ITB
PENSION FUNDS

AVCs - a guide

This document is correct as at January 2005 (date of issue) - please also see the other AVC guides which are updated as required.

ITB Pension Funds - A guide to AVC Investments

Prepared by YIG Consulting Ltd, part of Yorkshire Investment Group

For those individuals who are paying Additional Voluntary Contributions (AVCs), or are thinking of doing so, the ITB Pension Scheme offers a range of funds to choose from.

You may think, therefore, that the natural question to ask is, “Which is the best fund to invest in?” The answer is not so straightforward. Were it so there would be no need to offer a range of funds – one would do for everyone. Different funds will suit different people. It is this recognition that lead the Trustees to offer a range of funds in the first place. The number and the range of the funds were chosen so as to cover the main asset types comprehensively, of which more later, without being so vast as to be bewildering.

The purpose of this guide is not, therefore, to advise which fund is best for you. The Trustees do not know your personal circumstances and are not authorised to give financial advice. The purpose of the guide is to:

- Help you understand the subject of investment risk,
- Give you an understanding of the characteristics of the main asset types, such as equities and bonds
- Provide information about the AVC funds available, including a risk rating, so that you are better able to make an informed decision.
- Help you to assess your own attitude to investment risk

It is also important to realise that this guide is not intended to comment on the suitability of paying AVCs compared to alternative investments, such as ISAs or even other types of pension, such as a stakeholder pension, which may be an option for some. The Trustees recommend that if you require financial advice you should contact a financial adviser who is authorised for this purpose. You may need to pay a fee for such advice.

This guide should be read in addition to, not instead of, the guides entitled “ITB Pension Funds AVCs – the facts” and also the Prudential’s “ITB Pension Funds Members’ Brochure AVC Facility”.

Available Funds

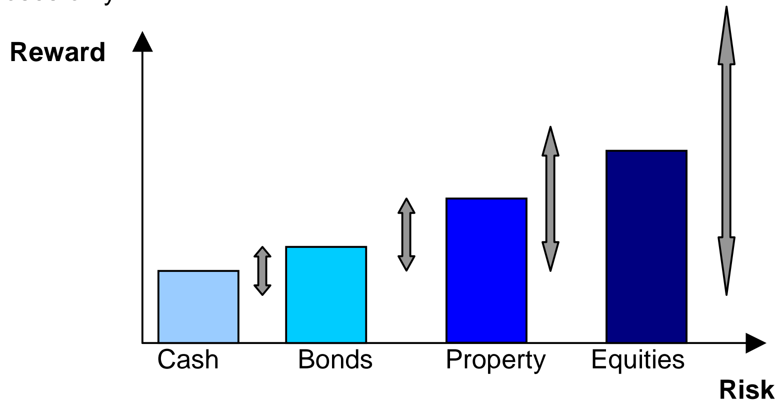
There are nine funds available to you within your pension scheme. These are as follows:

Prudential Deposit Fund
Prudential M&G Retirement Protection
Scottish Life Crest Secure Deposit Administration
Prudential M&G Fixed Interest
Prudential With Profits
Prudential DWS Balanced
Prudential M&G Socially Responsible
Prudential M&G UK Equity Passive
Prudential M&G Overseas Equity Passive

Information about each of these funds is given towards the end of this guide There is also a Lifestyle Fund option, which is covered in detail within the section explaining the characteristics of the different asset classes. This is because an understanding of this subject is key to understanding the aim of the Lifestyle Fund and how it works.

What is investment risk?

The dictionary defines risk as the possibility of incurring misfortune or loss. However, it is a measure of potential reward – the greater the level of risk, the higher (and more volatile) the potential returns. This can be demonstrated by the following chart which is for indicative purposes only.



The riskier the investment the more likely it is that the hoped for return will not be reached or the greater the shortfall from the expected return. This is shown by the arrows within the chart - but does not represent the highest or lowest possible outcomes.

Almost all investment opportunities involve a risk of some sort. For example UK Government securities do not suffer the risk of default, but are vulnerable to changes in interest rates.

Factors that can impact on investment returns and lead to variability include interest rates, inflation, exchange rates, tax rates, the general state of the economy and issues related to the specific investment.

No investment should be appraised using return alone. It is the combined risk-return profile that is important. What this means is that you should not simply pick a fund because it has performed the best. You need to work out whether the risk rating of the fund is appropriate to your circumstances.

Characteristics of Different Classes of Asset

There are basically four classes of asset (or stock) for our purposes:
Cash, Bonds, Property and Equities (Shares)

Cash deposits are generally perceived to be relatively low risk when held with institutions that are financially sound. The main risk to the wealth of investors holding cash is inflation which can erode the real value (purchasing power) of money. In addition, cash deposits offer little potential for real capital growth. The ***Prudential Deposit Fund*** is an example of this type of fund.

There is a further risk for pension investors. Although the capital is at very low risk, AVC funds will usually be required to buy an annuity. If interest rates, and therefore annuity rates, fall then pension expectations will similarly reduce, even where capital value has been protected.

Bonds are essentially debt instruments that are typically issued by Governments, International Institutions and Companies. Typically, throughout its life, a bond will pay investors a fixed rate of interest and have a predetermined price on maturity.

The principle risks associated with fixed interest investment are interest rates, inflation and credit (or default) risk. Whilst the features of fixed income and repayment of capital at the end of a fixed term imply that bonds should have lower volatility than, say equities, this may not necessarily be the case.

Bonds do have a particular place in pension planning, essentially for those approaching retirement. Bond values can fall, as well as rise, but tend to move contrary to interest rates (and therefore annuity rates). This means that whilst the fund might fall the annuity that can be bought is broadly maintained. The converse is also true; an increase in the value of the fund may be offset in annuity terms by a fall in annuity rates. So, whilst Cash can protect capital, Bonds can protect, to an extent, annuity prospects. This explains the name of one of the bond funds available to you - the ***Prudential M&G Retirement Protection Fund.***

Property is another means of diversification but investors should not forget their overall position because most investors will typically have exposure to property outside their pension scheme, in the form of their private residence. The commercial property market does not move in tandem with the residential property market but it cannot be divorced from the economic cycle or the fundamentals of valuation. Returns to commercial property come primarily in the form of rental income. There is no specific property fund available, but the Deposit Administration and the With Profit fund invest in property.

Equities, sometimes referred to as ***shares***, by their very nature are considered more risky than bonds. For ordinary shareholders there is no certainty of income and they have no rights to any specified capital repayment at some time in the future.

On average, returns to equity investors should reflect the growth in the economy, inflation and dividend yield. Stock specific issues (i.e. the fortunes of the company) and the dynamics of the economy have tended to be the most prominent factors affecting equity valuations. These have tended to make returns to equities more volatile than returns to other classes of asset. However, because companies tend to be dynamic and expand, the prospects for capital growth tend to be higher.

You need to select a fund or a combination of funds that you consider to be suitable to your own risk/reward profile given your time horizon (i.e. the number of years you believe that you will continue to work before retirement).

Diversification

It is important to understand the important role of *diversification* in reducing investment risk. Put simply, diversification is about not having all of your eggs in one basket.

There are two aspects to diversification. The first is *asset allocation*. A *managed fund*, for example, will invest across all types of asset. **Equities** and, usually, **property** are included to give potential for growth, but can be volatile. **Cash** and **bonds** are also included to temper the volatility, although this may restrict growth potential. An individual can therefore obtain a diversified asset allocation by investing in funds of different asset classification, or by investing in a managed fund.

The ***Prudential DWS Life Balanced*** and the ***Prudential With Profit Fund*** are both types of investment that diversify by asset class. The ***Scottish Life Crest Secure Deposit Administration*** is primarily a fixed interest fund but does have a small exposure to equities and property.

The next level of diversification relates to *stock selection*. *All* of the funds available to you are invested in a number of stocks. Once again a case of not having all of your eggs in one basket. However, some of the more specialist funds are, by their very nature, not as highly diversified as

the funds containing more than one particular class of asset or geographic region/sector. This is reflected in the risk rating given for each fund.

Active v. Passive Investment Management

Passive investment management refers to the case where a fund tries to copy or 'track' a given index of stocks. For example, the ***Prudential M&G UK Equity Passive Fund*** is designed to mirror the movement of all UK shares as closely as possible. This of course includes shares that will underperform as well as those that perform well. The ***Prudential M&G Overseas Equity Passive Fund*** is also a tracker, but reflecting overseas, rather than UK, shares. The ***Prudential M&G Retirement Protection Fund*** is a specialist fund which tracks a Government Bond Index.

The remaining funds are actively managed. Active management refers to the process whereby an investment manager aims to select the good stocks rather than the poor ones and will periodically review their selection. They may not achieve this so although the potential growth should be better than for an equivalent passively managed fund, there is the chance that it could do worse. This is another example of the expectation of higher reward coming at the expense of a higher risk.

Fund information and risk ratings

On a scale of 1 to 10 (where 1 is the lowest relative risk and 10 the highest) we have given each of the funds a relative risk rating to enable you to assess which fund(s) may be appropriate for you. Example ratings for this purpose are: 1 =Cash Deposits, 5/6 =Average Risk, 10 =Speculative. There are two points to note. Firstly, the ratings are correct at the time of writing, but can change over time, for example if a managed fund changes its asset allocation significantly. Secondly, the risk described is relative to the other funds available. For example, the UK Equity Passive fund might be considered low risk *relative* to the UK All-Share Index which it tracks. However, for these purposes its risk rating (7/10) is relative to the other funds available since it will fall and rise in value basically in line with stockmarket movements.

Prudential Deposit fund is designed to protect capital and provide rates of interest competitive with Building Society returns. The fund is very typical of the description given in the explanation of ***Cash Deposits*** in the Characteristics of Different Classes of Asset section, as are the associated risks.

Risk Rating: 1

Prudential M&G Retirement Protection fund is designed to broadly follow annuity rates and invests in long-dated UK Government Bonds. The fund is designed to track the FTSE A British Government Over 15-Years Gilt Index. It is primarily designed for those nearing retirement that want to preserve the annuity purchasing power of their pension portfolio. It is not designed to generate capital growth but will from time-to-time rise and fall in line with long-dated gilts. Because it is linked to the long-dated gilt market we consider it to be a specialist fund.

Risk Rating: 2

Scottish Life Crest Secure Deposit Administration fund is primarily a fixed interest fund. The underlying portfolio has an emphasis more towards security and preservation of capital than towards maximising total returns. It has a distinct bias towards less volatile classes of asset, such as cash and fixed interest securities, but it also includes some exposure to equities and property. This is a relatively low risk fund but the scope for returns in excess of those achieved from holding cash on deposit is limited. There is further comment about this fund in the section below headed 'Existing Investments'.

Risk Rating: 3

Prudential M&G Fixed Interest is an actively managed fixed interest fund that invests in UK Government securities and investment grade (high quality) corporate bonds. The majority of the return to investors in this fund will come from the income paid on the underlying assets. The capital value will be affected by interest rates (values will fall when rates rise and vice versa).

Because fixed interest securities are relatively less volatile than equities, this is considered to be a relatively low risk fund that in the longer term is likely to produce a steady return, slightly above the returns achievable through cash deposits.

However, because it invests in a relatively narrow range of the asset class, it should be considered a specialist fund and it could be used to provide the low risk element of a broader portfolio.

Risk Rating: 3

Prudential With Profits has in the past offered competitive long-term real returns whilst smoothing the peaks and troughs of day-to-day market movements. Smoothing is implemented by holding back some of the returns when markets are buoyant and using these to boost contract values when returns are poor. This has the effect of reducing the volatility of policy returns and has typically made with profits attractive to cautious (medium-low) risk investors. However, bonus rates have been falling steadily and Yorkshire Investment Group believe that there is little chance of past results being replicated in future years.

The stock market falls from the beginning of 2000 through to March 2003 had a significant impact upon the underlying asset values of with profit funds generally. Solvency requirements then forced many life companies to sell equities at a time when equity markets were at or near their lows and, as a result, with profit funds were unable to benefit from the upturn in equity markets from the second quarter of 2003 onwards to the extent that their traditional asset allocation would have allowed. A returns gap has emerged between the returns paid to with profit investors and the returns achieved on the underlying funds.

However, having commented on general trends in with profit funds the Prudential are rated by Standard & Poor's, an independent rating agency, as AA+, which means they are financially very strong (correct as at September 2004). This has enabled them to maintain a significant proportion of their With Profit Fund in equities and property, as at 31 December 2003, which in turn gives more scope for potential growth than the average with profit fund. Nevertheless, Yorkshire Investment Group consider this fund to be a medium risk investment, rather than below medium risk, in recognition that future gains in the underlying asset value may not translate directly into higher returns for policyholders.

Risk Rating: 5

Prudential DWS Life Balanced fund is actively managed and provides exposure to UK and overseas equities, UK and overseas bonds and cash, but not property. By definition, as a Balanced Managed fund, the maximum equity exposure is restricted to 85% of the fund. A minimum of 50% must always be invested in sterling based assets. This makes the fund suitable for medium risk investors who accept that investment risk is inevitable if they are going to achieve reasonably attractive returns. The fund offers good growth potential and is well diversified.

The fund manager will make asset allocation decisions based upon his view of the outlook and prospective returns for each asset class.

DWS Investments, part of the Deutsche Bank Group of companies, manages the fund. DWS is one of Europe's largest investment management groups.

Risk Rating: 6

Prudential M&G Socially Responsible fund is an actively managed UK equity fund that seeks to achieve capital growth through investment in selected companies which meet a set of investment criteria developed by Prudential in conjunction with EIRIS (Ethical Investment Research Service). The screening process means that the fund can invest in stocks representing around 60% by capitalisation of the FTSE All-Share Index.

This is clearly a specialist UK equity fund. It is unable to invest in approximately 40% of companies listed in the FTSE All Share Index and the relative risk rating given below reflects this restriction of choice. Oil and Gas, Mining and Tobacco are not represented in this fund. This could have a detrimental impact on performance.

This fund is suitable to provide some UK equity exposure, as part of a broader portfolio, for medium risk investors who accept that investment risk is inevitable if they are going to achieve reasonably attractive returns.

Risk Rating: 7

Prudential M&G UK Equity Passive fund is designed to provide an exposure to UK equities as represented by movements in the FTSE All-Share Index. This is achieved by full replication of the FTSE 100 Index and stratified representative sampling of the remainder of the Index. The fund is invested in a portfolio of UK shares designed to perform in line with the FTSE All-Share Index.

It is a specialist UK equity fund suitable to provide UK equity exposure for medium risk investors who accept that investment risk is inevitable if they are going to achieve reasonably attractive returns. The fund should be used in conjunction with other funds to build an adequately diversified portfolio.

Passive funds are sometimes thought of as relatively low risk, but this is only relative to the chances of underperforming the index which it tracks; in this case the UK All-Share. The top 6 UK companies currently account for around one third of the index which means the bulk of the fund is, in fact, concentrated in just a handful of shares. This limits diversification, which is a way of mitigating risk, and results in the risk rating shown.

Risk Rating: 7

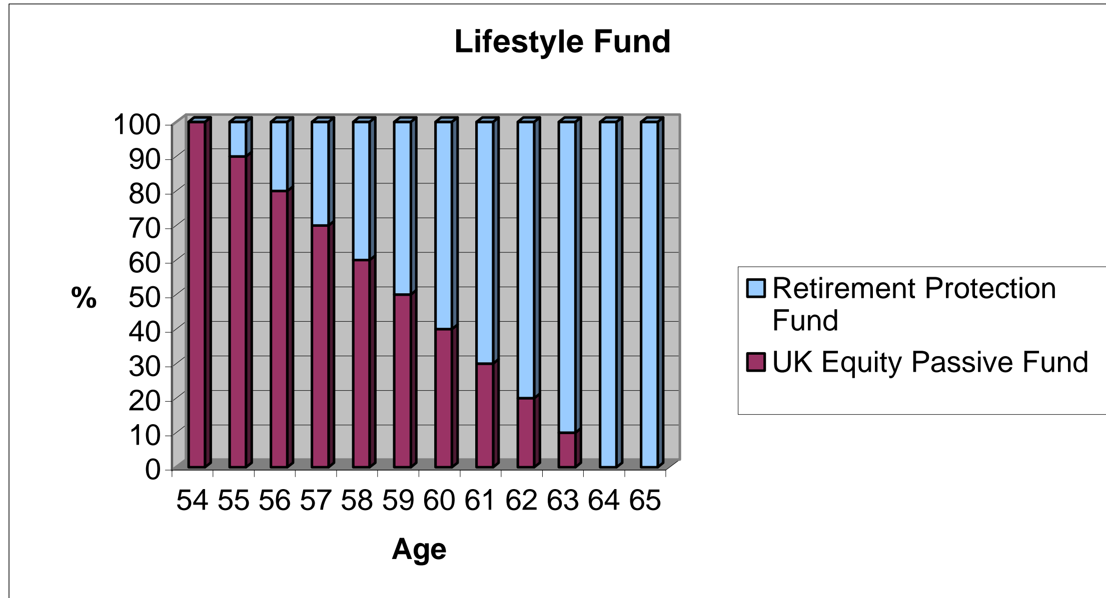
Prudential M&G Overseas Equity Passive fund aims to provide exposure to international equities by investing on a passive basis in North America, Europe, Japan and the Pacific Basin (ex-Japan) and actively in Global Emerging Markets. The strategic split between the regions will be broadly in proportion to each area's economic importance. These weightings are usually rebalanced every three months.

Whilst this fund invests in more than one geographic region it is a specialist overseas equity fund and whilst it can provide some overseas equity exposure for medium risk investors who accept that investment risk is inevitable if they are going to achieve reasonably attractive returns, it should be used in conjunction with other funds (UK equity and bond) when constructing a well diversified portfolio.

Risk Rating: 8

Lifestyle Investment Fund

The ***Lifestyle Fund*** invests in 2 of the funds offered within the ranges. Its aim is to balance the desire to maximise returns over the longer term, but to protect the value of accumulated funds as retirement approaches. It does this by investing in equities (***UK Equity Passive Fund)*** until a member is 55 years old and then, during the 11 years to age 65, accumulated funds and new contributions are progressively and automatically invested in the ***Retirement Protection Fund*** such that the entire fund is in the ***Retirement Protection Fund*** by your normal retirement date***.*** The chart below demonstrates this.



The lifestyle fund can be chosen at outset, or at any time subsequently. Similarly, you can choose to come out of the lifestyle option at any time and select your own fund, or funds, from the range available. If you are already over 55 on selecting the lifestyle option your contributions will be invested partly in the UK Equity Passive Fund and partly in the Retirement Protection Fund based on your age in accordance with the chart above.

You should be aware that the effectiveness of this approach is designed to work best for retirement at age 65. If you retire before 65 then there will still be an element of your fund in equities as you approach retirement, with corresponding potential for volatility.

Existing Investments

Until 2002 the only AVC fund available to members was the ***Scottish Life Crest Secure Deposit Administration Fund.*** In many ways Deposit Administration is similar to With Profits in that the fund invests across a mix of assets and bonuses are declared. The capital value, and bonuses once declared, are guaranteed. Bonuses are added in such a way as to smooth out investment returns over the long term. However, a key difference, compared to With Profits is that the underlying assets are such that the actual investment return of the fund is inherently less volatile with less invested in equities and a correspondingly higher proportion in bond type assets.

The performance of the Crest Secure Fund has declined markedly over the last 10 years. This is perhaps not surprising in itself given stockmarket returns as a whole over the period. However, the asset allocation has also become increasingly defensive over recent years as Scottish Life need to protect the guarantees for policy holders and cannot risk significant exposure to potentially volatile equities. In 2002 about 58% of this fund was invested in bonds with the remaining 42% split equally between equities and property. In 2004 85% is invested in bonds

with the remaining 15% again split equally between equities and property. In other words, if equity markets do perform well over the next few years the fund will not benefit now to the extent it would have done up until a few years ago.

This risk profile of this fund is now lower than it was 2 or more years ago. This may suit cautious investors and particularly those who are close to retirement. However, those who are less cautious may wish to consider whether it remains a suitable fund for them, compared to the other funds available. Members can also consider whether they wish to leave funds accumulated to date in this fund or transfer the value to one of the Prudential funds (including the Lifestyle Option).

Please note that the Trustees are not advising that switching or transferring funds in this way is in your best interests. Care should be taken to establish the charges which may be applied when money is taken out of a fund at any time other than your normal retirement date or on your death. A Market Value Reduction (MVR) may be applied to this fund and to with profit funds generally. Please request details of any MVRs at the point you are considering a transfer from this fund, or any with profit fund. The information is being made available in order that members can make an informed choice, or seek financial advice, as appropriate.

Understanding your own investment risk profile

Although the rewards of investment are attractive, some degree of investment risk is unavoidable. Individuals have different views about risk, these views can change over time and different investment funds carry different levels of risk.

It is therefore important to make sure that your attitude to risk does not conflict with the profile of the fund or collection of funds that you choose at any one time. Amongst other things, you need to take into account:

- Your current age
- Your intended retirement age
- Any other sources of pension and income
- Investment conditions
- The funds in which your main pension scheme benefits are invested (if money purchase in nature)

The risks associated with your pension are that:

- Investments may not grow enough to keep pace with inflation or provide a large enough fund to purchase a good pension
- Investments may fall sharply in value immediately prior to retirement
- Interest rates may fall sharply immediately before retirement thereby reducing the amount of pension that can be bought with your accumulated fund

As you can see, taking too cautious an approach can be as dangerous as being too adventurous close to retirement.

Historical returns indicate that equities (company shares) out-perform other classes of asset in the longer term, although they have tended to fluctuate more widely over the short-term than other investments. Past performance should not be seen as a guide to future performance and investors must be willing to tolerate fluctuating values in the shorter term. If, however, you are a long way from your intended retirement these short-term fluctuations are not as relevant.

This suggests that to minimise risk and maximise returns:

- If you are a long way off retirement you should invest predominantly in equities; and
- If you are close to retirement you should invest predominantly in low risk vehicles such as bonds

If the ITB AVC fund proceeds are likely to be a small part of your overall retirement income then you may be prepared to take a higher risk than would otherwise be the case, in the hope of achieving a higher return.

In providing broad guidelines certain general assumptions are made, and your personal circumstances may be such that these general guidelines are not appropriate for you. In providing these guidelines we are not in any way suggesting that they are suitable for you, and if you are in doubt as to which funds to choose you should consult a financial adviser.

The most important point is that you must be comfortable with the level of risk in the fund selected now and in the future.

Remember this is not a one-off choice. You will be able to change you investment decision at any time in the future if you so wish.

Summary

As many factors can impact upon your investment returns it is necessary to have a clear understanding of risk and reward and be confident that your expectations are realistic given the degree to which you can tolerate risk, time to retirement and available capital.

Taking too cautious approach in the long-term can be as dangerous as being too aggressive too close to retirement. There is a need to strike a balance and be comfortable with the level of risk associated with the fund or funds that you select. And whilst investing for retirement tends to be a long term venture you should periodically review your investment choice to ensure it meets with your circumstances at that time.

This guide has been prepared for the Trustees of the ITB Pension Funds to assist the understanding of those ITB Pension Funds members paying AVCs. The generic guidance should not be taken as specific advice as to a particular course of action.

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