

A Guide to With-Profit and Unit Linked Annuities



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With-Profit Annuities

With-profit annuities combine the advantages of an income for life, with the advantages of investing in a with-profit fund that is linked to the stockmarket.

With-profit annuitants share in the future investment gains (or losses) of the fund and so their annuity income may rise or fall in future years, depending on declared bonuses. However, some with-profit annuities incorporate guaranteed minimum income levels, below which the annuity income can never fall.

The objective of a with-profit annuity is to provide income growth over time, through steady investment performance. This is in contrast to conventional (non-profit) annuities where the income is guaranteed, but there is no investment growth.

Not all annuity providers offer with-profit annuities and a specific minimum fund size may be required. Those that are offered, range from conventional with-profit annuities to minimum income guarantee with-profit annuities. Enhanced with-profit annuities are also available. The way their bonus structures work can also vary. Generally, however, they offer the same optional 'add-ons' as for conventional annuities.

'Conventional' With-Profit Annuities

These typically offer no guaranteed minimum level of income at outset. They allow you to select the level of your first year's income by choosing an anticipated annual bonus rate, which must be within the provider's current range (typically, this is from 0% to 5% per annum). In reality, you are choosing the minimum annual bonus level that you believe the underlying with-profit fund will achieve.

The higher the chosen anticipated annual bonus rate, the higher the initial level of income will be (and vice versa). Each year, the provider will declare a bonus rate for their with-profit fund. If the actual bonus rate declared is less than your chosen anticipated annual bonus rate, your income level would be reduced for the next twelve months.

Obviously, if the provider achieves better results and the actual annual bonus rate declared is greater than your chosen anticipated annual bonus rate, then your income level would be increased for the next twelve months.

'Guaranteed' With-Profit Annuities

These are similar to 'conventional' with-profit annuities outlined above, but have minimum income guarantees, which, in some cases, will never be less than the starting level of income. Some providers have also removed the requirement to select an anticipated annual bonus rate at outset and have also modified the bonus structure, in order to simplify the product. However, the underlying principle of linking your annuity to the performance of the provider's with-profit fund, still remains.

Some providers of with-profit annuities allow you to switch to a conventional annuity under certain circumstances. However, the annuity offered is unlikely to be the best in the market and you would not

be allowed to move to another provider. Once a conventional annuity is purchased, you cannot then switch back into a with-profit, or unit-linked annuity, at some future date.

All with-profit annuities carry an element of risk and, because of this, we recommend that you firstly seek advice from ourselves before purchasing one.

Important Notes

- Some with-profit annuity providers offer you the option to select a revised anticipated annual bonus rate each year. This allows you to adjust the level of risk you are willing to take, or adjust the level of income you require to suit your needs
- The total annual bonus is made up of a 'reversionary' element and a 'terminal bonus' element. How these bonuses are applied to your annuity can vary between providers
- Your annuity is linked to the investment performance of the annuity provider. 'Conventional' with-profit annuities aim to 'smooth out' investment returns in a volatile equity market
- Your income is likely to vary on an annual basis and, as shown in part (a) above, can move down as well as up
- On switching to a conventional annuity, a 'Market Value Reduction' could potentially be applied
- As this is an investment-linked annuity, the anticipated performance of a particular with-profit fund is the key to choosing the right annuity provider. We can provide you with more detailed information and/or advice on this aspect, if you wish to purchase a with-profit annuity
- Any 'Guaranteed Minimum Pension' (GMP) benefits cannot be taken from either with-profit or unit-linked annuities (see below). However, it is now possible to effect a 'Protected Rights' with-profit annuity

Unit-Linked Annuities

If you are relatively young and healthy, prepared to take more risk with your pension fund, can cope with a fluctuating income and want a totally investment-linked annuity, then a unit-linked annuity will possibly suit you.

This type of annuity is only offered by a few providers and will typically appeal to those who have other sources of income in retirement, on which they can also rely. Unit-linked annuities are generally not for the 'faint-hearted'. Unlike other annuities, they will usually require regular ongoing investment advice, as you can switch between different funds to try and maximise your annuity income. However, any ongoing advice and above-average switching between funds will incur additional costs. As a result, unit-linked annuities are generally more costly to run.

How Unit-Linked Annuities work

The unit-linked annuity provider will use its own actuarial tables to work out the amount of income it will pay you. This will be based on your age and your spouse or civil partner's age, if appropriate, taking into account any 'add-ons' you have selected and the size of your pension fund. The income amount is then converted into units for the unit-linked fund(s) selected.

Each annuity payment made is equal to the value of those units on a particular date, which is normally about 10 days before the annuity payment is due. Income from a unit-linked fund, which invests in stocks and shares, is likely to fluctuate, according to the market conditions at the time of each payment.

With most unit-linked annuities you can opt for an anticipated growth rate, which has a similar effect on the initial level of income as the 'anticipated annual bonus rate' for with-profit annuities.

You choose a rate of growth within the provider's permissible range, which will also determine your initial income amount. The higher the growth rate you choose, the higher your initial income, but the lower your future increases are likely to be. If the selected unit-linked fund(s) do not perform as well as the chosen growth rate, then your income amount will reduce.

A higher initial income amount is achieved by increasing the initial number of units. To compensate for this increase, the number of units is then reduced each year on a set basis. In effect, your total units are reducing each year by the anticipated growth rate you have chosen.

Provided the price(s) of your units increase above your chosen growth rate, your income should not decrease. However, if the price(s) of your units continually perform below your chosen growth rate, your ongoing income will decrease.

Important Notes

- Your annuity income is only as secure as the unit-linked fund(s) in which you are invested
- Your on going level of income is not guaranteed
- Your annuity income will rise or fall and will be subject to economic market conditions prior to each payment
- Past performance is not a reliable indicator of future results.
- Once a unit-linked annuity has been purchased, you cannot usually transfer your annuity to another provider. However, some providers may allow you to switch to a conventional annuity or a non-unitised with-profit annuity, but your income could go down, depending on the options you choose
- You do not own the units in which you are invested and you cannot 'cash them in'. They are simply a way of valuing the income payable, as each payment falls due
- There is no surrender value
- Funds available typically range from high risk to those of a more cautious nature
- Unit-linked annuities are not available to all types of pension funds

Turning a Unit-Linked Annuity into a Conventional Annuity

Some unit-linked annuity providers will allow you to convert your unit-linked annuity into one of their conventional annuities, although they may charge you for doing so.

However, it is unlikely that their conventional annuity rates for your specific requirements will be the most competitive on the market.

We recommend that you consult us firstly, if you are thinking about exercising this 'conversion option'. This is because once you have changed to a conventional annuity, you cannot switch back into a unit-linked annuity at a later date.

Death Benefits

As with any annuity, be it conventional, with-profit, or unit-linked, the death benefits are limited to any 'add-ons' selected on commencement of the annuity. These 'add-ons' may include a guaranteed payment period, surviving spouse's or dependant's pension and value protection.

Fund Switching

Unlike conventional annuities, most unit-linked annuities allow you to switch between the provider's specified range of unit-linked pension funds, enabling you to change your investment strategy in future

years. Normally, a provider will not charge you for switching between funds, provided that you limit the number of switches to one or two a year.

Investment-linked income is usually the only option, but some providers may offer a 'unitised with-profits fund' (if so, the unit price will work differently). You may also be able to use 'secure' funds, which minimise the degree of downside movement and which may have guaranteed minimum income 'floors'.

If you are looking for total guarantees, however, there seems little point in buying a unit-linked annuity that invests wholly in a 'secure' fund, as it would be easier and potentially less expensive to buy a conventional annuity.

Some unit-linked annuity providers may also offer you access to 'external' funds, operated by various well-known fund managers, giving you the potential to choose from numerous funds, which invest in specific sectors and/or countries around the world.

The 'Self-Invested' Unit-Linked Annuity

For ultimate freedom of investment choice within an annuity, you could choose a 'self-invested' unit-linked annuity, up until your 75th birthday. This is considered by some to be the riskiest annuity you could purchase.

Self-invested unit-linked annuities are best suited to experienced investors, who prefer to invest directly in world stock markets and who want to keep their pension fund fully linked to the ongoing performance of equity markets.

Important Notes

- Under the 'self-invested' option, you could possibly invest in a wide range of investments including, for example, shares, gilts, fixed interest deposits, building society deposit accounts, authorised unit trusts and investment trusts;
- There is a very limited marketplace for this type of annuity, so it could prove difficult to find a product that completely suits your requirements; and
- If you are seriously considering a self-invested unit-linked annuity, you should also consider 'phased retirement', 'income drawdown', 'phased drawdown', or one of the new 'mid-market' products, as possible alternative options. Please ask for our other guides on these alternative options, for further details.

Suitability

With-profit annuities will potentially suit those individuals who want the potential to benefit from future investment returns, whilst retaining some measure of guarantee and 'the smoothing' of volatility on their future income payments. They would, therefore, suit an individual with a 'low-to-medium' attitude to investment risk.

They may also suit individuals with a relatively small pension fund, who are not heavily reliant on the annuity income obtained from it.

Investors currently invested in an unsecured pension (income withdrawal) may find it advantageous to consider effecting a with-profit annuity at an older age, because it enables them to maintain some exposure to equities, but without as much volatility, whilst having the added bonus of benefiting from the mortality cross-subsidy, which is an important feature of a lifetime annuity.

By comparison, unit-linked annuities are more likely to suit individuals who do not require guarantees on their income payments, but would prefer the potential to benefit from higher future investment returns, through being directly linked to the ongoing performance of equity-based funds.

They therefore suit individuals with 'medium-to-high' attitudes to investment risk. In certain circumstances, they may also suit individuals with a relatively small pension fund, who are not solely reliant on the annuity income obtained from it.

Unit-linked annuities are deemed higher risk than either conventional or with-profit annuities.

Please note that the Appendix to this Guide sets out, in tabular form, a summary of the different types of annuities outlined in this Guide, together with a concise appraisal of their inherent risks.

For further information or to book an initial consultation, please call us free on 020 8760 9940.

Monetary Solutions Ltd is an appointed representative of Burns-Anderson Ltd.

Information given in this article is for guidance only and should not be taken as individual advice. We cannot assume legal liability for any errors or omissions it might contain. Specific advice should be taken before acting on any of the guidance set out in this article.

APPENDIX: Comparing With-Profit and Unit-Linked Annuities

Feature	Guaranteed – conventional annuity		Conventional with-E1profit	Guaranteed with-profit	Unit Linked
	Level Income	Escalating Income			
Offers the potential to benefit from investment growth	x	x	✓	✓	✓
Pays and income for life	✓	✓	✓	✓	✓
Provides a fixed (known) amount of income for life	✓	✓	x	✓	x
Could help against the effects of inflation	x	✓	✓	✓	✓
Provides some flexibility to choose the level of income	x	x	✓	✓	✓
Income is guaranteed not to fall	✓	✓	x	✓	x
Enhanced income available if adverse health condition or lifestyle conditions applies	✓	✓	✓	✓	x
Can be purchased on a single or joint life basis	✓	✓	✓	✓	✓
Can choose a payment guarantee period	✓	✓	✓	✓	✓
Can convert to a guaranteed/conventional pension annuity	x	x	✓	✓	✓