over longer periods of time equities outperform fixed assets. Over shorter periods the bias toward equities may lead to a loss in the overall fund value. It is against this backdrop that the method of “reserving” and “bonuses” was developed so that investors can receive constant growth no matter what is happening to the underlying assets.

Example

The following is a simplification of how bonuses and reserving work over a five year period;

- Year 1 - Fund grows 18% - Annual Bonus declared 7% - Reserves increased by 11%
- Year 2 - Fund grows 14% - Annual Bonus declared 6% - Reserves increased by 8%
- Year 3 - Fund falls 4% - Annual Bonus declared 5% - Reserves reduced by 9%
- Year 4 - Fund grows 16% - Annual Bonus declared 7% - Reserves increased by 9%
- Year 5 - Fund grows by 4% - Annual Bonus declared 6% - Reserves reduced by 2%
- After 5 years; Fund growth 48%, Bonuses declared 31%, Reserves 17%

5. Market Value Adjustments and Penalties. Almost all With Profits bonds have no fixed term. However, providers stress strongly that they should be regarded as a medium to long term investment, which generally means at least five years. If investors wish to withdraw their money in the first five years, many bonds have penalties.

In addition many companies reserve the right to apply a market value adjustment (“MVA”) when a plan is surrendered early. This will only apply in exceptional circumstances.²⁸ In practice it is unusual to see it applied outside of the first 3 years. MVAs are designed to protect the fund for the benefit of continuing investors. If the expenses incurred in the liquidation of stock were borne by the fund they would reduce the returns of those who remained. Instead they are passed on to those who are causing the expense to be incurred.²⁹

Providers prefer not to apply MVAs, recognizing that they may deter potential investors in the future.³⁰ To date the application of the MVA has been relatively rare. They are usually applied by the weaker companies.³¹

Strength To Invest³²

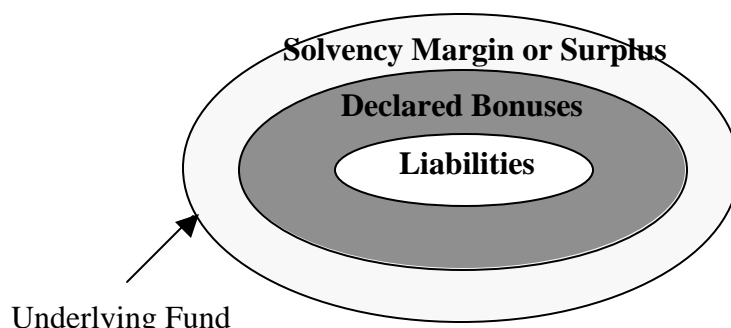
Financial strength refers to the amount of money the company holds as reserves. It is a measure of a company's ability to meet its liabilities and provides an indication of the magnitude of its future bonuses.³³

“Financial strength is probably the most important factor for investment managers of with profits funds. It determines whether they have the freedom to use their investment skills to enhance long term returns. Financial strength...has a number of direct implications. It means that the solvency of the fund and the commitment to stable payouts is not dependent on the investment returns in any one period. That gives fund managers scope to invest in assets which offer higher long term returns but entail higher short term risks.”³⁴ Company’s with large reserves can justify greater exposure to risk equities which can generate long term growth. Company’s can also draw on these reserves when the stock market goes into a slump in order to maintain it’s bonus rate. Financially stronger companies generally produce better long-term returns on their With Profits products.³⁵ Financial strength is measured by:

1. Solvency. Because of the guarantees given, the underlying fund must maintain an adequate solvency margin. Solvency is the difference between the liabilities

of the fund including the guaranteed amounts, and the value of the fund. Fairness must be maintained between surplus retained and bonuses paid.³⁶ The company actuary has to accomplish this with a view to his or her prognosis for the future investment climate and with respect to anticipated future Terminal bonuses.

Figure 3



2. Free Asset Ratio (FAR).³⁷ This is a measure of the free assets that a company holds expressed as a percentage of its total assets. It encompasses the assets left over once the company's liabilities have been taken into account. However, the FAR must be considered with reference to the historic returns received on a company's With Profits policies. Companies will give out varying proportions of their free assets. A company's FAR may be high because it has distributed small bonuses, keeping profits back to top up its reserves.
3. Standard & Poor's . Standard & Poor's assesses factors such as companies' free assets, the markets in which they operate, how well they are run, investment strategy and past performance to come up with financial strength ratings ranging from AAA for 'superior financial strength' to CCC, which indicates that a company is 'extremely weak' (see Table 3, below).

The question is not "How likely is this company to meet its financial commitments in the future?" The safeguards put in place through the British regulatory regime and initiatives such as the Policyholders' Protection Act mean that the total collapse of a company is extremely rare. The question is, "How likely is this company to outperform its competitors?"³⁸

Table 3

<u>Insurer Financial Strength Ratings</u>	
Company	Standard and Poor's Rating
Prudential	AAA
Clerical Medical	AA
Norwich Union	AA
Scottish Mutual	AA
Sun Life	AA
Eagle Star	A+
Friends Provident	A+

AAA = rated extremely strong; AA = rated very strong; A = rated strong.
Source: Standard and Poor's UK-Life Financial Strength Digest (2000 Edition)

The Future of Bonuses

Over the last several years there has been a falling trend for Annual bonuses, but overall payouts have maintained their value. Annual bonuses have been affected by falling inflation, interest rates and investment returns. The uncertainty of the market makes it imprudent for companies to promise too much in the form of a guaranteed Annual bonus. Is this a bad sign for future returns?³⁹

As stated above, the performance of a With Profits bond depends on the fund's asset allocation. Equities are risky, but are likely to generate more growth than fixed yield instruments. Only companies with sufficient reserves can invest heavily in volatile equities and continue to deliver consistently reasonable returns. Weaker companies are forced to maintain a higher proportion of their investment in fixed interests, thus limiting growth potential. In addition, companies offering high headline bonus rates in the first year and/or high Annual bonus rates thereafter, usually have to hold a greater proportion of fixed interest assets to meet these guarantees. This could affect the long term performance of their fund.⁴⁰

A company which need only maintain a medium sized reserve because its guarantees (e.g. its Annual bonuses) are low, can maintain a higher percentage of its assets in equities. If this increases fund growth Terminal bonuses can be large, and a high overall yield produced. Of course, the Terminal bonus must compensate for low Annual bonuses which is why a close eye has to be kept on total historical payouts.⁴¹

Gearing

As can be seen in Table 1, UK With Profits funds have averaged a 9.7% return over the past 5 years.⁴² Because of the financial strength of these insurers (see Table 3), many banks will loan money to allow their clients to gear (“leverage”) their investments.

Gearing in the 2.5 times investment range is common with up to 6 times possible. The portfolio is geared by borrowing funds from a bank against the security of the initial (and geared) investment. The borrowed funds are used to invest in additional With Profits bonds. Funding at rates of 1.5% over Libor, is currently available. Interest is capitalized, and therefore accrues rather than having to be settled on an annual basis.⁴³

It is advisable (but not necessary) to borrow in the same currency as the fund invested in thereby eliminating currency risk. Many investors are currently investing and borrowing in Euro denominated funds and taking advantage of relatively low interest rates in Euro's as well as the Euro's perceived growth potential. No personal guarantees or additional security is required.

Table 4
Effect of Gearing on Returns

1. Assume a five year investment of \$1m.
2. Table 1 shows that the average return of 27 onshore funds is 9.7%. As we will for purposes of this example utilize “offshore” With Profits funds (which being tax advantaged yield a greater return) we will (we believe conservatively) assume a 9% and 10% return.⁴⁴
3. Assume a 7.5% bank money cost and \$2.5m (2.5 times) of gearing. Banks normally charge a 0.5% to 1.0% one time set up or loan fee. For purposes of this example we have not calculated this in.

<u>Return</u>			
<u>9% Return</u>		<u>10%</u>	
\$1m @ 9%	= 9.00%	\$1m @ 10%	=10.00%
\$1m @ 9% -7.5%	= 1.50%	\$1m @ 10% -7.5%	= 2.50%
\$1m @ 9% -7.5%	= 1.50%	\$1m @ 10% -7.5%	= 2.50%
<u>\$1/2m @9% -7.5%/2= .75%</u>		<u>\$1/2m @10% -7.5%/2=.1.25%</u>	
Yield	=12.75%	Yield	=16.25%

The above is for example purposes only and should not be viewed as a guarantee as to the yield a particular investment will produce.

The powerful effect of leveraging on returns is evident in Table 4. Figures in Table 1 are for UK “onshore” funds. Many of these companies have created offshore (non-UK taxed) funds in Jersey, Guernsey, and the Isle of Man. These “offshore” funds are generally managed by the same teams as manage the onshore (UK) funds and with the exact same investment philosophy. “Offshore with profits bonds are available from a variety of insurance companies with UK parents: including Clerical Medical International, Friends Provident International, Royal & Sun Alliance International, and Scottish Life International. Offshore with profits bonds work in the same way as their onshore counterparts. The only difference between them being that offshore insurance companies are not subject to tax... This enables the fund over a period of time, to grow at a faster rate than an onshore fund.”⁴⁵ As seen in Table 4, an increase of 1% on investment performance (or a decrease of 1% on money cost) has a very marked impact on investment returns.

Conclusion⁴⁶

Americans should and can diversify their investments, not only by company, but also by marketplace and currency. The smoothing concept applied to a guaranteed investment has in the past proven to be quite attractive to the continental investor. 1999 was a banner year for With Profit bonds with over \$18bn sold. This investment can be made by an American through an FAPT. With interest rates dropping, gearing for greater returns is attractive.

The With Profits “market has weathered many storms over the last two hundred years or so. The size of the market remains substantial...and undoubtedly there have been many thousands of customers who have been more than happy with the results of their with profits experiences. There is no fundamental reason why this should not continue to be the case for many more years yet.

“One must remember that most real-life debates about financial strength in the context of with profits companies really only revolve around trying to sift through the available product providers to try to pick out the likely best provider in the future. This is an interesting intellectual exercise, and obviously very profitable if you can do it successfully.

“However, one should not lose sight of the fact that history shows us that it is quite likely that even the most modest performers in the market will produce perfectly acceptable returns at the end of the day.

“As ever, it is a question of horses-for-courses. Investments should be selected on the bases of ‘best advice’ given a client’s needs and risk profile. With profits products remain a very suitable solution for a risk adverse client who appreciates the benefits of a smoothed investment return.”⁴⁷

Endnotes

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² The US’s Gross Domestic Product (“GDP”) grew at a 5.1% rate in 2000, and is forecasted to decrease to 2.5% in 2001 and then increase to 4.2% in 2002. Whereas the E.U.’s GDP grew at 3.3% in 2000, is forecasted to decline to 2.6% in 2001, and it is then forecasted to exceed its 2000 growth in 2002 (at a time when the U.S.’s GDP will still be down 20% from its 2000 level). *Markets Sell-Off Is a Symptom of Major Economies Slowing*, The Wall Street Journal Europe, December 21, 2000, Page 1.

³ Some have compared the With Profits investment (discussed herein) to the equity indexed annuity (“EIA”) introduced by U.S. insurance companies in the mid ‘90s. The EIA can not be geared (see “Gearing” in the main body). The EIA is not “smoothed”, hence gains can virtually be wiped out in a down market (see “4. Smoothing” in the main body). In addition, the EIA is subject to significant penalties if amounts are withdrawn before age 59 ½.

⁴ An FAPT is a self-settled revocable trust with careful attention put on certain clauses. Used primarily for investment purposes, an FAPT can be set up for a quite modest cost.

⁵ *Why So Popular?* Laverne Hadaway, Money Management, Supplement, December 2000, at 2.

⁶ Except where an encashment is made before the investment is held about 5 years, in which case penalties and a market value adjuster may be applied. See Components of a With Profits Investment in the main body.

⁷ *Ibid.* Please note that there is no guarantee that a Terminal bonus will be paid. However, in the last 5 years, Table 1 shows it virtually always has been paid.

⁸ The guaranteed status of this type of investment assures the investor that he will absolutely receive more than he or she paid in. With profits offer something quite unique—the opportunity for many investors to band together and share risk and, through the process of smoothing returns over time, to substantially reduce the volatility of returns which characterize equity investments. See *With Profits Endowments* by Mike Urmston, Money Management, April 1999 at 2. As noted in the body of the article, investments which are encashed before 5 years may be subject to both a penalty and a Market Value Adjustment. Because the application of these may cause the return to the investor to be less than his original investment, some advisors believe the use of the term “guaranteed” may be misleading. Please note the discussion re Laverne Hadaway and Janet Wolford, in their article *How Have They Performed?* Money Management Supplement, December 2000, at 8, and below in footnote 11.

⁹ These funds for many years have formed the backbone of the individual pension market in the U.K. They provide clients a reasonable degree of security together with good potential for long-term capital growth. Figure 1 is from *Why So Popular*, Laverne Hadaway, Money Management Supplement, December 2000, at 2.

¹⁰ Perhaps the major case against with profits has been the complaint that getting full disclosure of financial information from some providers have been virtually impossible. “If...greater disclosure were to take place, this would surely make with profits endowments a serious player in the savings market, especially in a time of increased market volatility as is currently the case.” See *With Profit Endowment Survey* by Dominic Hiatt, Money Management, Supplement April, 1999 at 30.

¹¹ See *Ibid.* at 4. “There is no doubt that with profit endowments become distinctly more popular during times of stock market turmoil.... Since the marketplace continues to be volatile, moreover, and because with profit endowments are currently offering greater exposure to the markets with the protection of pooled investment, there is reason to believe that they will become a more significant runner in the race...”

¹² See Laverne Hadaway and Janet Wolford, *How Have They Performed?* Money Management Supplement, December 2000, at 8. Table shows: Current and actual cash in values as of 9/1/2000 for a £10,000 With Profits investment in a UK “onshore” fund. The bonus records shown provide no guarantee of future performance, but may cast light on the sort of returns that investors can expect. Companies that have managed to produce good returns in the past like to be at the top of the performance tables, and so often strive to maintain that position. It is

mostly in the early years that the cash in values differ substantially from the current value figures. In the early years any initial charges and early encashment penalties will be payable. With Profits bonds are designed to be held for the medium to long term. Many providers impose early exit penalties to discourage encashment before then. Exit penalties can be as high as 10% in the first year, falling to around 1% in the fifth year. Exit penalties, initial charges and any Terminal bonuses due are reflected in the cash in values. As a result, eight bonds would have paid out less than the initial investment in year one. After two years the bonds returned at least the initial investment. Over three-years the returns begin to look reasonable.

13 Several of the companies more commonly used in geared (leveraged) structures are noted in footnotes 13-16.
14 Clerical Medical is a wholly owned subsidiary of the Halifax Group one of the largest financial groups in Europe. Halifax's total assets are about US \$214b, CMI was founded in 1824, has an S&P AA rating, and about US \$32b in assets.
15 Friends Provident was founded in 1832. Total assets of approximately US \$54b. Friends Provident is one of the UK's leading financial services groups. It's offshore subsidiary Friends Provident International is S&P rated A+.
16 Royal and Sun Alliance: History dates back to 1710. One of the top 25 insurers in the world. Transacts business in over 120 countries. Total assets in excess of US \$95 billion.
17 Scottish Mutual has a AA S&P Credit Rating, its With Profits fund has been in existence for over 100 years. Scottish Mutual is a wholly owned subsidiary of Abbey National plc The 5th largest bank in the UK. Total assets of about US \$289b.
18 To invest into With Profits funds an investor must purchase an insurance policy. The funds of the policy can then be directed into the insurer's With Profits funds. For instance the participant purchases a \$1,010,000 policy for \$1m. The \$1m is invested (after expenses) into the insurance companies With Profits fund. With Profits only carry 101% x fund life cover which is provided free of charge by the carrier.
19 From a paper entitled "*With Profits Without Mystery*" presented to the British Institute of Actuaries by Roy Ranson on March 20th, 1989. The guaranteed amount of benefit is the amount invested net of expenses to enter the fund. Early encashment may attract penalties and an MVA may be applied.
20 High first year headline bonus rates are being offered by some companies in an attempt to lure investors. This is a practice not dissimilar to the "teaser" rates offered by American credit card companies to enroll new users. The Faculty and Institute of Actuaries has criticized these high first year headline bonus rates as misleading.
21 *Why So Popular?* Laverne Hadaway, Money Management, Supplement, December 2000, at 4.
22 As, most likely, will a Terminal Bonus which has been actuarially "smoothed". Please note the warnings in footnotes 7 and 11 re penalties and the MVA.
23 Table 2, from *No longer a safe Option?* Jennifer Irwin, Money Management, April 2000, at 88.
24 The Terminal bonus is declared and added at maturity. It is clear that apart from the guaranteed part of the fund it is quite difficult to monitor an investment's current value as one does not precisely know the amount of the Terminal bonus till the investment is terminated. However, it is possible to request and receive a transfer value, which is the amount, which would be transferred into another fund if so desired.
25 From *With Profits Endowments Survey*, Dominic Hiatt, Money Management, Supplement, April 1999, at 8.
26 *With Profits Endowment Survey*, Jennifer Irwin, Money Management, April 2000, at 67.
27 *With Profits Endowments Survey*, Dominic Hiatt, Money Management, Supplement, April 1999, at 7, citing Roy Ranson. The concept of smoothing is a concept not found in investment choices in the U.S.
28 E.g. where the market is falling rapidly and a large number of investors are cashing in their bonds. In this case the fund will need to liquidate stock quickly, thus incurring losses and expenses.
29 Since the application of the MVA is entirely at the discretion of the provider, critics have argued that MVAs have been used to enable some life companies to avoid paying out the full amount owed to policyholders.
30 Some companies including Clerical Medical, Scottish Equitable, Scottish Mutual and Scottish Widows have never applied an MVA. This is a strong selling point to maintain. With some companies, if an investment is encashed within generally the first three (3) to five (5) years of investment, a penalty as well as a MVA could be applied.
31 What happens if investors want their money back before the insurance company is ready? Laverne Hadaway and Janet Walford look at the penalties imposed by the bond in *Cashing In Early*, at 10-11, Money Supplement, December 2000.
32 See *Lifetime Financial Plan* by Oliver, Financial Times Pitman Publishing, Pages 25-27.
33 See *Strength to Invest* by Laverne Hadaway, Money Management December 2000, at 6
34 *Financial Strength*, Ruth Read, Money Management, Supplement, April 1999 at 31.
35 See discussion in the main body under the heading "The Future of Bonuses".
36 See Figure 3. This is currently monitored by the British Department of Trade and Industry.

³⁷ With Profits funds have to report to the Department of Trade & Industry “DTI” every year and prove that the fund is large enough to meet the liabilities of declared Annual bonuses if all policyholders left at once.

³⁸ According to the actuarial consultancy firm, AKG.

³⁹ Ibid., at page 6 “the trend of particular interest is that ...[annual] bonuses have yet again fallen and terminal bonuses risen as a proportion of final maturity value.” The article poses the question that although with profits are “[i]n theory a stable and low risk financial product, could it be that the with profit endowment is becoming less so in pursuit of the higher returns achieved through the greater investment freedom and hence exposure to equities afforded by lower guaranteed annual payments?” The article goes on to state at page 14: “whereas, for some, smaller ...[annual] bonuses offer greater investment freedom and hence potential for higher returns, a more conservative approach prefers higher ...[annual] bonuses since once they have been allocated, they cannot be taken away.”

⁴⁰ Axa Sun Life, Standard Life, Scottish Mutual, and Britannic have a high proportion of assets in equities. Those with a high proportion in fixed interest are Scottish Equitable, Turnbridge Wells, Scottish Life, and Friends Provident. See Table 2.

⁴¹ A look at the past movement of bonus rates shows a marked, trend downwards. From highs of 10% and 11% in 1991, the best annual bonus rates are currently around 7%. The falling Annual bonus rates have led to a greater emphasis on Terminal bonuses. Critics argue that as a result With Profits bonds are not as safe as they used to be, because the final value depends less on the Annual bonuses and more on the Terminal bonus which is paid right at the end of the life of the investment at the discretion of the provider.

⁴² Because of their tax advantages, offshore With Profits funds produce a greater return.

⁴³ The British call this a “roll-up” loan. The Americans are perhaps a bit more dramatic in calling it a “bullet” loan.

⁴⁴ In light of the returns shown in Table 1 (onshore returns), projections of 9% and 10% in the example would appear to be realistic. “The top with profit endowment over [the past] 10 and 15 years returned an annual yield of 12.2% and 13.3% respectively.” *Hidden Strengths*, Jane Sumpter, Money Management, November 1999 at 63. In addition please note that offshore tax advantaged returns tend to be higher.”

⁴⁵ *Bonds and Tax*, Hadfield and Clarkson, Money Management Supplement, December 2000 at 16.

⁴⁶ As stated in the Financial Advisor, 7 December 2000 at page 45: “All things considered , the future for with profits bonds... looks extremely encouraging and this is borne out by the following significant findings...: - Investors are not put off by investments linked to stock market performance as long as they are low risk...”.

Although many have considered the With Profit which has been in existence for well over a century the “dinosaur of personal financial products”, With Profit endowments have so far managed to evade extinction. The stock market crashes...as well as the slumps...emphasize the advantage of the smoothing effect of with profits policies, providing steady growth and security.” *Hidden Strengths*, Jane Sumpter, Money Management, November 1999 at 63.

⁴⁷ *Is there still life in with profits?* Derek Holtham, Money Management, October 2000 at 78.