

Unlike a standard annuity where the income payments are fixed, a with profits annuity offers you the chance to increase your income by participating in the potential returns offered through investing in equities. This is conducted in a controlled manner in the form of annual bonuses.

A standard annuity does not offer protection against the impact of inflation which may reduce the buying power of the payments you receive unless indexed, which to achieve will normally be at a considerable cost to the initial income level. The With-profits option is often used as a workable alternative to the high cost of indexation by providing a higher initial income and a long term option to beating inflation. The risk is that your income can fall if future bonus declarations fall. It is important to choose the right provider in this market to ensure the best chance of success. Your total income will be divided into two parts.

Firstly you will be provided with a minimum starting income, which will be determined by the selected Annual Bonus Rate (ABR). The second part will be determined by the actual bonus rate declared which is normally announced on a yearly basis and will set the rate for the following 12 months. This rate will depend upon the With-profit fund performance and will have some relation to stock market performance. The concept behind with profits though, unlike other investment linked annuities, is to smooth the returns. If you select a lower ABR at outset then the chance of the income falling is smaller as opposed to a high ABR (the maximum normally being 5%) then your starting income will be higher but there is then a higher chance of a future fall if the markets and bonus levels fall.

If the funds include protected rights funds then you must normally select a 0% ABR. Some companies also offer the guaranteed Bonus rate but this will affect your starting income.

## With-profits annuities

These link your income directly to the performance of the insurance company's with-profits fund. Typically, your income is made up of two parts:

- **a minimum starting income** – this is usually set at a low level but, unless investment conditions are very bad, you will usually get at least this much income. Some with-profits annuities guarantee it;
- **bonuses** – The insurance company usually announces bonuses each year. Bonuses can be 'reversionary' (usually announce once a year and guaranteed to pay out for the duration of your annuity) and 'special' - these only pay out a year or so until the next bonus announcement. The amount of any bonus depends on many factors, the most important of which is stockmarket performance. Some insurance company's may guarantee a bonus rate, for example 3% a year. Sometimes you can choose the guaranteed rate, *but the higher the guarantee, the lower your starting income.*

Usually, your starting income is based on an 'assumed (or anticipated) bonus rate' ABR. You choose the ABR at the outset from a range set by the insurance company - for example 0% (which assumes no bonuses at all) to 5%. Once chosen, most insurance companies do not allow you to change the ABR.

Your choice of ABR may depend on your need for income. For example, suppose you intend to carry on working for now. *By choosing a low ABR you can plan for a low income now, increasing by the time you fully retire.*

The insurance company announces new bonus rates every year. If the rate equals your chosen ABR then your income does not change. If the declared bonus is higher than the ABR, your income increases. But, if the bonus is lower than the ABR then your income falls.

*If you choose a low ABR, your starting income is low.* But, you increase the likelihood that future bonuses will exceed the ABR and that your income will rise. You also reduce the risk that your income will fall. If you choose a higher ABR, your starting income will be higher.

If you choose the lowest ABR of 0% - in other words, assuming no bonuses - your starting income will be the minimum. As long as the company declares a bonus, your income will increase. In general, your income cannot fall because the bonus rate can never be lower than 0%. (However, if long term stockmarket performance was very poor, even this minimum starting income could be cut, except in the case of with-profits annuities that guarantee the minimum).

### Example of with-profits annuity

Chris is 60 and about to retire. He uses his £100,000 pension fund to buy a with-profits annuity. The starting income depends on the ABR that Chris chooses. His options are:

- The lowest ABR of 0% - Chris' starting income would be £4,600 a year. Providing the insurance company announces any bonus at all, his income would normally increase each year.
- The highest ABR of 5% - Chris' starting income would be much higher at £7,700 a year. His income would increase in future years only if the actual bonus were more than 5%. Every time the insurance company announced a bonus of less than 5%, his income would fall.
- An ABR between 0 and 5% - This gives a starting income of more than £4,600 but less than £7,800 a year.