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**EXPENSE CHARGES AND BEST ADVICE:
OUT OF SIGHT, OUT OF MIND?**

by

Gerry Budd FIA

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The views expressed in this paper do not necessarily reflect those of my employer

Expense Charges and Best Advice:

Out of sight, out of mind?

1. INTRODUCTION - CHALLENGING THE FAITH

- 1.1 With the advent of the Financial Services Act a new concept was introduced to the UK life assurance industry, namely the concept of "best advice". It would probably have come as some surprise to the layman that this development would cause such fierce debate and argument. No doubt he would have believed, perhaps naively, that the industry would already have been operating the principles of best advice after a couple of hundred years in existence. It is perhaps an indication that some form of tighter controls were needed on the transaction of life assurance and investment business that this was sadly, in my opinion, not the case. It would often have been considerations such as levels of commission, the quality of local sales support, computer back up facilities and other non product related reasons why a particular insurance company was used by many high street brokers.
- 1.2 It is little wonder that, in this sales oriented environment, the relative impact on "best advice" of the different elements such as expense charges and investment performance has not been the subject of serious investigation. For many offices new business production via intermediaries, pre FSA, did not depend on having an inherently competitive contract as long as with the use of well developed marketing techniques an impression of general competitiveness could be given, whether real or imaginary.

The truth of the matter was that genuine competition between products rarely existed, a state of affairs reinforced by voluntary industry guidelines on competitive advertising. Any competition that did exist was usually related not to product differences but to past with profit performance and past investment fund performance. I believe that this gave rise to the cult of "investment performance" being all important. It certainly found favour with marketing departments as virtually every company could hang their hat on some past investment success, particularly

if they had numerous funds from which to choose and an almost infinite choice of period over which to compare.

- 1.3 However now that "best advice" and more recently disclosure is upon us it does directly raise the question of the relative importance of expenses, charges, investment performance and other factors on the likely benefits available to the client.

The SIB commissioned Peat Marwick McLintock study addressed these fundamental questions. Appendix VI of the report contained the following comments (the underlining has been added by myself).

"This appendix details the work that was carried out to investigate the effect on the ultimate values of with profits policies of a number of different variables and the relative importance of expenses.

In general, offices considered that expense levels play only a small part in the determination of bonus rates and that investment returns were a much more important factor. We found no published work addressing this issue directly."

The method adopted by Peat Marwick McLintock to tackle this problem will be examined in Section 2, but it is interesting to note that they were obliged to carry out original work on the subject.

- 1.4 It is surprising that in the absence of any published work that the industry holds almost unanimous views on the subject. A few quotations give a flavour of prevailing opinion:

"Expenses and commissions should not be overplayed in this booklet. Their significance is much less than that of investment performance . . . The underlying purpose of more disclosure is to help the consumer is choosing which company to use. Expense information is peripheral to that."

Section 6.7. response from Institute and Faculty of Actuaries to SIB document.

"ABI would suggest that this argument could itself be seen as a serious criticism of the % P format. The differences it would show could create a disproportionate impact on the consumer's considerations and it would certainly be totally out of context with investment performance. Only by relating expense disclosure to investment performance can it be seen in its proper perspective."

ABI's submission to SIB. Section 5.6(v)

" . . . there would be a risk that investors would give charges disproportionate weight in the investment decision, although in the long term they are of much less significance than investment performance."

SIB disclosure document. Section 58 (i)b

- 1.5 In this paper I seek to demonstrate that contrary to the prevailing view expenses or more precisely expense charges have an important impact on the likely range of final benefits available to the client. As such consideration of the levels of expenses charges should be an integral part of the "best advice" process.

In putting forward this view I am not so naive as to suggest that absolute investment performance is not potentially the most important element in the overall result. Clearly if the investment manager placed the clients total fund on the 100 1 outsider of the 2.30 race at Cheltenham it would be rather academic to worry about expense charges, whatever the outcome of the race. However in the "best advice" context we should be considering the importance of relative investment performance within the parameters of likely fluctuations. Against this background I will demonstrate that expense charges are not merely of "peripheral" importance.

2. THE PEAT MARWICK MCLINTOCK REPORT

2.1 The expense calculations

The SIB commissioned Peat Marwick McLintock (PMM) study investigated the effect of differing expense charges on final benefits in the process of the wider examination of the need for further disclosure. To assist in this exercise PMM constructed an asset share model to approximate to a typical with profits policy. Essentially the method used is very similar to the way in which a unitised contract would be projected year by year to arrive at a final maturity value.

For the purposes of this paper we constructed a similar model with minor enhancements to allow for the payment of annual premiums as an alternative to monthly premiums and to include the recycling of any profit made on withdrawals.

2.1.1 My investigations were concentrated on the relative importance of expense charges and investment performance. It is therefore appropriate to repeat the assumptions used by PMM:

"Expenses were assumed to vary between 75% and 125% of the standards used by the ABI in the inter-office expense investigation. This range is understood to approximate to the variation in results of most offices as reported to the ABI by those offices currently participating in the investigation.

The investment return was assumed to vary between 11.5% per annum and 14.5% per annum, with 13% being the standard assumption. This was based on the range of investment performance of life and pensions managed funds which can be ascertained from financial magazines."

Appendix VI. Page 79

The results of the PMM investigations are set out in Pages 80 and 81 of the report. The following is an extract from the summary:

"Results

Eventual payouts are heavily dependent on the investment return achieved, as expected. Not surprisingly, the effect is particularly marked over long durations; the variation totals over 50% for long-term, but about 11% for a short-term contract.

Expenses seem to have a smaller, but significant effect. It varies from about 9% for a long-term endowment, to 5% for a short-term contract."

. . . The conclusions are:

- Investment return is usually the dominant factor*
- Expense performance is less important, but can nonetheless be significant particularly for shorter duration products . . ."*

2.1.2 What I will attempt to show in the following sections is that the PMM conclusions were merely a product of the assumptions used. The use of industry average expenses created a comparison which does not accurately reflect the actual level of expense charges levied by many companies on current products. This distinction between average per policy expenses and actual expense charges has to be clearly recognised so as to avoid the pitfall of averages masking the underlying reality.

By way of examples I have concentrated on selected endowment and pension products. The tabular presentations used are similar to those contained in the PMM report (Appendix VI, Page 81).

2.2 Endowment policies

Using an asset share model I examined two endowment products, namely a 10 year and a 25 year savings plan. In order that I could compare the theoretical results with actual products I chose a growth rate of 15% pa gross (10.5% net of 30% tax). This enabled a comparison to be made with

projected benefits published in the FTBI 1988/89 Handbook on Investment Linked Insurance Plans for an investment of £50 per month.

2.2.1 As in the PMM study the percentage change in ultimate policy proceeds was calculated separately for an increase/decrease in the investment return and the levels of expense charges. The variations used were as follows:

i) Investment return

A variation of 1½% pa in the gross investment yield was used. Results were therefore obtained for 13½% pa and 164% pa investment returns.

ii) Expense charges

The base level of expense charge was that used in the PMM report which was obtained by adjustment to the ABI inter office expense investigation. This standard assumption was £72.16 per policy plus 40% of annualised premium in the first year and £14.43 per annum subsequently, increasing by 5% per annum. For ease of presentation these expenses will be referred to as IOE.

I then carried out variations on these expense levels. Initially the PMM approach of using 75% and 125% of IOE was followed. I also looked at much wider variations, 0% of IOE, 200% of IOE, 300% of IOE and in some cases 400% of IOE. These variations will, for simplicity, be referred to as follows:

No expenses	:	IOE -100%
75%	:	IOE -25%
Standard	:	IOE
125%	:	IOE +25%
200%	:	IOE +100%
300%	:	IOE +200%
400%	:	IOE +300%

2.2.2 In addition to these management expenses commission loadings in accordance with the LAUTRO commission terms have been included. In all cases 100% of the LAUTRO scale has been used. (The full set of assumptions together with an example of an asset share model is shown in the Appendix.)

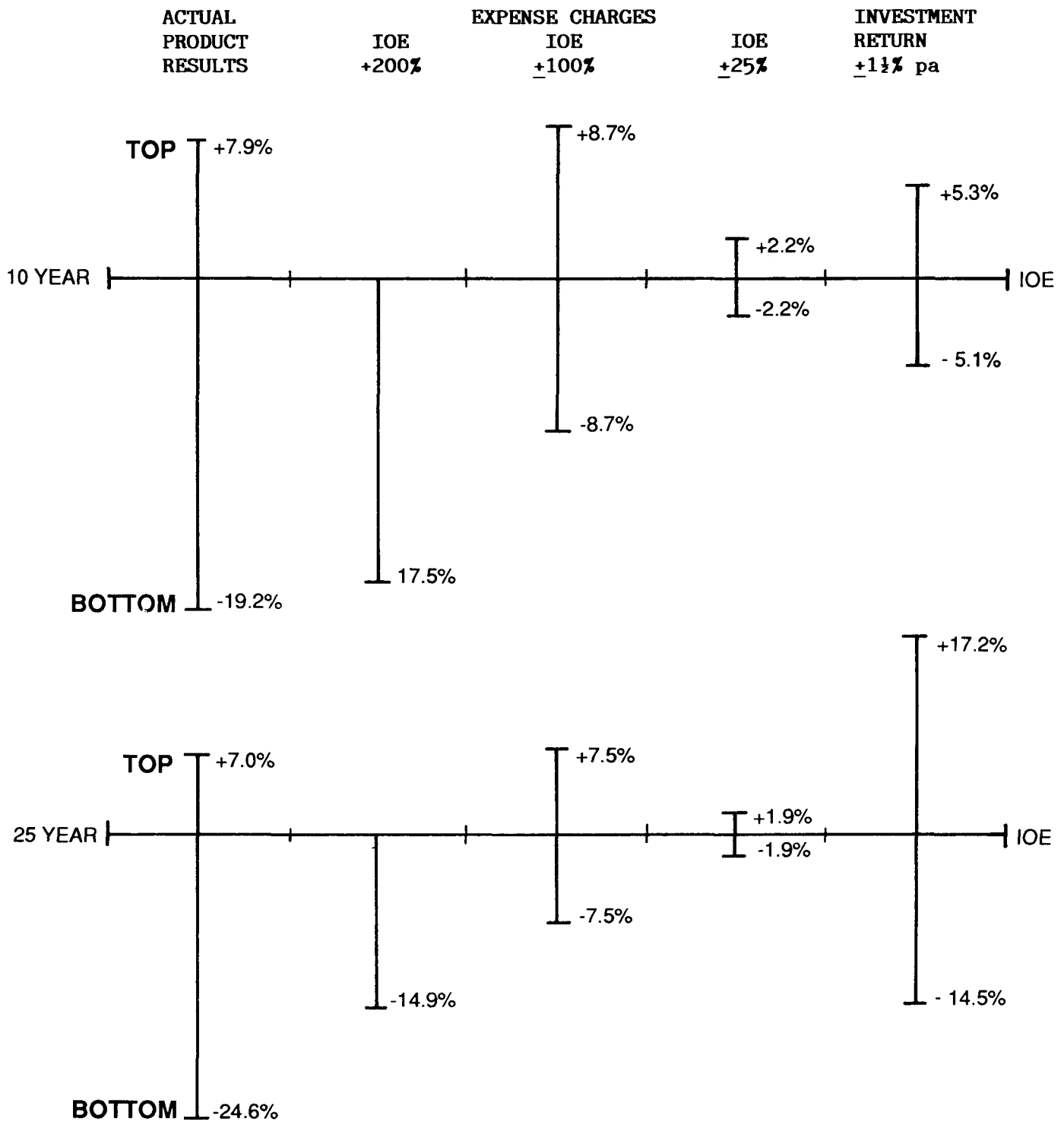
The results of this exercise are set out in Table 1 together with the position occupied, relative to the standard IOE projection, of the companies with the top and bottom projected benefits from the FTBI handbook survey.

2.2.3 From these results we can see clearly that the inter office expense levels bear little resemblance to the actual charges being levied by some companies on actual products available in the market. The use of the PMM study approach showed variations of only $\pm 2\%$ caused by expense factors whereas in practice the differences are quite staggering with variations of $+7.9\%$ to -19.2% on a 10 year plan and $+7.0\%$ to -24.6% on a 25 year plan.

This spread of expense charges is similar to the spread caused by a variation of $\pm 1\%$ pa on the investment return for a 25 year contract and approximately three times the investment return spread for a 10 year contract.

TABLE 1

EFFECT OF VARIATION OF ASSUMPTIONS - ENDOWMENTS



2.3 Pension policies

A similar exercise was carried out for 5 year, 15 year and 25 year personal pension policies. For the examples I used an annual premium of £1000 and a gross growth rate of 13% pa in order for a comparison to be made to actual projected benefits published in the FTBI 88/89 Handbook on Personal Pensions. (The full set of assumptions are set out in the Appendix.)

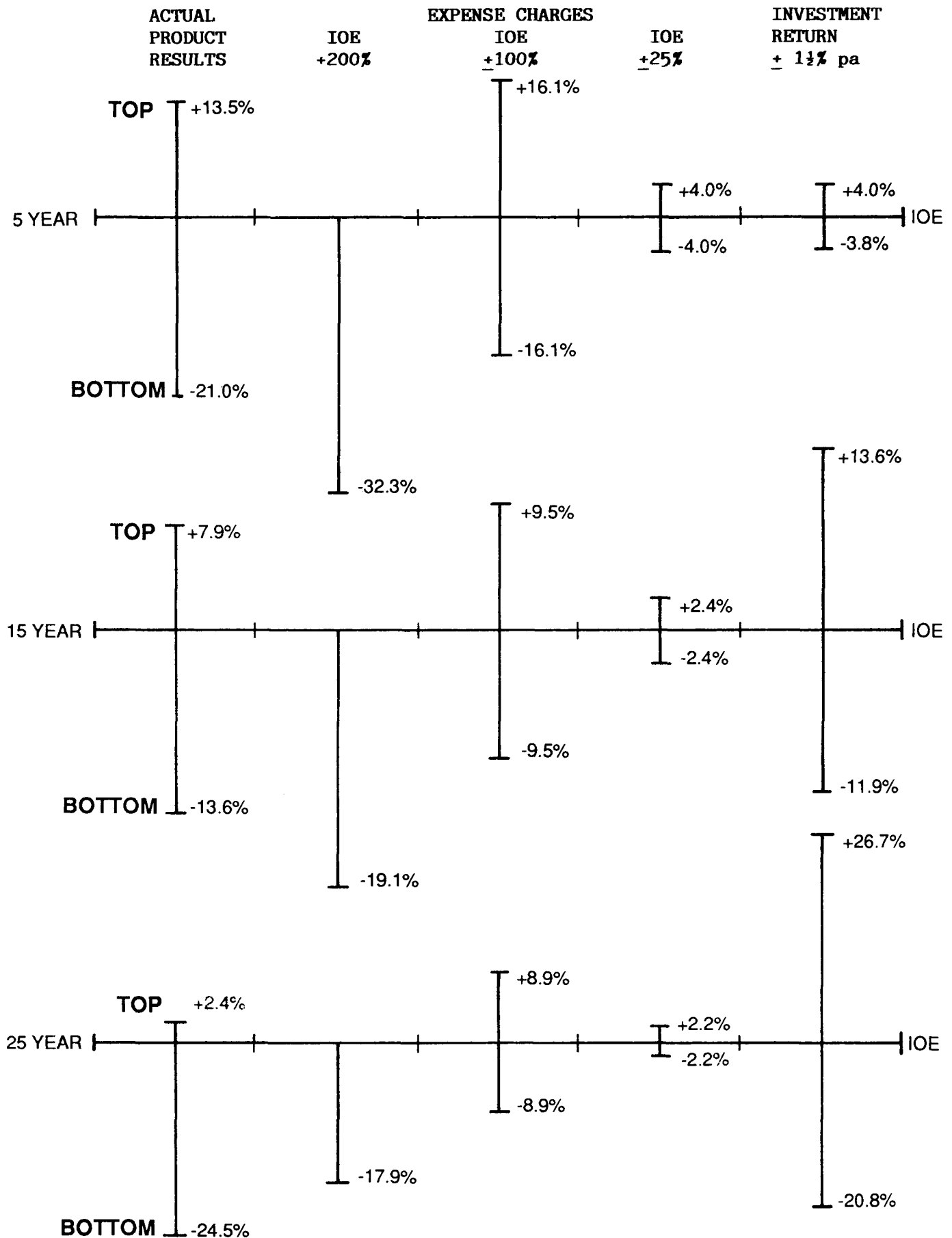
The results of this exercise are tabulated in Table 2. As with the endowment policy projections the use of the PMM approach of a $\pm 25\%$ variation in inter office expenses grossly underestimates the variation in expense charges. As for the relative importance of expense charges and investment return for a 5 year policy the spread caused by the use of actual expenses is some four times the spread resulting from a $1\frac{1}{2}\%$ pa variation in investment return. For a 15 year term contract the relative spread is similar and for a 25 year term the effect of the gross roll up causes the investment spread to become almost double that caused by the expense charge variations. However in the latter examples the spreads are extremely wide at $+2.4\%$ to -24.5% for expense charges and $+26.7\%$ to -20.8% for the variation in investment returns.

2.4 Preliminary conclusions

The Peat Marwick McLintock report formed the basis for the SIB's stated view that charges are of much less significance than investment performance. The calculation summarised in this section would suggest that if actual charges had been used rather than industry averages then the balance of importance between actual expense charges and the likely fluctuation in actual investment performance would have been much less marked. Certainly over shorter term contracts the indications are that high expense charges would be extremely difficult to make up even with superior investment performance. This aspect is examined more closely in Section 4.

TABLE 2

EFFECT OF VARIATION OF ASSUMPTIONS - PENSIONS



3. THE INSTITUTE'S VIEW

3.1 The response to the SIB

In response to the SIB draft proposals on Life Assurance and Unit Trust Disclosure the Institute and Faculty of Actuaries produced a summary document dated February 10th, 1989.

In the Institute's document it was explained that the response had been formulated based on discussions centred on the paper entitled "Report of Working Party on Information relating to Long Term Insurance Business". The Working Party had carried out a wide ranging review of many aspects relating to "best advice", covering both with profit and unit linked business issues.

Despite the fact that the Working Party had covered both with profit and unit linked aspects, the Institute's response to the SIB concentrated solely on with profit business, with no mention whatsoever of disclosure in relation to unit linked business.

3.1.1 On the question of expense disclosure the following is an extract from the Working Party report (Appendix F, Section 4). Again the underlining is my own addition:

" . . . While recognising that the expenses incurred are very much secondary to investment performance in their impact on the overall return to with profit or unit linked policyholders it is nonetheless a factor to which some regard should be paid in the formulation of Responsible Advice.

The Working Party has not devoted significant study to this area. . . ."

Yet the Institute's response contained the following definitive comments (Section 3):

"The factor which has the greatest influence on the potential size of the maturity payout is the investment performance of the assets representing the policyholders funds . . .

Other factors, such as expenses, service, mortality, tax, miscellaneous profits and form of ownership are of much lower order of priority to investment."

- 3.1.2 By way of illustration of this point the document referred to the results of past with profit performance for a £100 annual premium 25 year endowment policy published in the November edition of Planned Savings. This survey showed a very wide range of maturity values between the top and bottom performers, from over £14,500 to below £7,000 respectively.

The document went on to state:

" . the difference is far too big to be explained by differences in expenses

. investment performance can explain most of the difference."

- 3.1.3 It is, of course, impossible to verify this statement without access to records of the expense and investment history of the companies concerned together with an examination of the relative bonus distribution policy over the past 25 years.

It is, however, possible to estimate the likely range of investment yields which would be necessary to achieve these past results. Using an asset share model of the type used by Peat Marwick McLintock I have estimated that a uniform gross investment yield of 19% per annum over 25 years would have been required to reproduce a maturity payout in excess of £14,500. At the other extreme the worst performing offices would have produced gross investment yield of little more than 11% per annum over 25 years, based on similar levels of expenses.

Clearly this would demonstrate some quite staggering and consistent differences in investment performance if this was the sole reason for the extremes of with profit track record. However I believe the reality is far more complex.

3.2 Investment history

As a starting point I examined the investment returns available to insurance companies over the past 25 year period. Obviously the mix of assets will have an impact on the performance achieved as will the actual asset selection. However as a broad approximation I used two scenarios:

- a) Premiums invested solely in equities, the sector which has shown the strongest growth over the 25 year period.
- b) Premiums invested in the industry average mix of assets, as published by the ABI.

In each case notional unit prices were constructed using suitable published sector indices over the past 25 years and this unit price information was fed into the asset share model. The expenses, as previously, were fixed at a level which would approximate over the whole term to a reduction in premiums of 10% to conform to the Institute's comments on the expense levels of one of the top performing offices. Tax was taken to be uniform at 30%.

The results of these asset share projections were as follows:

	<u>Asset Mix</u>	<u>Approximate Maturity Value</u>	<u>Approximate Equivalent uniform gross yield</u>
a)	Equities only	£11,200	16% pa
b)	Industry average	£9,500	14.5% pa

This approach is obviously simplistic, particularly in its tax treatment but it does provide an interesting benchmark to compare the actual returns produced.

3.3 The effect of withdrawals

As part of the same Planned Savings November 1988 survey actual surrender value information was also tabulated. The most relevant example was for a 25 year endowment policy effected on 1 October 1968 and surrendered and after 20 years premiums had been paid. The following table shows a comparison of the top ten 25 year maturity payouts and the 20 year surrender payouts from these ten companies.

TABLE 3

<u>25 YEAR MATURITY</u>		<u>20 YEAR SURRENDER VALUE</u>	
<u>Payout</u>	<u>No of offices*</u>	<u>Payout</u>	<u>No of offices</u>
£14,500 - £15,000	2	£8,000 - £8,500	1
£14,000 - £14,500	5	£7,500 - £8,000	1
£13,500 - £14,000	3	£7,000 - £7,500	2
	—	£6,500 - £7,000	2
Total	10*	£6,000 - £6,500	2
	—	£5,500 - £6,000	0
* Top ten performers only		£5,000 - £5,500	0
		£4,500 - £5,000	0
		£4,000 - £4,500	2
			—
			10
			—

The equivalent investment yield on the 25 year maturity amounts for these companies range between 18% pa and 19% pa. Yet on a 20 year surrender value the equivalent investment yields range between 20% pa for the top office to 12% pa for the office with the poorest surrender value. The middle group of offices returned the equivalent of 16% pa to 17% pa on early surrender.

These figures are particularly surprising given that the years between 1963 and 1968 were unspectacular in investment terms. One would therefore have expected even higher yields on a 20 year surrender value than on the earlier 25 year endowment policy if investment performance alone was the important factor. Clearly expense charges, in this case expressed as an early termination penalty, play a major role for some of the contracts.

3.4 Average policy size

The Planned Savings survey used an annual premium of £100 for its comparisons. I could not readily find any industry published statistics for the average size of endowment premiums in 1963 but I suspect that for many offices an annual premium of £100 would have been well above its own average. Over this period average earnings have increased 13 fold so it is likely that an average annual premium of £30-£40 would have been common. Such discrepancies in average premium levels between offices could have a very marked difference in the real return even with similar levels of per policy expenses.

3.5 Some hypothetical examples

In order to demonstrate the variables at work I looked at three hypothetical companies effecting 25 year endowment policies in 1963, with identical expense levels and identical investment performance. The investment yield was chosen to be similar to the higher yield obtained on the notional policies in Section 3.2. The three examples were as follows:

- a) Company A achieved 16% pa investment growth and returned 16% pa on early terminations. Average annual premium of £100.
- b) Company B achieved 16% pa investment growth but returned only 12% pa on early terminations. Average annual premium of £100.
- c) Company C achieved 16% pa investment growth and returned 16% pa on early terminations. In this case the average annual premium was £30.

Using an asset share model which reinvests profit made on typical levels of withdrawal for the benefit of policyholders we obtain the following results:

Maturity Payout

Company A	£11,276
Company B	£15,345
Company C	£7,810*

* adjusted for an average premium of £100 pa

3.5.1 It is therefore theoretically possible to arrive at very wide discrepancies in maturity payouts without investment performance playing any part at all. In this example Company A is a solid performer, careful to maintain equity between all policyholders, Company B has its commitment to those who stay to maturity, presumably rewarded by a large terminal bonus and Company C is a higher expense company by virtue of the fact that its marketplace has a much lower average premium level than Companies A and B.

In the real world life is much more complicated. Of course differences in investment performance have played an important part, particularly the pace of change in selection of assets over the past two decades. What these simplistic examples seek to demonstrate is that other factors such as the mix of business and accumulated surplus from withdrawals and other miscellaneous sources in addition to the absolute level of expenses also have an important impact on the final returns to policyholders.

4. ACTUAL EXPENSE CHARGES AND INVESTMENT PERFORMANCE EXAMINED

In Section 2 a number of contracts were run through the asset share model and the results compared with the companies with the highest and lowest projected benefits from published surveys. This demonstrated a staggering variation between the top and bottom performers in the expense charges league.

It is, however, interesting to examine further the groupings between these charging extremes. The figures have been extracted from the FTBI Handbooks 88/89.

4.1 Endowment policies

4.1.1 In Table 4 the number of companies whose 10 year projected benefits fall in each of the various expense charging bands has been tabulated. The notation is that used in Section 2.

TABLE 4

10 YEAR SAVINGS

	<u>No of Companies</u>	<u>Maturity Value</u> £
IOE - 100%	----- 17	9,821
IOE - 25%	----- 8	9,203
IOE	----- 27	9,033
IOE +25%	----- 3	8,575
IOE +100%	----- 5	8,244
IOE +200%	----- 1	7,455
IOE +300%	-----	
TOTAL -	61	

Source: FTBI 88/89 Handbook on Investment Linked Insurance Plans. £50 per month

4.1.2 A similar exercise was carried out for a 25 year savings policy and the results tabulated in Table 5. Some companies do not have a 25 year savings plan but operate on a 10 year plan with a 15 year continuation option. This contract will suffer lower commission deductions but I have included these figures in the table because as far as the consumer is concerned the two products are similar with the latter offering better value for money.

TABLE 5

25 YEAR SAVINGS

	<u>No of Companies</u>			Maturity Value £
	25 year	10 + 15 year	Total	
IOE -100%	-----	-----	-----	62,474
	0	4	4	
IOE -25%	-----	-----	-----	59,223
	0	1	1	
IOE	-----	-----	-----	58,139
	1	7	8	
IOE +25%	-----	-----	-----	57,054
	6	11	17	
IOE +100%	-----	-----	-----	53,800
	17	7	24	
IOE +200%	-----	-----	-----	49,458
	5	1	6	
IOE +300%	-----	-----	-----	
TOTAL =	29	31	60	

4.2 Pension policies

Personal pension policy results, extracted from the FTBI 88/89 Handbook on Personal Pensions for term of 5, 15 and 25 years are set out below in Tables 6-8.

TABLE 6

5 YEAR PERSONAL PENSION

	<u>No of Companies</u>	<u>Maturity Value</u> £
IOE -100%	----- 51	7,932
IOE -25%	----- 18	7,213
IOE	----- 5	6,973
IOE +25%	----- 5	6,734
IOE +100%	----- 2	6,013
IOE +200%	-----	5,043

TOTAL =	81	

TABLE 7

15 YEAR PERSONAL PENSION

	<u>No of Companies</u>	<u>Maturity Value</u> £
IOE -100%	----- 6	43,683
IOE -25%	----- 6	40,898
IOE	----- 26	39,969
IOE +25%	----- 38	39,040
IOE +100%	----- 5	36,254
IOE +200%	-----	32,539

TOTAL =	81	

TABLE 8

25 YEAR PERSONAL PENSION

	<u>No of Companies</u>	<u>Maturity Value</u> £
IOE -100%	----- 1	163,656
IOE -25%	----- 1	153,641
IOE	----- 2	150,301
IOE +25%	----- 39	146,962
IOE +100%	----- 35	136,943
IOE +200%	----- 3	123,580
	----- —	
TOTAL =	81	
	----- —	

4.3 The effect of actual investment returns

The charges tabulated in Sections 4.1 and 4.2 show a very wide variation between offices and therefore the lowest charging offices show considerably higher maturity values than the average charger. However the claim will no doubt often be made that these differences can be made up by superior investment performance probably backed up by impressive sales aids of past investment successes.

It is therefore instructive to look at the variation in actual investment performance achieved by companies. Unfortunately it is not possible to make any meaningful comparisons beyond 10 years because of the relative immaturity of most linked investment funds. I have, however, carried out some calculations based on a 10 year plan.

4.3.1 10 year savings plans

There are 29 life managed investment funds listed in the FTBI Handbook with a 10 year track record. The average unit price growth per annum of the various funds are tabulated below in Table 9. Obviously the unit prices have already suffered a fund management charge, but as most offices life funds have had similar management charges over the past 10 years these figures should give a reasonable comparison of underlying fund performance.

TABLE 9

10 YEAR LIFE MANAGED FUND PERFORMANCE

Average Unit Price Growth per annum	No of funds
17% - 18%	1
16% - 17%	1
15% - 16%	2
14% - 15%	9
13% - 14%	9
12% - 13%	3
11% - 12%	4
10% - 11%	2
	—
Total	29
	—

The average investment performance is tightly grouped in the range 13% 15% per annum with a lower number of higher and lower performers. The median performer (ie No 15) averaged 13.4% per annum unit price growth.

I took the actual year on year unit price growth of the median performer and using the asset share model calculated the projected maturity value of the company with the lowest 10 year charges using these unit prices. This gave a benchmark figure of the combination of the lowest charger and average investment performance.

From Table 4 it can be seen that 36 of the 61 companies with a 10 year savings plan had actual expense charges higher than the inter offices expense investigation (IOE). I therefore used the IOE expense levels as an approximation to an average charging company (ie 26th out of 61).

Using the asset share model the actual year on year unit prices of each of the funds with a 10 year investment record were fed in turn into the model to determine at which point superior investment performance can overturn the effect of the higher charges. The results are set out in Table 10 below.

TABLE 10

<u>Comparison with Lowest Charger/ Average Investment combination</u>	<u>No of funds</u>
Higher Maturity Value	3
Lower Maturity Value	26
	—
Total	29
	—

These results demonstrate that over a 10 year period a very low charge contract with only average investment performance is very likely to produce higher maturity value than an average charge contract, unless the latter can produce exceptional investment performance.

4.3.2 10 year Personal Pension Plan

The exercise described above was repeated for a 10 year personal pension plan. In this case the lowest charging company equated to a charging level of IOE-80% whereas the average charging companies of the 86 surveyed were close to the IOE level of expense charges.

Unfortunately the FTBI Handbook listed only 15 companies with linked pension managed fund experience of at least 10 years which made the comparison less representative than the similar savings plan example. Nevertheless the results were very similar.

The unit price growth variations of pensions managed funds are listed in Table 11 below and although less marked than the life managed funds also showed a grouping around the median performer which averaged 17.5% per annum over the 10 year period.

TABLE 11

10 YEAR PENSION MANAGED FUND PERFORMANCE

<u>Average Unit Price growth per annum</u>	<u>No of funds</u>
above 21%	1
20% - 21%	1
19% - 20%	1
18% - 19%	1
17% - 18%	5
16% - 17%	1
15% - 16%	2
14% - 15%	3
	—
	15
	—

Again the median performer/lowest charging combination (IOE-80%) was used as a benchmark. I then repeated the exercise of feeding the actual fund performance of each of the funds in turn into the average charging (IOE) asset share model to determine at which point superior investment performance would outweigh the lower charges. The results are set out below in Table 12.

TABLE 12

<u>Comparison with Lowest Charger/ Average Investment combination</u>	<u>No of funds</u>
Higher Maturity Value	2
Lower Maturity Value	15
	—
Total	15
	—

Albeit with a much smaller number of funds the same conclusions could be drawn that if the lowest charging company can achieve just average investment performance it would, in practice, be difficult to beat by the average charger over the 10 year period.

4.3.3 Longer investment periods

It is not possible at present to examine the effect of actual investment performance over longer periods than 10 years because of the lack of funds with the necessary length of experience. I would however be very surprised if the tendency for many funds to be grouped around the median performer was not repeated over the longer durations. Obviously the scope for superior investment performance to overtake lower charges is greater the longer the duration, as demonstrated by Tables 1 and 2 in Section 2 of this paper. However even at a 25 year term it does require consistent outperformance of around 1% pa to bridge the gap between the average and lowest charging companies. This may not seem a great deal but I would suspect that it would be worth more than a few Porches if the investment team could guarantee, in advance, to deliver this level of outperformance of the market each year over a 25 year period.

4.4 The effect of variable expense charges

It has often been quoted by those who seek to relegate the importance of expense charges that the fact that, in modern contracts, there are no expense guarantees renders all comparisons meaningless. This comment ignores the constraints placed on companies by the market in which they

operate. Should a company which captured a large volume of business based on a low charging philosophy suddenly make a radical change to the detriment of existing policyholders I do not believe that the company would have a very sustainable marketing position for the future. Nevertheless the ability to change expense charges in the future is a factor worthy of investigation.

4.4.1 The PMM study did investigate the importance of possible future changes to expense charges. It concluded that as the majority of expenses in unit linked contracts are incurred and charged at the front end of the contract then future changes were not, in practice, likely to have a major impact on the benefits available.

4.4.2 I thought it would be useful for completeness to check this conclusion, if for no other reason than to remove one of the objections to more detailed disclosure of expense charge information. I took a very simplified product design, without any front end loadings, with a charging structure as follows:

Allocation	:	95% throughout (no bid/offer spread)
Service fee	:	£2 per month (no indexation)
Fund charge	:	3/4% per annum

In this product the allocation percentage is guaranteed but the service fee and fund management charge are not guaranteed and may be subject to future increases.

As previously I looked at endowment and personal pension products separately. In each case I examined the effect of an immediate introduction of an index linked service fee of 5% pa and 10% pa respectively and separately examined the effect of an immediate increase in the fund management charge from 3/4% pa to 1% pa. So as to put these figures in the context of the total charges each projected maturity value was expressed as a percentage of the projected maturity value with no charges. The product details and growth rates were similar to those used in Section 2.

4.4.3 The results obtained are tabulated in Table 13 below.

TABLE 13

EFFECT OF VARIATION IN CHARGES

<u>Product Type</u>	<u>Total charges as a % reduction in maturity value</u>			
	<u>Basic design</u>	<u>5% pa service fee increase</u>	<u>10% pa service fee increase</u>	<u>1% pa fund charge</u>
10 YEAR SAVINGS	11.1%	11.7%	12.5%	12.3%
25 YEAR SAVINGS	17.9%	19.2%	21.9%	21.0%
10 YEAR PENSIONS	10.9%	11.4%	12.0%	12.2%
25 YEAR PENSIONS	17.8%	18.8%	20.6%	21.1%

4.4.4 These figures demonstrate that a future increase in the variable expense charges is much less significant than the level of the original charging structure in determining the final outcome. So any future increase would have to be rather draconian to negate the advantages obtained by choosing an initially low charging product.

4.5 The effect of LAUTRO commissions

It is useful to quantify the effect of LAUTRO commissions within the total expense charges, particularly as a small number of offices featured in the personal pensions surveys carry no commission loadings in their contracts. Another group of providers, mainly unit trust groups, charge single premium commission within their contracts. As in previous examples I have used the IOE expense level as a benchmark and expressed the total of all expenses, including commissions where appropriate, as a percentage reduction from the maturity value available with no charges. The results are tabulated in Table 14 for a fl,000 annual premium personal pension plan.

TABLE 14

EFFECT OF DIFFERENT COMMISSION LEVELS

Contract term	<u>Total charges as a % reduction in maturity value</u>		
	Full LAUTRO commission	4% single premium commission	No commission
25 YEARS	15.1%	11.6%	7.6%
15 YEARS	14.7%	12.1%	8.1%
5 YEARS	18.4%	17.1%	13.1%

Clearly LAUTRO commission payments are an important element of the total expense charges reducing the benefits available in these examples by between approximately 6% and 8% dependent on term. However it should be remembered that most offices' total expense charges are significantly above IOE for the longer terms so LAUTRO scale commission payments are by no means the major factor in the total charges.

5. EARLY WITHDRAWALS - THE SILENT MAJORITY

- 5.1 It is an unfortunate fact that for many life assurance products there will eventually be less policyholders who reach maturity than those who cease to pay premiums along the way. This is particularly so for the longer term contracts.

Most life offices will, as a matter of course, compile statistics on the lapse and surrender rates on the various classes of business and will therefore be perfectly aware of the incidence of withdrawal for a particular distribution channel and/or product type. This information will likely be used in the product design process and in many instances there will be a profit element built in before calculating the amount available to the policyholder on withdrawal.

Modern contract design is very complex with a number of the charging features spread over the whole term of the contract. So a withdrawal denies the company the future profit which could emerge from these charging features and in many cases the policyholder will be penalised for this loss of future profitability.

- 5.2 There are many ways in which a surrender penalty can arise. On with profit contracts the surrender value is at the total discretion of the company and can therefore be pitched at whatever level the company may wish in relation to the accumulated reserve held. On linked contracts the surrender values are usually related more directly to the value of units but companies are often reluctant to reveal the exact basis used in reducing the face value of units.
- 5.3 In Section 3 I showed a hypothetical example of how with profit maturity values could be increased substantially through the recycling of withdrawal profit to the stayers at the expense of leavers. In fact this approach has increasingly been reinforced by the elements of product design. Features such as terminal bonuses, loyalty bonuses, increased allocations after fixed periods, recycling of fund management charges, no return of initial units on death and many others are, in fact, surrender penalties in a more

presentable form. For unless the terminal bonus, loyalty bonus, recycled fund charge and so on are also available to leavers then this surely must be the reality.

- 5.4 It is therefore interesting to consider that if leavers are likely to be in the majority on many contracts then what part should early termination terms play in the process of 'best advice'. In fact one could advance a case for the recommendation of a company which treats leavers and stayers equitably in favour of one which features strongly in maturity projections at the expense of the early leaver.

It is also interesting to examine the expense charges and investment performance issues as related to the early leaver. I have therefore looked more closely at the projected 5 year early termination values on two typical 25 year linked contracts - a personal pension plan and an endowment mortgage plan.

5.5 Personal Pension Plans

The FTBI 88/89 Handbook on Personal Pensions tabulates transfer values for a 25 year term, £1,000 Annual Premium plan. The transfer values after 5 years of the 78 plans surveyed range between £6,400 and £1,743. In fact less than half of the companies returned more than the total premiums paid over the 5 year period.

The effective expense charges underlying these transfer values are set out in Table 15 below, using the same expense notation as in Section 2.

TABLE 15

<u>Expense level</u>	<u>No of Companies</u> (A)	<u>Top 10 Maturity</u> <u>Projections</u> (B)	<u>Transfer</u> <u>Value</u> £
IOE -100%	4	2	6,277
IOE	12	2	5,318
IOE +100%	55	5	4,359
IOE +200%	6	1	3,399
IOE +300%	0	0	2,438
IOE +400%	1	0	1,476
	—	—	
TOTAL -	78	10	
	—	—	

The above figures are based on the assumption of a 13% pa gross investment return. As an example of the relative impact of superior investment performance on these transfer values I calculated that a company at the IOE level would require gross investment return of 21% pa to overtake the leading transfer value and a company at the IOE +100% level would require a 33% pa gross return. The average company would lie between these two figures.

This table clearly demonstrates that as far as the early leaver is concerned underlying termination charges are much more significant than investment performance.

Column B shows the ranking of the top 10 companies from the projected maturity value tables. This group would appear to include some who have achieved a high ranking maturity appearance at the expense of the early leaver.

5.6 Endowment Mortgage Plans

A similar exercise was carried out on unit linked mortgage plans based on a survey published in the 9 March 1989 edition of Post Magazine. The policy used was for a £50,000 loan repaid on a 7½% pa unit price growth, net of fund charges. The monthly premiums ranged from £63.75 to £88.74. For comparison purposes all premiums and benefits were adjusted by proportion to £70 per month, which I appreciate may introduce some slight bias.

Table 16 classifies the 5 year surrender values in a similar way to that used for the personal pension contract. In this example the adjusted surrender values ranged between £4,238 and £1,513.

TABLE 16

<u>Expense Level</u>	<u>No of Companies</u>	<u>Surrender Value</u> £
IOE -100%	----- 1	
IOE	----- 23	3,815
IOE +100%	----- 21	3,349
IOE +200%	----- 4	2,883
IOE +300%	----- 1	2,417
IOE +400%	----- 1	1,951
IOE +500%	----- 1	1,485

TOTAL =	51	

A company at the IOE +100% level would require a net investment return of 14.7% pa (compared with a 7.5% pa base assumption) to achieve a surrender value at the IOE level. To move from the IOE +200% level up to IOE would require a net investment return of in excess of 30% pa.

So again the companies with the most favourable early termination charges cannot be overtaken by an average charger without quite exceptional outperformance on the investment front.

5.7 Shorter contact terms

The difference between the surrender values on offer for shorter term contracts is no less marked than that for a 25 year term. To illustrate this point the range of transfer values available on a 15 year personal pension policy are set out in Table 17 below. The figures are from the survey of 80 companies published in the FTBI Handbook.

TABLE 17

15 YEAR PERSONAL PENSION POLICY - TRANSFER VALUES

Transfer value <u>after</u>	Highest <u>Value</u> £	Lowest <u>Value</u> £	No of Companies where TV is less than <u>premiums paid</u>
5 YEARS	6,400	1,982	14
4 YEARS	4,860	1,086	55
3 YEARS	3,470	484	72
2 YEARS	2,200	NIL	73

5.8 From the examples set out in this Section it is clear that as far as early termination values are concerned the nature of the expense charges and the various penalties imposed is the dominant factor in determining the amounts available to the client.

6. PAST PERFORMANCE - A GUIDE TO THE FUTURE?

6.1 In assessing the relative importance of expense charges and investment performance in the context of best advice regard should be taken to the degree of certainty with which future performance can be predicted. We have seen from Section 4.4 that if a low charging company is selected then it is likely that future changes will not drastically affect that position at least as far as that tranche of policyholders are concerned. This is as a result of the most important factors on the total charging package such as the allocation percentages and front end charges remaining fixed once the choice has been made. But what of the choice of a company with a superior past investment performance? How secure is that choice for the future?

6.2 All advertisements now carry the usual health warnings - "Past investment performance cannot be taken as a guide to the future, etc" - but I doubt whether this is taken seriously by most within the industry. After all the majority of marketing spend is probably directed at reinforcing the opposite message. Past investment performance success is all important in inspiring confidence in both intermediaries and the public that this can be repeated in the future. The more discerning will probe to discover whether past success was really due to inspired investment management or foolhardiness or just down to plain luck but I am sure many will take past performance as a clear signpost for the future. It is therefore of interest to see whether the facts support this position.

6.3 With profit policies

As I sought to demonstrate in Section 3, I believe that to consider top ranking past with profit performance as being synonymous with outstanding investment performance could be misleading. However the superior past performance record has rewarded those clients who benefited from the high maturity payouts and it is therefore quite understandable for these top performing companies to be recommended to new with profit clients. What is less certain is whether in 25 years' time the same companies will prove to be the top performers. In the February 1989 issue of Money Management,

Geoffrey Bernstein wrote an article entitled "A Blast from the Past" in which he came to the conclusion that, over the period since 1950, past league tables of maturity values have been of little use for choosing with profit policies for terms of 10 years or more. I do not intend to develop these arguments in this paper but would instead quote a couple of extracts from the article.

6.3.1 *"A similar set of graphs is produced for 25 year policies maturing in 1950 comparing the league table positions then and 5, 10, 15 and 25 years later . . . You can see from the graph that there is no relationship at all between the 1950 positions and those 25 years later. Figure 10 shows the same thing for 1960 league table positions 25 years later.*

A statistical calculation of the 'correlation coefficient' indicates that there is a weak relationship between the 1970 league table positions for 10 year endowments and the 1980 ones. So, using the 1970 tables was a modest help in choosing a good policy.

The same calculation for 25 year policies indicates that there is no link at all (statistically speaking) between the results at the beginning and end of the 25 year period. Therefore, past results were no help at all for choosing a 25 year policy."

6.3.2 *"Those offices near the top of the league and consequently benefiting from a flood of new business may find that their reserves are more rapidly diluted than their apparently less fortunate competitors. This may in turn drive them to a position lower down the league table.*

In other words this survey looks back over a period when being top of the league table brought additional business, but this was not necessarily a bad thing. We look forward to a period in the future when being top of the league table and attracting a flood of new business may actually make it more difficult for the life office to maintain its competitive position."

6.4 Linked policies

As I have mentioned previously past linked fund performance is relatively short in duration for most life offices. There are however enough managed funds with a 10 year track record to draw some tentative conclusions as to the reliability of past investment performance as a guide to the future, albeit over relatively short durations.

6.4.1 Linked life funds

On the Micropal system there are 39 life managed funds with a ten year performance record. I have broken the past ten years from 1 March 1979 into two periods of five years and taken the top 10 performing funds over the first five year period and classified their relative performance in the second five year period which had 78 funds listed. The results are set out in Table 18.

TABLE 18

TRACKING OF TOP TEN PERFORMERS - LIFE FUNDS

<u>Position</u>	<u>1.3.79 to 1.3.84</u>	<u>1.3.84 to 1.3.89</u>
1-10	10	0
11-20	-	1
21-30	-	1
31-40	-	3
41-50	-	0
51-60	-	2
61-70	-	3
71-78	-	0
	—	—
	10	10
	—	—

Source: Micropal. Percentage change. Offer to offer. Life Mixed (3-way)

From this table we can see that over the 5 year view the choice of one of the top ten performers from the period 1 March 1979 to 1 March 1984 would with one or two exceptions have resulted in at best an average performance and at worst one of three fourth quartile rankings.

In fact not one of the top 10 performing funds in the second five year period has a ten year performance record. It will be interesting to see if they fare any better over the next five years than their top performing predecessors.

6.4.2 Linked pensions funds

There are only 18 managed pension funds on Micropal with a ten year record so a similar comparison is less meaningful. Nevertheless I have repeated the exercise this time taking the top five funds from the period 1 March 1979 to 1 March 1984. In this instance there were 57 funds in the second five year period. The results are set out in Table 19 below.

TABLE 19

<u>Position</u>	1.3.79 to <u>1.3.84</u>	1.3.84 to <u>1.3.89</u>
1-5	5	0
5-10	-	1
11-20	-	0
21-30	-	2
31-40	-	1
41-50	-	0
51-57	-	1
	—	—
	5	5
	—	—

Source: Micropal. Percentage change. Offer to offer. Life Mixed (3-way)

Again with one exception the choice of a top performing fund from the first period would have resulted in just average performance in the second period or at worst near to bottom returns.

6.4.3 There is little evidence to suggest from these figures in Tables 18 and 19 that top performing past performance is a useful guide to future top performance. What is a much more realistic proposition is, with the use of past performance information, to look for fund management skills which can likely deliver consistent above average performance. It would appear unrealistic to be able to select with any certainty the funds which are going to be the top performers of the future. If this is a conclusion to be drawn then it does impact on the relative importance of expense charges on best advice. For if the top end of investment performance is ruled out as a selection possibility, sights must realistically be set lower towards say consistent second quartile or better performance. Thus by removing the extremes of the investment performance expectations the ability for future investment performance to be confidently predicted to make up for higher charges is much reduced.

7. EXPENSE DISCLOSURE - THE DEMISE OF CONVENTIONAL WITH PROFITS?

7.1 I would like to touch briefly on the future for conventional with profit business particularly against the background of the requirement for disclosure of expense information. Much of the industry opposition to more extensive disclosure revolves around the complexity of devising a meaningful method for with profit business. In fact the ABI in their submission to the SIB went as far as proposing that with profit considerations should take precedence in determining the expense disclosure regime. The following is an extract from their response:

"Moreover, with profits regular premium business is about 55% of new business (unit linked 35%, non profit 10%) and it would be inappropriate for the minority of the business to influence unduly the overall decision on disclosure format just because actual charges in unit linked business may be comparable."

7.2 Perhaps it is an unfortunate fact that the real problem that most life offices have with expense disclosure to the public in relation to with profit business is that they have never had adequate expense disclosure to themselves. I doubt whether many offices, with some notable exceptions, really know the underlying expenses of various tranches of past with profit business by product type as, unlike linked contracts, there was no such business need in the past. As charges are not explicit the development of expenses could be treated more or less globally with the safety valve of the bonus declaration available to compensate any expense overrun. It would therefore be a great pity, in my view, if this expense ignorance were to be perpetuated by suppressing the move towards more transparency.

7.3 It could well be that compulsory expense disclosure will force offices to reconsider the continuance of traditional reversionary bonus with profit contracts. The mere complexity of unravelling the expense situation on conventional business could accelerate the already discernible move towards a unitised with profit concept. There are also significant advantages to offices in the flexibility of product design, new business strain considerations and the openness of charging in promoting unitised with profit business. It could also fit very neatly in the overall regime of

expense disclosure with only minor modifications required to the linked business rules.

- 7.4 It is interesting to note that in the latest FTBI Handbook on personal pension plans there are only 13 companies listed who continue to market conventional with profit contracts compared with 86 linked contracts many of which offer a unitised with profit fund. I expect that the main reason why this trend has not been so marked on endowment mortgage contracts is the desire by many leading offices to retain the marketing advantage of a good quality existing bonus track record particularly with an eye to the Building Society sector. It could well be at the point when offices have to consider reducing bonuses significantly from the record levels of recent years that the move to unitised with profits will be accelerated.
- 7.5 Whatever the pace of the demise of conventional with profit business I am convinced that it will happen because the long term advantages of the unitised approach are so strong. If this is the case it would be wrong to allow the complexities of a class of business in decline to influence unduly the shape of future expense disclosure.

8. CONCLUSIONS

8.1 In the introduction to this paper I stated that I would demonstrate that expense charges are not of merely peripheral importance to best advice. I will leave it to the reader to judge whether I have achieved this aim. If not I hope I have, at least, provided interesting food for thought.

8.2 I will leave you with what I believe are the main headlines of my investigations:

- Differences in expense charges between offices are extremely wide.
- Actual expense charges are usually higher than the industry average expenses.
- The differences are usually more significant at terms of 10 years or less than differences in investment performance.
- Over shorter terms it is difficult for an average charging company to overtake the lowest charger unless exceptional investment performance is achieved.
- Early termination values can be extremely penal and should be carefully considered in the best advice process.
- Over longer terms investment performance variations are more significant than variations in expense charges but not overwhelmingly so.
- There is little evidence to suggest that top performing past investment performance is a useful guide to the future.
- Good with profit performance does not automatically equate with superior investment performance as other factors such as expenses, mix of business, miscellaneous surplus and bonus policy are also important.

8.3 As I stated in the introduction, absolute investment performance is always going to dominate other factors in determining the benefits emerging from a particular investment contract. However, within realistic parameters, relative investment performance only becomes the clearly dominant factor over the longer terms where the ability to select the investment winners and losers is most doubtful. For this reason the known initial level of expense charges should become an important factor, alongside the assessment of future investment performance in the best advice process.

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APPENDIX

ASSUMPTIONS USED IN THE ASSET SHARE MODEL IN SECTION 2

The following example policies were used:

		<u>Premiums</u>	<u>Sum Assured</u> £	<u>Age at Commencement</u>	<u>Premium Term</u> (years)
i)	Endowment	£50 pm	£4,500/ROF	30	10
		£50 pm	£11,250/ROF	30	25
ii)	Personal	£1,000 pa	ROF	60	5
	Pensions	£1,000 pa	ROF	50	15
		£1,000 pa	ROF	40	25

ROF = return of fund

Investment return: The basic rate of investment return used was 15% pa, before tax, for endowment products and 13% pa for personal pensions. Tax at 30% was used for life business. (These assumptions were used to coincide with FTBI Handbook published surveys.)

Commission: LAUTRO scales. No volume override.

Expenses: The notation of IOE related to the adjusted inter office expense investigation figures as used in the PMM study. The variations used were as follows:

	Fixed per policy	<u>Initial</u> % of first premium	Initial per annum	<u>Renewal</u> inflating at
	<u>£</u>		<u>£</u>	
IOE -100%	0	0	0	0
IOE -25%	54.12	30%	10.82	5% pa
IOE	72.16	40%	14.43	5% pa
IOE +25%	90.20	50%	18.04	5% pa
IOE +100%	144.32	80%	28.86	5% pa
IOE +200%	216.48	120%	43.29	5% pa
IOE +300%	288.64	160%	57.72	5% pa
IOE +400%	360.80	200%	72.15	5% pa
IOE +500%	432.96	240%	86.58	5% pa

Mortality: 85% of A67/70 ultimate mortality table.

Withdrawals: None.

Benefits: These were calculated using the unit price on the date the policy matures.

Note: An example of the asset share model printout for a 10 year savings plan is set out overleaf.

ASSET SHARE MODEL - EXAMPLE

YEAR	NET		WITHDRAWAL				UNIT PRICE AT				NUMBER OF UNITS				END YEAR	
	GROWTH	RATE	PENALTY	PREMIUM	EXPENSES	COMMISSION	MORTALITY	WITHDRAWALS	START OF YEAR	PREMIUM	EXPENSES	COMMISSION	MORTALITY	WITHDRAWALS	TOTAL	WITHDRAWAL
1	10.5	0.0	0.0	600.00	218.51	105.00	2.47	0.00	1.00	573.40	218.51	100.34	2.37	0.00	252.17	279
2	10.5	0.0	0.0	600.00	10.61	42.00	2.24	0.00	1.11	518.91	9.60	37.24	1.94	0.00	722.32	882
3	10.5	0.0	0.0	600.00	11.14	10.50	1.94	0.00	1.22	469.60	9.12	8.22	1.52	0.00	1173.06	1583
4	10.5	0.0	0.0	600.00	11.69	10.50	1.58	0.00	1.35	424.98	8.67	7.44	1.13	0.00	1580.81	2357
5	10.5	0.0	0.0	600.00	12.28	10.50	1.15	0.00	1.49	384.60	8.24	6.73	0.74	0.00	1949.71	3212
6	10.5	0.0	0.0	600.00	12.89	10.50	0.60	0.00	1.65	348.05	7.83	6.09	0.35	0.00	2283.49	4157
7	10.5	0.0	0.0	600.00	13.54	10.50	0.05	0.00	1.82	314.98	7.44	5.51	0.03	0.00	2585.50	5201
8	10.5	0.0	0.0	600.00	14.21	10.50	0.00	0.00	2.01	285.05	7.07	4.99	0.00	0.00	2858.49	6354
9	10.5	0.0	0.0	600.00	14.92	10.50	0.00	0.00	2.22	257.96	6.71	4.51	0.00	0.00	3105.23	7627
10	10.5	0.0	0.0	600.00	15.67	10.50	0.00	0.00	2.46	233.45	6.38	4.09	0.00	0.00	3328.21	9033
=====																
										3810.99	289.55	185.16	8.06	0.00	3328.21	
=====																

	Term	10						Total return	No Units	Value	%
	Sum Assured	4500						Withdrawals	3328.21	9033.04	87.33%
	Premium	600.00	p.a.	(payable monthly)					0.00	0.00	0.00%
	Age	30						Excluding Withdrawals	3328.21	9033.04	87.33%
	Mortality	85.0 %	A67/70	Ultimate				Deduct: Commission Year 1	100.34	272.34	2.63%
	Initial Expenses	72.16						Year 2	37.24	101.06	0.98%
	Plus	40.00 %	Premium					Year 3+	47.58	129.13	1.25%
	Renewal expenses	14.43	at start					Expenses Year 1	218.51	593.06	5.73%
	Inflation Rate	5.00 %						Year 2+	71.04	192.81	1.86%
	Reversionary bonus	0.00 %						Cost of mortality	8.06	21.89	0.21%
	Death bonus	0.00 %									
	Initial commission	25.00 %						Gross value	3810.99	10343.33	100.00%
	Renewal commission	2.50 %									
	% of lauro commission	100.0									
	Initial commission payable for	16 months									
	Renewal commission ceasing after	10 years									
	Tax Rate	30 %									
	Growth reduction for withdrawals	0 %									
								Sum Assured		4,500.00	
								Reversionary Bonus		0.00	