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New Model Adviser®

WEALTH MANAGEMENT A newsletter for broker consultants

Reviewing with profits investments has become an urgent issue. With an estimated £385 billion invested in these funds, informed advisers are well placed to provide a valuable service to many clients.

It is often said that the real secret of successful wealth management is in the timing. If that is the case, then there is perhaps no better time than the present for broker sales consultants to be talking to independent financial advisers about their clients' with profits policies.

One very important reason for this need for speed is that the authorities are getting very interested in the area. The Financial Services Authority (FSA) recently announced that it intended to focus its attention on the millions of policyholders stuck in underperforming with profits funds in the year ahead.

According to the FSA's new business plan for the up-coming 12 months, a major priority will be ensuring that with profits policyholders in both open and closed funds received 'clear and accessible post-sale information that enables them to take informed decisions about whether to keep or surrender their policy'.

The regulator has also promised to look at the quantity and quality of advice available to existing policyholders. Its high-level attention to the matter follows concern that many investors who have in the past bought with profits policies are now failing to receive ongoing advice.

The breadth and depth of the with profits issue is vast, and throws up challenges for broker sales consultants, advisers, and of course their clients, which, with some diligent application, can be converted into opportunities that benefit all those involved.

The great prize

Let's start with the size of the matter. According to figures from the FSA, there is around £385 billion of investors' money in with profits funds, including some £85 billion in funds that are no longer open for business.

Not only is that sum enormous in its own right – more than £6,000 for every man, woman and child in Britain – but it is also roughly equal to the amount currently invested in retail Oeics and unit trusts. In other words, were the assets within with profits funds to be transferred into conventional investment funds tomorrow, we would see an industry doubling its size.

That, of course, is not going to happen. But look at the sums the other way. Let us suppose that 15% of this money – around £60 billion – can

An Adviser's View

Nicola Downs
Director
Trentham Invest

'The FSA is well overdue in taking any action on this issue. The amount of money in with profits funds providing total returns of 0-2% is frankly shocking. As an IFA I can honestly say that we have no one in with profits where it makes clear sense to get out and those who are still in are provided with a watching brief at least annually.

'The FSA talks of giving consumers more information to help them make a decision on such funds. Yet it is clear that consumers are unable or unwilling to read the current information sent that clearly states the bonus rate is 0%.

'What consumers need is some practical assistance in making these decisions and that means getting professional help and a hand to hold. If you had toothache and were given a manual on how to make an extraction – would you? Of course not. Then why should the FSA expect consumers to extract themselves from with profits funds?

'I know that many IFAs would not support a transfer out because of the penalties involved in so doing, but this is a very short-sighted and superficial view. There is some mathematical analysis and understanding that needs to be applied in every case you deal with.

If the bonus rate on a policy with 10 years to run is 0% on a closed fund and the withdrawal penalty 4%, then the maths tells us that the money, invested in a more sensible place only needs to grow at 0.39% a year to make a withdrawal worthwhile. Of course if the market does more – they will get more.

'Which would you choose? Given these facts I am confident that most people will take the transfer out.'

and should be moved out of with profits funds. If there are, say, 6,000 IFAs in Britain today predisposed to looking after their clients on a wealth management basis, that leaves a potential £1 million per IFA of additional assets that can generate ongoing income, year after year.

Some will come from existing clients, but a part can also come from new clients, establishing fresh relationships that can open the way to further new business. In summary, this is a prize most IFAs will be interested in devoting time to winning.

Complex matter

But if it is the size of the prize that can open the door to a conversation with an IFA on with profits, it is the complexity of the picture that will mean any dialogue is bound to be both serious and in-depth. All classes of investment products contain good and bad examples of available products, but the range contained within with profits is wider than most.

At one extreme there are with profits funds which remain open for business, are financially strong, have an asset allocation balance that any wealth manager would be proud of and are confident and clear about their future bonus prospects. In other words, they are still able to do what with profit funds were meant to do – provide smooth and safe returns from a variety of assets for cautious minded investors.

And then there are those funds which are closed to new business, having been forced to do so by the whirlwinds which hit both the investment markets and the life assurance industry in the first years of the 21st century. Many of these funds have declared that future bonuses are unlikely, such is their delicate financial position. However, as the FSA stresses, the status of a fund is no automatic guide to its potential. There are both poorly performing open funds and closed funds that have decent prospects. Each fund has to be evaluated on its own merits.

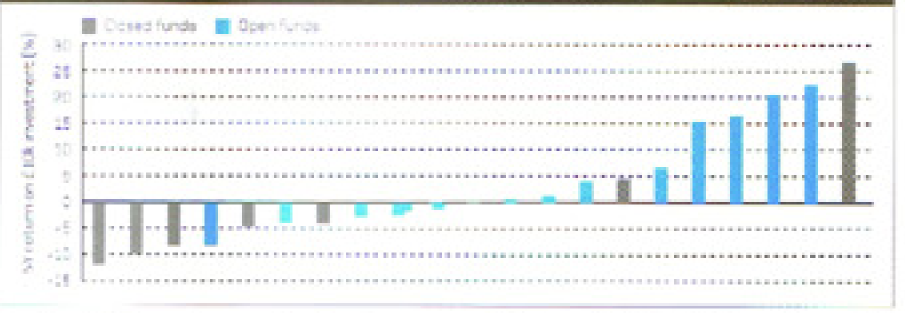
Look under the bonnet of some of these funds and you are likely to find a preponderance of fixed interest investments, a structure drawn up according to the diktat of actuaries with an eye to future liabilities rather than fund managers making informed choices about the future relative performance of different asset classes. It would indeed be strange to put new money into such a fund, even if it were open for business.

There is of course a huge variation between these two extremes, as is well illustrated by the two charts, both produced by AKG Actuaries & Consultants. The one above shows the variations in returns from a range of funds over five years, while the other summarises a selection of AKG's fund ratings drawn form recent issues of *New Model Adviser®* magazine.

Such variations form the mathematical basis behind which IFAs have to think through what is best for their clients – should they remain in the fund or switch out to more conventional investment products? But they are only the basis and any discussion with an adviser has to take other factors into account.

- What charges are involved in leaving the with profits fund (through a market value reduction) and in investing in a unit trust or Oeic (through initial and trail commissions or fees)?
- How well is the new investment predicted to perform – and therefore how long will it be before it makes up for these charges?
- What is the time horizon and the risk appetite of the client involved?

With-profits bonds: returns over 5 years. Based on a £10,000 single premium



A solution, not just a problem

Raising the problem of what to do with investors stuck in poor with profits funds is just part of the equation. Helping advisers find a decent solution is another, and perhaps the more important part.

Here the discussion needs to focus on the type of managed funds that can replace all that was good about traditional with profits funds. Namely, a well run fund, looked after by a talented fund manager, which gives risk-averse investors an opportunity for steady growth over the medium term, and a low risk of significant losses – all from a carefully thought-out selection of assets, the balance of which can be changed and tilted as the manager sees fit.

If that sounds like a fund in the Cautious Managed sector, you might have hit on the ideal with profits replacement, especially given that such funds come without any of the drawbacks – most notably a lack of transparency and liquidity – which are present in so many with profits funds today.

Legalities and delicacies

The other dimension of the with profits question is the duties and obligations of advisers to do the right thing for their clients. Amid the blizzard of principles, reports, guidance notes and plain old-fashioned regulations that have rained down on advisers over recent years, one message has shone through – namely that advisers must have a firm grip on the suitability of particular products for each of their clients, taking into account the strength of the investment, the needs of their clients and the matching of risk between the two.

Any slippage on this matter can spell serious trouble for an adviser. This is no easy matter and again, any help and dialogue is going to be greatly appreciated.

It is worth remembering that there are 'soft' factors at play here. Above and beyond whatever the FSA is telling them, most investment-minded advisers are passionate about improving the lot of their clients. In that sense, they provide an open door to start a discussion.

But at the same time, there are sensitivities to be aware of. In some cases, the adviser will have sold the with profits policies he or she will now be telling clients need to be reviewed. This can be tricky ground to walk on.

With Profit funds: the good, the bad and the in between

Group	Company	Fund	AKG Star Ratings (max 5)		
			Transparency	Future performance	Financial strength
Aegon	Scottish Equitable	New Generation With Profits Growth Fund	★★★★★	★★★★★	★★★★
Independent Order of Foresters*	Forester Life	With Profits Sub Fund	★★	★★★	★★★
Pearl Group*	Pearl Assurance	With Profits Fund	★	★★	★★

* fund closed to new business

Source: With Profits X-ray column, written by Guy Vanner of AKG Actuaries & Consultants and published every week in *New Model Adviser®* magazine.

email us at nma@citywire.co.uk with your views and experiences on wealth management