

With profits: smoothing the way

In these days of economic uncertainty, it's hard to know where to place your savings so that they can grow in a safe environment. What most people want is an investment that will keep their hard-earned cash as safe as possible and still allow it to grow. This is particularly true if you are saving for a specific goal, such as your children's education or retirement. In this situation, with-profits bonds and policies may offer a safer way to invest in the stock market as they aim to provide a good return on savings, while smoothing the impact of market volatility.

What is a with-profits investment?

In this type of investment, your money is pooled with that of other policyholders and invested in a range of assets such as shares, bonds and property. The fund manager will seek to increase the value of your investment based on the investment profits made by the fund, as well as a share of the profits from the rest of the business, by adding 'bonuses' to your policy.

An attractive feature of with-profits funds is the way the investment returns are paid out. Instead of seeing your investment fluctuating up and down in line with volatile stock markets, with-profits investments aim to smooth out the returns. In years of strong investment growth, the provider can hold back some of the total growth of the fund and use this to bolster bonuses in years of poorer returns. However, you should bear in mind that if investment conditions decline over a long period, this process of smoothing out returns will not entirely protect you from poor market returns.

In older-style with-profits funds, returns were smoothed through the addition of a guaranteed bonus added annually, plus additional final bonuses. Nowadays, with-profits funds are usually 'unitised' so annual bonus additions are given through daily increases in the unit

price. This price cannot then go down. Final bonuses are normally also added when the investment matures or is cashed in to reflect the longer-term overall performance of the fund.

During sustained periods of poor overall fund performance an adjustment factor, known as a market value reduction, may be applied in order to protect the fund and its other investors. This can lead to short-term falls in your fund value, but this system aims to protect longer term returns, which could be damaged if many investors were able to take their money out at inflated prices. A market value reduction will only apply if you decide to take your money out early and will not apply on an investment's maturity date.

What are the benefits of with profits?

With-profits investments can give you the best of both worlds. Cash investments, such as bank accounts, can provide more security but could mean your money losing its purchasing power as inflation eats into your returns. Shares, on the other hand, have tended to produce higher returns than cash over the long term but, as recent market conditions have clearly shown, can be volatile over the short term and could lose you money if the stock market plunges. The same is true of shares held through a unit trust investment as the fund value fluctuates directly with the underlying values of the assets on a day-to-day basis.

With-profits funds invest across a range of investments including shares, bonds, property and cash in order to balance their investment risk and returns. This way you get an exposure to shares and property, which can produce growth above the rate of inflation, at the same time as having bonds and cash to provide a greater element of security. Together with the smoothing out of returns this can provide valuable protection when investment conditions change.

With-profits funds are run by professional investment managers who monitor and fine-tune the portfolios on an ongoing basis. So once you have decided on the

amount you want to invest, the rest is taken care of for you by professional specialists.

What should I look for when choosing a with-profits provider?

The performance of with-profits funds relies on the success of the provider. In recent years, some with-profits providers have been considerably better able than others to manage their funds and smooth their returns through the stock market fluctuations that have occurred. Therefore, it is very important to choose your provider with care, bearing in mind that past performance is not a guarantee of future success.

The best performing with-profits providers have often been those with the greatest financial strength which has allowed them to stay more fully invested in equities over the longer term. A survey of with-profits funds by *Money Management* in April 2008 showed the average with-profits provider share content was below 40%, but two funds had at least 70% in shares. Financial strength also reflects a provider's ability to smooth out investment returns in the future having held back some returns in good times. The greater the fund's financial strength, the more it can withstand stock market turbulence.

Remember that, in order to get the best out of any savings or investment product that invests in shares, you should be prepared to leave your money invested for the medium to long term – ideally at least 5 years.

Nowadays, with-profits investments have become a lot more flexible than they were in the past. You don't have to commit yourself to making regular savings for a set term if you don't want to, but can buy lump sums instead. There is also a handful of individual savings accounts (ISA) which allow you to invest tax efficiently in with-profits funds. You can either invest a lump sum or make monthly savings totalling up to £7200 (the current limit in this tax year for such ISAs). **BJHM**

The above information does not constitute financial advice. For further information please speak to your financial adviser.

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