

## **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 London Aberdeen & Northern Mutual Assurance Society Limited (LANMAS) on 31 December 2007. Therefore, all further references to the with-profits fund within this document refer to the, separately identified, LANMAS with-profits fund which is within the Scottish Friendly fund but earmarked for LANMAS 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.

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

Your with-profits policy will contain an element of capital security. The unit price of your with-profits fund is guaranteed not to fall. Provided you maintain your policy then, on your death, the minimum value that will be paid on your policy will be the number of units multiplied by the unit price. If your policy specifies dates upon which you are able to take cash from the policy on guaranteed terms then this guaranteed minimum basis would also apply.

If you cash in your policy at any other time it may incur a Market Value Reduction (see below for further details).

The value of your policy can grow in two ways. Firstly, through the addition of *regular bonuses* which are normally declared once a year. Regular bonuses are paid by increasing the unit price of the with-profits fund. Secondly, a *final bonus* of additional units may be added to the guaranteed cash sum when you cash in units.

Some LANMAS policies specify the minimum amount of regular bonus that must be added to a policy each year. You should refer to your policy document to see if this applies to your policy.

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.

The rate is subject to the minimum level that may apply on the policy.

Currently, unless a policy has a right to a minimum rate, the regular bonus rate is nil. Regular bonus rates are unlikely to increase in the foreseeable future as the fund investment profile is targeted to ensure that the existing guarantees given to policyholders can be fully met from the fund.

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 calculates rates of final bonus or Market Value Reductions (see below) which are used to adjust the value of your policy units when you wish to cash them in. The purpose of this adjustment is to bring the value of your policy broadly into the line with the overall value you would have obtained had you invested directly into the underlying assets that are held by the with-profits fund.

Final bonus rates (or Market Value Reductions) are maintained on an ongoing basis throughout the year and ensure that your policy payout remains in line with the underlying market value of the assets within the with-profits fund.

When you cash in units from your policy, if the value of the units is less than the value which would have been available had you invested directly in the underlying assets of the with-profits fund then a final bonus will be payable to reflect this difference.

However, if, when you cash in units, the value of the units is higher than the value which would have been available had you invested directly in the underlying assets of the with-profits fund, then no final bonus will be payable. Indeed, unless you are cashing in units at a time when unit prices are guaranteed a Market Value Reduction will be applied to the units (as explained below).

### **What is a Market Value Reduction?**

A Market Value Reduction (MVR) is an adjustment that is used to reduce the value of your policy when you wish to cash in units at a time when the value of the units allocated to your policy are greater than the value that would have been available had you invested directly in the underlying assets of the with-profits fund.

It is designed to ensure that you receive no more than your fair share of your investment return when you cash in your policy units.

When you take out your policy it will usually specify dates where the unit price is guaranteed and a market value reduction can not apply. For example, this may be on dates when you are taking an income payment. If you cash in policy units at any other date then Scottish Friendly may apply a market value

reduction. Such an adjustment will have the effect of reducing the value of your units. A market value reduction will only apply where the value of your exiting units is greater than the value you would have received had you invested in the underlying assets of the with-profits fund.

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

The charges made to 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 die before the end of the policy term?**

In the event of your death Scottish Friendly will pay out the full value of your accumulated fund including 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 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 LANMAS fund will be distributed to the LANMAS 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 LANMAS 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. Due to the nature of these guarantees the fund is mainly invested in government bonds and other high quality corporate bonds. Since 2009, around 20% of the fund has been invested in shares.

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

The with-profits fund is expected to be managed until 2018 or until the number of in force policies falls below 1500. 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 LANMAS book of business, which were included in the transfer to 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 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.