

## **How we invest your money?**

### **Our 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.

This guide explains to you how we manage our With-Profits fund. It contains important information about how your policy works and how you can expect us to manage it. You may wish to read it alongside:

- Your policy or Key Features document, which gives essential information
- Your personal illustration (where appropriate), which shows what you might get back in the future

After you have read this guide, please keep it in a safe place.

#### **What is the With-Profits Fund?**

Our With-Profits fund is an investment fund where your money is combined with that of other customers. We manage the fund on behalf of all with-profits policyholders and pay all policy benefits and costs from the fund.

By investing in the fund through one of our with-profits products, you become a member (owner) of Scottish Friendly.

As a mutual organisation, we have no shareholders and all the profits from the With-Profits fund are used for the benefit of our members.

#### **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 part of the with-profits fund in respect of those policyholders who were transferred to Scottish Friendly from Marine & General Mutual Life Assurance Society Ltd (M&G) on 31 May 2015. Therefore, all further references to the with-profits fund within this document refer to the, separately identified, M&G with-profits fund which is within the Scottish Friendly fund but earmarked for M&G policyholders. Separate documents outline the operation of business that was set up directly with Scottish Friendly and any other policies that have been transferred to Scottish Friendly where the terms of the transfer determined that these

policies should be managed separately (such as business transferred from Scottish Legal Life or Rational Shelley).

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

### **Types of With-profits Policies**

There are three types of with-profits policies

- 'conventional' with-profits policies;
- 'unitised' with-profits policies; and
- with profits annuities.

Under conventional with-profits policies, in return for your premiums, we pay a guaranteed lump sum (called a sum assured). We aim to increase the guaranteed amount by adding bonuses.

Under unitised with-profits policies, premiums are used to buy units in the fund at the current unit price. We aim to increase the unit price by adding bonuses. To work out how much you get back, we use the value of the units allocated to your plan.

For with profits annuities, the level of annuity payments can be increased through the addition of bonuses, which will be determined from time to time. The level of bonuses depends on the profitability of the business in the M&G with-profits fund.

### **What are the guarantees?**

For with profits annuities, there is a guaranteed minimum level of annuity. The actual amount of annuity will depend on the performance of the underlying assets and the experience of the fund. Once a bonus has been added to the policy and the annuity payment has been increased to reflect this, the bonus will not be removed.

Conventional and unitised with-profits policy will contain an element of capital security. All policies provide a guaranteed cash sum on a specified maturity date provided all premiums have been paid.

The guaranteed cash sum at maturity can grow in two ways. Firstly, through the addition of regular bonuses which are 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.

The following sections explain how Scottish Friendly goes about calculating the regular and final bonuses.

### **How does Scottish Friendly decide regular bonuses?**

Regular bonuses for with profits annuities are determined by the profitability of the annuity business within the M&G with-profits fund.

Regular bonuses on conventional and unitised with-profits policies 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 rate 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. It is however possible for negative bonuses to be declared on the with-profits annuity business in the event of adverse experience.

Every year you will receive a *bonus notice* statement which will provide you with details of the amount of units your policy holds and their value.

### **How does Scottish Friendly decide final bonuses?**

Scottish Friendly sets final bonuses on conventional and unitised with-profits policies with the intention of ensuring that the value of your policy represents a fair return on the premiums you have paid bearing in mind the investment returns that have been available on the assets held in the with-profits fund during the period your policy has been in force. No final bonus is payable on the with-profits annuity policies.

Our 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 some freedom to invest a 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 for a smooth progression of policy returns by varying the regular bonus rates relatively infrequently and making gradual adjustments to the final bonus rates on an annual basis.

### **What are the charges?**

The charges under the fund cover 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. The expenses that may be charged to the fund are specifically limited by the terms upon which the business was transferred.

### **What happens if I leave the fund early?**

If you transfer your with profits annuity to another provider, the fair value of your policy will be determined and this amount transferred to the other provider.

The guaranteed cash sum on conventional and unitised with-profits policies 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.

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

For conventional and unitised with-profits policies, in the event of your death Scottish Friendly will pay out 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.

There is no policy term for with profits annuities. If you die, and the policy has been set up to provide a benefit to your spouse, the spouse's benefit will be paid on the event of your death. If you die and the policy has been set up to provide no benefit to your spouse, the policy ends on your death.

### **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 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 are the with-profits fund exposed to?*"). They are also used to meet the cost of guarantees granted to with-profits policyholders.

Ultimately, all of the assets within the M&G fund will be distributed to the M&G policyholders.

### **What determines what the with-profits fund invests in?**

The underlying investments of the with-profits fund were broadly determined at the time of transfer and are aimed at ensuring an orderly winding down of the M&G book of business. 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.

### **How long will the fund be managed?**

The with-profits fund is expected to be managed until 2030 or until the number of in force with profits policies falls below 8,000. At this time, Scottish Friendly may distribute any residual inherited estate to the remaining with-profits policies, the fund will be wound up and the assets and liabilities of the fund will be transferred to the Scottish Friendly Main Fund.

### **What risks are the with-profits fund exposed to?**

The main risk within the with-profits fund is that associated with investment management. Whilst the fund is managed to ensure that Scottish Friendly can continually meet guarantees provided to policyholders, 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 the guarantees within the fund. These risks are initially met from the support capital within the with-profits fund; thereafter they will impact on with-profits fund returns.

The fund will also be exposed to the business risks associated with the non profit policies within the M&G book of business, which were included in the transfer to the M&G sub fund of Scottish Friendly. There is no significant exposure to business risk from the M&G business transferred to the Main Fund of Scottish Friendly.

### **How is the with-profits fund managed?**

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 by the Monitoring Committee, and every year a report will be prepared for 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 the M&G fund within 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.