

Your guide to the Scottish Friendly with-profits fund

Introduction

Your policy is invested in the Scottish Friendly with-profits fund. This guide will provide you with an overview of how the fund works, how Scottish Friendly manages the fund and the risks and rewards you can expect from your policy.

PLEASE READ THIS GUIDE – IT GIVES IMPORTANT INFORMATION ABOUT HOW WITH-PROFITS POLICIES WORK

What is the with-profits fund?

The with-profits fund is an investment in Scottish Friendly. All payments into the with-profits fund, are added together and invested in a range of different assets managed by Scottish Friendly after taking off expenses and payouts from the fund. The value of the with-profits fund rises and falls to reflect the underlying investment return on these assets. Scottish Friendly's expertly managed investments include stock market shares, bonds, property, and cash assets. The fund will also invest in additional projects as part of Scottish Friendly's growth strategy. The return on these investments will include any profits and losses from the sale of new business, the consolidation of other friendly societies and other business partnerships which the Society undertakes.

As Scottish Friendly has no shareholders, after the deduction of expenses, the whole fund is used to provide benefits for investors in the with-profits fund.

The overall fund is expertly managed to meet all the legal and regulatory requirements in a sound, prudent and professional manner designed to treat all customers fairly. In addition the fund is managed to ensure it can meet the guarantees which are granted to with-profits policyholders, and these are explained below.

Is there more than one with-profits fund?

Scottish Friendly has a single with-profits fund, however part of the fund has been specifically earmarked to provide benefits for certain classes of policyholders. This document covers the operation of the main part of the with-profits fund in respect of those policyholders who invested directly with Scottish Friendly through what is known as a conventional Ordinary Branch policy. Separate documents outline the operation of Industrial Branch policies (normally those where premiums were collected by a door-to-door salesperson), unitised with-profits policies and any policies which were transferred to Scottish Friendly where the terms of the transfer determined that the policies should be managed separately.

You should therefore ensure that this guide relates to your policy.

What are the guarantees?

Your with-profits policy will contain an element of capital security. All policies provide a guaranteed cash sum on a specified maturity date (typically ten years) provided all premiums have been paid.

The guaranteed cash sum at maturity can grow in two ways. Firstly through the addition of *regular bonuses*, normally paid once a year. These bonuses increase the value of the guaranteed cash sum on maturity. Once the guaranteed cash sum on maturity has been increased it cannot fall, provided all premiums continue to be paid. Secondly, a *final bonus* may be added to the guaranteed cash sum on maturity.

The level of bonuses that may be paid will depend principally on the long-term performance of the underlying investments in the with-profits fund and how Scottish Friendly decides to allocate those profits between regular and final bonuses. Bonuses will depend on legal and regulatory requirements, the prudent management of the business with a view to treating all customers fairly and obligations to meet the benefits and guarantees that have already been set.

Notwithstanding these principles, the following sections explain how Scottish Friendly goes about calculating the regular and final bonuses.

How does Scottish Friendly decide regular bonuses?

Regular bonuses are normally decided annually, although in extreme circumstances, such as during a severe stock market downturn, they may be changed more frequently.

When setting regular bonus rates Scottish Friendly starts from a rate that reflects the level of interest paid on the long term government bonds that are held within the with-profits fund. This is adjusted to allow for the effect of charges (and, where appropriate, tax).

In addition Scottish Friendly aims to ensure that the bonus level should not change dramatically from year to year.

In severe market circumstances, such as a significant and sustained fall in the stock market and/or interest rates, the regular bonus rate could fall to zero. It cannot however fall any further.

Every year you will receive a *bonus notice* statement which will provide you with details of the amount of bonus which Scottish Friendly has paid on your policy and its effect on your guaranteed cash sum at maturity.

How does Scottish Friendly decide final bonuses?

Scottish Friendly sets final bonuses with the intention of bringing the guaranteed cash sum on maturity into the line with the overall return you would have received had you invested all your premiums into the underlying assets within the with-profits fund. Final bonus rates are normally set once a year but can change more frequently if there are significant market movements.

Scottish Friendly's preference is normally to pay the larger part of bonuses as final bonuses as this helps to reduce the cost of guarantees within the fund. This in turn provides greater freedom to invest a higher proportion of the fund in assets with potentially higher long term returns but which also carry greater risk.

Final bonuses can be substantial but can fall to zero if the performance of the with-profits fund is particularly poor for a sustained period of time. If at maturity the value of the guaranteed cash sum plus any regular bonuses that have been added is greater than the value which would have been received had premiums been directly invested in the underlying assets then it is likely that no final bonus will be payable.

All bonus payouts are also subject to smoothing and this is explained in the next section.

What is smoothing?

Scottish Friendly aims to ensure that over time policies which start and end within a similar period experience similar costs, risks and benefits. This helps to smooth out the day-to-day ups and downs of investment markets, administration costs and the costs of paying death benefits, helping to reduce the overall risk experienced by individual policyholders.

This smoothing process is only designed to lower the day-to-day risk of investing in the with-profits fund and is not designed to hold back profits or rightfully earned investment returns. Therefore the aim of the policy is to share out all profits over the long term.

When Scottish Friendly sets both regular and final bonuses it is done in a way that attempts to ensure that, on average, investors will receive the amount they would have received had their money been directly invested in the underlying investments within the with-profits fund. However Scottish Friendly also aims, through smoothing, to ensure that the payout on identical policies will not change by more than 10% in one year in anything other than extreme market circumstances. This helps to even out some of the ups and downs of the underlying investments.

What are the charges?

The charges under the fund cover the costs of selling and setting up each policy, the expense of investing the premiums, the cost of ongoing administration and life insurance. These charges are

passed directly to the with-profits fund but Scottish Friendly aims to ensure fairness between different policies and classes of policies.

What happens if I leave the fund early?

The guaranteed cash sum assumes that payments will be made for the full policy term so if a plan is cashed-in before the maturity date the guaranteed cash sum will not be paid. Instead Scottish Friendly will aim to pay a value which is consistent with what you would have received had you invested directly in the underlying investments within the with-profits fund. This means that you could receive less than you have paid in, especially in the early years.

To reflect the cost of setting up your policy there will be no value on certain policies which cash-in or stop paying premiums during the first two years. You should consult the appropriate Key Features documents for your policy.

What happens if I die before the end of the policy term?

In the event of your death Scottish Friendly will payout the full value of your guaranteed cash sum plus any bonuses that have been added and this may include a final bonus. Any final bonus will be added at a rate that will ensure the total amount payable is similar to policies maturing with the same term as your investment.

Why does the fund hold more assets than it needs?

The with-profits fund will always hold more assets than it needs to meet every individual policyholder's plan benefits. These support assets provide additional security to policyholders by being the first call on any unforeseen risks which may potentially impact policyholder returns (see "*What risks is the with-profits fund exposed to*"). They are also used to sustain the smoothing policy and are designed to meet the cost of guarantees granted to with-profits policyholders. Generally Scottish Friendly aims to hold between 5% and 25% of these excess assets.

As Scottish Friendly does not have any shareholders, with-profits policyholders benefit entirely from any profits made but at the same time they bear the risks of all the business activity of Scottish Friendly. The costs of these risks can be met initially from the fund's support assets and these risks are set out in more detail below.

What determines what the with-profits fund invests in?

Scottish Friendly determines the underlying investments within the with-profits fund and these are formally reviewed at least once a year, more frequently during times of market turbulence. Scottish Friendly closely monitors the value of guarantees that are provided to with-profits policyholders and keeps a close eye on the proportion of the fund that is invested in more volatile shares and property investments.

It is of paramount importance to Scottish Friendly that the organisation can meet all the guaranteed benefits provided to policyholders. Therefore should the value of the fund fall close to the value of the guarantees provided to policyholders Scottish Friendly is likely to significantly restrict the scope for the fund to invest in shares and property.

Subject to this and depending on Scottish Friendly's judgement of current market conditions and growth opportunities the fund would normally expect to hold between 40% and 70% of the assets in shares and property with the balance invested in fixed interest investments made up of gilts and corporate bonds. However should any class or type of policy provide a significantly different level of guarantee to other classes of policies invested in the with-profits fund a different investment strategy may be followed for that class of business.

The amount of excess assets (above) within the fund will also help to determine the amounts invested in shares and property. Should these excess assets fall then Scottish Friendly would normally reduce the proportion of the fund invested in shares and property. On the other hand should they rise then Scottish Friendly would increase exposure to these more volatile but potentially rewarding investments.

The fund may make use of derivative instruments to reduce risk or more efficiently manage the underlying assets, although the fund currently does not own any such derivatives. A maximum of 50%

of the fixed interest investments may be invested in corporate bonds. These will be made through a unit trust which takes due account of their credit quality. The core holding of any investment in stocks and shares (about 80%) will be in the form of index tracking assets with the balance in aggressively managed active equity funds.

What risks is the with-profits fund exposed to?

The main risk within the with-profits fund is that associated with Scottish Friendly's investment management. Whilst the fund is managed to ensure that Scottish Friendly is continually able to meet its guarantees, the growth potential of the fund depends on Scottish Friendly's investment management decisions and the performance of the assets within the fund.

In addition the fund accepts the risks and rewards of Scottish Friendly's overall performance. These risks are initially met from the support capital within the with-profits fund; thereafter they will impact on with-profits fund returns. The following gives an overview of the main risks of the with-profits fund.

- New business – new business written by Scottish Friendly may cost more than the immediate charges which will flow from each policy. Therefore new business levels can affect short term costs and hence the performance of the with-profits fund.

Scottish Friendly carefully controls these through an annual business plan.

- Existing costs – should the cost of administering new business increase, these costs will be borne by with-profits policyholders. Similarly decreases in the cost of administering new business will benefit with-profits policyholders.

Policies that potentially expose with-profit policyholders to this expense risk only represent around 10 to 15% of Scottish Friendly's policies. Furthermore expenses are carefully monitored and controlled.

- Other business ventures including partnerships, new product launches and mergers and consolidations with other friendly societies will impact on the returns and risks within the with-profits fund.

All new ventures of this description must be thoroughly scrutinised and approved by the Board of Scottish Friendly after advice from the With-Profits Actuary who looks after the financial interests of all with-profits policyholders. New ventures will be expected to achieve returns which exceed the costs of any risks and are at least comparable with other available investments.

- Should the assets earmarked for specific policyholders become unable to support those policyholders' guaranteed benefits then the assets of the with-profits fund may be called on to support those policyholders' guaranteed benefits.

Each separate group of policies with benefits that are supported by their own set of earmarked assets are carefully managed to ensure that they can meet their guarantees without the need for additional support from the main with-profits fund.

Governance of the with profits fund

The fund will be managed according to the principles and practices set out in the full Principles and Practices of Financial Management which is available on the Scottish Friendly website or on request. You will be notified three months in advance of any changes to the principles governing this fund.

The fund is overseen by the Board of Scottish Friendly and every year they will report to policyholders confirming that the fund has been managed in accordance with the principles and practices of the fund and also noting any discretion which they have exercised under advice from the fund's With-Profits Actuary.

Where can I get more detailed information?

You can find additional information about the way in which your individual policy will invest in the with-profits fund in the Key Features document for your policy.

This document is a summary of the more detailed Principles and Practices of Financial Management for Scottish Friendly's with-profits fund. Copies of this document are available on request from Scottish Friendly or simply by downloading it from the Scottish Friendly website.