TFA 30 (1966-1968) 17-80

UNIT TRUSTS AND EQUITY LINKED ENDOWMENT ASSURANCES

by

A. T. GRANT, F.F.A., F.I.A. and G. A. KINGSNORTH, F.I.A.

[Submitted to the Faculty on 19th December 1966. A synopsis of the paper will be found on page 56.]

SECTION I

GENERAL DESCRIPTION OF UNIT TRUSTS

HISTORICAL

1. Unit trusts originated in the United Kingdom in the second half of the nineteenth century, but an early Court ruling that unit trusts were not legal resulted in all but one unit trust changing to the form of investment trusts. Although the Court ruling was later reversed, little further headway was made by the unit trust movement until after the Great Crash of 1929.

2. In the United States of America, unit trusts—or "mutual funds" as they are still known there—have attained considerable popularity. Promoted by aggressive sales methods, mutual funds have grown rapidly in the U.S.A. until in 1965 they amounted to about $35,000 million compared with $17,000 million in 1960. Large numbers of door-to-door salesmen have been employed selling units and while this form of marketing has undoubtedly been successful, the high costs entailed have led to criticisms of the system.

3. In the United Kingdom the growth of unit trusts in recent years has been dramatic, as Table 1 below indicates:

TABLE 1

End of year	Number of unit trusts authorized by the Board of Trade	Number of unit holdings	Total assets
		Million	*£m*
1960	51	0·66	191
1961	53	0·67	222
1962	54	0·82	257
1963	70	1·05	350
1964	105	1·31	406
1965	121	1·42	500

Source: Financial Statistics (H.M.S.O.)

To put this in perspective, Table 2 below shows the accumulated total funds in 1960 and 1965 of the main financial institutions and the amounts invested in equities.

TABLE 2

Market values of funds in £m (except where otherwise stated)

	Approximate total funds		Approximate amounts invested in equities	
	1960	1965	1960	1965
Unit trusts	191	500	185	462
Investment trusts	1,989	3,143	1,831	2,877
Private pension funds	N.A.	3,425	N.A.	1,593(1)
Local authority pension funds(2)	562	866 (est.)	24	240 (est.)
Other public sector pension funds	N.A.	1,148	N.A.	420
Insurance companies —life(2)	5,428	8,656	1,187	1,900
—general(2)	1,182	1,540	230	393

Source: *Financial Statistics* (H.M.S.O.) except for insurance companies where information has been provided by the British Insurance Association. "N.A." means that no official statistics are available.

Notes: (1) Excludes equity holdings of co-operative society pension funds.
(2) Book values.

LEGISLATION, BOARD OF TRADE REQUIREMENTS AND COMMENTS ON OPERATIONS OF UNIT TRUSTS

4. Since its resurgence in the 1930's the unit trust movement has been carefully controlled by the authorities. Unit trusts provide a useful savings medium for the smaller investor, and to protect him safeguards have been evolved to ensure that funds are not embezzled by unscrupulous promoters, and equally to ensure that excessive and expensive sales methods are not used to persuade people to commit themselves to unduly high levels of saving. Under the Prevention of Fraud (Investments) Act 1958, unless a unit trust is authorized by the Board of Trade, it is illegal to distribute circulars relating to it (unless the Board of Trade gives special approval). Whilst it is possible for an unauthorized unit trust to exist, it cannot be advertised, and Section I of the same Act forbids anyone to deal in securities as a business unless he has a dealer's licence under the Act. Unauthorized trusts are therefore encountered only in special circumstances.

5. The Board of Trade *may* authorize a unit trust scheme provided that four conditions are met:

(i) Separate corporate bodies must act as the manager and the trustee under the scheme. Both corporations must be incorporated under United Kingdom law and must have a place of business in Great Britain.

(ii) The effective control of the corporation which is the manager under the scheme must be quite separate from the corporation which is the trustee under the scheme.

(iii) The powers, duties, etc. of the trustee must be expressed in a deed providing, to the satisfaction of the Board, for the matters specified in the First Schedule of the Act (see Appendix 1).

(iv) The corporation acting as *trustee* must have an issued capital of not less than £500,000 of which not less than £250,000 must be paid up and the assets of the corporation must also be sufficient to meet its liabilities. Alternatively, more than four-fifths of the capital of the corporation acting as trustee must be owned by another corporation which satisfies these conditions.

6. It is important to understand the dichotomy between the manager and the trustee. The trustee's main functions are to keep all the investments of the trust in safe keeping, to control the issue of certificates to the holders, to ensure that the sales literature issued by the manager is satisfactory and generally to ensure that the manager acts properly within the limits set by the trust deed. The trustee can require the manager to retire from the trust if the trustee is satisfied that it is in the interests of the unitholders that he should do so. Reliance is placed on the trustee to prevent embezzlement of the trust funds, and accordingly the stipulation of the Act is that the trustee (not the manager) should have substantial issued and paid-up capital. The main duties of the manager are to invest the funds wisely, to attend to the sales promotion of the trust units, to conduct a market in the units as such and generally to administer the trust. The existence of a market in units is one of the characteristics of unit trusts distinguishing them from other financial institutions.

7. Confusion sometimes arises between investment trusts and unit trusts. Investment trusts have fixed amounts of capital outstanding, although from time to time the capital may be increased by operations such as rights issues or debenture issues, and each year it is normal for investment trusts to retain a small proportion of available surplus

earned in that year to add to the total assets of the trust. Issues of debenture capital provide " gearing " on the equity capital, which works to the advantage of the equity holders in a rising stock market and to their detriment in a falling market. Furthermore, holdings in the fixed number of ordinary shares in the investment trust available at any one time are normally bought and sold on a recognized stock exchange. The price is governed purely by supply and demand, so that it is possible for the market price of the investment trust share to be materially above or below the asset value of the underlying stock exchange securities. Indeed, the value of these underlying securities is normally published only once per year, at the end of the investment trust's accounting year.

8. By contrast, the number of units in a unit trust is not fixed. Additional units may be created by the manager if there is sufficient demand, and the money subscribed is invested. Correspondingly, if unitholders wish to encash their units, the manager may cancel the units and liquidate the corresponding underlying securities. It follows that the market value of the total units issued cannot differ to a large degree from the market value of the underlying securities, and indeed for an authorized unit trust the Board of Trade virtually sets limits on the extent to which a unit price can differ from the value of the underlying securities. Before a unit trust can be " authorized " by the Board of Trade, the Board insists that the trust deed sets limits on the prices at which units may be offered to or purchased from the public. These maximum and minimum prices are determined by reference respectively to the minimum prices at which Stock Exchange jobbers are offering the underlying shares, which form the unit trust investments, to the public and the maximum prices at which Stock Exchange jobbers will purchase these shares from the public. The valuation of the underlying securities is therefore important and must be calculated frequently, usually daily. Although the issue and extinguishing of units is permissible in response to fluctuations in public demand for units, the expense of such operations can be avoided if buyers and sellers of units can be married off. The manager carries out this function and thus his activities create a market in the units themselves outside the Stock Exchange, the feature of which is that the manager fixes both the offer and bid prices, just as a jobber does in the Stock Exchange, within the limits of variation from asset value permitted by the Board of Trade. The feature of gearing is not found in unit trusts.

9. This is a convenient stage at which to consider the Board of Trade limits on the prices of units, the costs of creating and extin-

guishing units and, as a corollary, the costs and margins involved in the buying and selling of existing units by the manager. The method of arriving at the maximum permitted offer price and minimum permitted bid price will first be considered: the procedures adopted as between manager, trustee, and unitholder are dealt with later. In the following analysis it is assumed that the unit trust invests in British ordinary shares, so that the appropriate rates of stamp duty and stockbroker's commission apply. For simplicity, it is also assumed that the middle market value of these underlying shares is 100, and that the average stockjobber's turn in them is only 2, so that the average Stock Exchange quotation for the underlying ordinary shares is 99-101. The following examples show how the maximum permitted Board of Trade offer price and the minimum permitted bid price are calculated.

(*a*) *Board of Trade offer price*

Costs of purchasing underlying shares from jobbers .	101·000
plus 1% *ad valorem* stamp duty, stockbroker's commission, etc., say	1·641
	102·641
plus Instrument duty ($\frac{1}{4}$% on 102·641)—a duty which is payable by the trustee when new units are created . .	·257
	102·898
plus Dividend equalization	Nil

This is an adjustment to achieve equity between new and existing unitholders regarding the dividend revenue accumulated for distribution. In this example, it is assumed for simplicity that there are no units already in existence and the adjustment is therefore nil.

plus Manager's initial service charge ($3\frac{3}{4}$% on 102·898) . .	3·859

The trust deed normally provides for such a charge to reimburse the manager for his initial expenses, including advertising and promotional literature and any agent's commission; the rate usually lies in the range 3% to 5% and is fixed in the trust deed. This charge is discussed at length later.

	106.757
plus Rounding-up adjustment, say	·445

The Board of Trade permits a rounding-up adjustment not exceeding the lesser of 3d. or 1%, or it can be such lesser amount as permitted by the trust deed. If it is assumed that the trust deed permits an adjustment of only ½d., then on a price in the region of 5s. the average would be ¼d. per unit or 0·417% which is the percentage used in this example.

Maximum permitted Board of Trade offer price . . .	107·202

(*b*) *Board of Trade bid price*

Assumed proceeds of selling underlying shares to jobbers	99·000
less Stockbroker's commission, say	·619
	98·381
plus Dividend equalization (ignored for simplicity). . .	—
	98·381
less Rounding adjustment—again assumed to be 0·417% on average	·410
Minimum permitted Board of Trade bid price . . .	97·971

10. The spread between the Board of Trade offer and bid prices in the example above is quite large at 9·231. The spread could have been larger as many trusts levy a 5% initial service charge and permit a higher rounding-off adjustment, and the jobber's turn may be larger. The spread of 9·231 may be split into the following components :

Costs which would be incurred by a private investor in purchase and resale, i.e. jobber's turn, stamp duty, stockbroker's commission, etc.		4·260
Additional costs of investing through unit trust:		
Instrument duty	0·257	
Payable to manager	4·714	
		4·971
		9·231

When units are extinguished, the instrument duty already paid on them may be carried forward as a credit against any such duty which may be payable in the future when fresh units are again created. To this extent in a fluctuating trust the effective spread could be regarded as 8·974 points. The amount of 4·714 to the manager consists of 3·859 for the initial service charge and 0·855 for the rounding-off charges. If the units of a trust are dealt in on the Stock Exchange, rounding-off charges must be credited to the trust fund and not to the manager.

11. The initial service charge is discussed later in this paper, but the following observations may be made at this stage:

(i) The manager receives a *maximum* 4·714 on the assumptions made.

(ii) The Board of Trade bid price is based on the maximum jobber's bid price, which may apply only to a small number of shares. On a large scale withdrawal of funds by unitholders, the manager may find that he cannot dispose of large volumes of the underlying shares at this price level, and the only protection to the manager would be the small rounding adjustment of 0·410. Thus the manager may be vulnerable in the event of large scale withdrawals.

(iii) Commission, usually of 1¼%, is payable by the manager to certain introducers such as bank managers, accountants and stockbrokers. For newly created units, this is met out of the manager's initial service charge.

12. By maintaining a market in existing units, the manager considerably reduces the costs involved in buying and selling units. The jobber's turn and ½% instrument duty are avoided. The stamp duty position is as follows:

(*a*) When new units are created 1% *ad valorem* conveyance duty is levied on the purchase price of the underlying ordinary shares, although no further duty is levied on the units when these are first sold to the public by the manager.

(*b*) When the manager repurchases units from unitholders, the manager must pay 1% *ad valorem* stamp duty, but this is recoverable if the units are *cancelled* within two months of the date of repurchase. If the units are resold to the public within the two months' period, the manager must also pay stamp duty at the lesser of 10s. per transaction or 1%; thus on a resale of £200 the stamp duty is reduced to the equivalent of ¼%. This is the most usual event.

We estimate that on the resale of repurchased units, for the same margin of profit, the manager in our example must try to make a jobber's turn of about 6%, out of which he will pay the stamp duty.

13. Within the limits of the Board of Trade prices, the manager is free to quote any offer and bid prices that he wishes for units to the public. When units are being created or extinguished, the manager has little room to manoeuvre. When the fund is static and repurchases of units exactly match resales to the public, the manager has consider-

able freedom to decide both what spread he will maintain between the offer and bid prices and also whether these prices will be nearer to the top or bottom of the range permitted by the Board of Trade. For example, the manager might decide to maintain a spread of five points between the offer and bid prices. After paying 1% *ad valorem* stamp duty on the repurchased units and duty equivalent to say ¼% when they are resold, the manager would have around 3·75 points left for expenses, commission and profit, which is less than the 4·714 points available to him out of the Board of Trade spread of prices when units are created and extinguished. As we demonstrated in paragraph 10, on our assumptions a private investor investing directly in ordinary shares and subsequently selling the shares would incur expenses equivalent to 4·260 points, so that if he can buy and resell trust units within a spread of only 5 points, he is obtaining the advantages of spread and expert management for virtually no initial charge. (As will be explained later, he will have to pay a small recurrent management charge which is payable out of the gross income of the fund to cover the recurring expenses of managing the trust.)

14. If the trust is steadily expanding, repurchases of units by the manager will be exceeded by sales of units and it will not be necessary to extinguish units. To avoid making losses when new units have to be created, the manager should fix the offer price of units near to the Board of Trade offer price. Accordingly, if the manager is not taking the full margin on repurchased units permitted by the Board of Trade—and most managers would probably regard this margin as excessive—he will fix the bid price appreciably higher than the Board of Trade bid price and the quoted price will be in the upper part of the permitted Board of Trade range. Similarly, if the trust is steadily contracting, the bid price quoted should be fixed close to the Board of Trade bid price to avoid losses on extinguishing units, and the offer price may be pitched appreciably lower than the Board of Trade offer price if the manager so decides.

15. For the performance of his duties, the trustee is paid a fee which is met by the manager. The trustee's duties have already been outlined in paragraph 6. It will be appreciated that at no time does he act as a principal. The manager normally acts in both an advisory capacity and as a principal. In determining how the funds are invested, the manager is not acting as a principal; if the funds are wisely or unwisely invested, it does not *directly* involve him in profit or loss. However, in conducting a market in units and in the creation and extinguishing of units, the manager does act as a principal. If new units are created or old units are repurchased by the manager

and the underlying securities appreciate in value while the units are held in his name, the resulting profit accrues to him. Such profits are called " holding " profits. Conversely holding losses may be made. Apart from the profits relating to trading in units, the only source of profit to the manager is in the expense charges imposed, i.e. the initial service charge on newly created units and the annual management charge paid out of the gross income of the trust. We should mention that some trusts are managed on what is known as the " agency " system as opposed to the " principal " system ; under this system, the manager never holds units on his own account and does not make holding profits or losses, but an outside jobber in units carries out this function and conducts the market.

CAPITAL GAINS TAX

16. The rate of capital gains tax payable by a unit trust is 30%, corresponding to the long term capital gains tax rate for individuals. Tax is payable by a unit trust on capital gains less losses resulting from the switching of investments. To avoid double taxation of the unitholders, provision is made under Section 67(3) of the Finance Act 1965 for the net capital gains after deduction of the capital gains tax to be apportioned to the unitholders, and a certificate is sent to the unitholders stating the amount involved. The unitholder may then add the " net capital gains apportionment " to the cost price of his units for long term (but not short term) capital gains tax purposes, so that when he eventually sells his units, he effectively receives a credit for the capital gains tax already paid by the unit trust.

17. Although capital gains tax is paid within the unit trust on realized capital gains resulting from the switching of investments, there will normally be unrealized gains (or losses) at any point of time. There will thus be a contingent liability to capital gains tax which will become an actual liability when switches of the investments of the trust are made. Since the price of units closely corresponds to the market value of the underlying investments, a purchaser of units effectively takes over this contingent liability and the units are strictly worth less than the market value of the underlying investments. For simplicity, we assume that there are no dealing expenses or margins and that the price of a unit is exactly equivalent to the market value of the underlying investments. We also assume that the unitholder invests 100 in the purchase of units and that the underlying investments of the trust have a market value of 100, but that unrealized capital gains of P exist on these investments. If, immediately after the purchase of the units, the trustee sells all the underlying

investments, the market value of the trust after capital gains tax at 30% will fall from 100 to (100 − 0·3P). The unitholder will in due course receive a capital gains tax apportionment certificate exempting him from capital gains tax on 0·7P, and so for long term capital gains tax purposes he amends the original cost of his units from 100 to (100 + 0·7P). If he subsequently sells his units at the new market value of (100 − 0·3P) (assuming no change in market prices of the underlying investments), he will have a loss for long term capital gains tax purposes of P and, providing that he has other long term capital gains against which this loss can be offset, the sale of his units will effectively provide a saving of long term capital gains tax of 0·3P, so that in total he receives 100 and emerges without loss. The assumption that the unitholder has long term taxable capital gains against which he can offset the loss on his units is critical, particularly since unit trusts cater for small savers who may not have other investments.

18. In dealing with the capital gains tax assessment on the underlying investments, we have assumed that the capital gains (or losses) arise from the switching of investments without any contraction in the total number of units issued by the trust. Under Section 67(2) of the Finance Act 1965, if the value of the units liquidated during an accounting period exceeds the value of newly created units during the same period, the chargeable gain during that period on which the trust must pay capital gains tax is reduced. The scaling down factor to be applied to the total charge for gains tax is $\frac{A}{B}$ where A represents the capital sums paid by the trustee on the cancellation of units during the year less the capital sums received in respect of the creation of units, and B is the net consideration received by the trustee on the disposal of investments during the year less the costs incurred in the disposal. The purpose of this arrangement is to relieve the unit trust of tax on chargeable gains to the extent to which it disposes of assets to meet payments on the cancellation of units while still retaining the charge to tax on the switching of investments.

Section II

EXPENSE LOADINGS FOR UNIT TRUSTS AND FOR UNIT TRUST LINKED POLICIES

GENERAL

19. The only reference in legislation to the charges which may be made by the manager for expenses is contained in paragraph 5 of the

First Schedule of the Prevention of Fraud (Investments) Act 1958—see Appendix 1. This states that the trust deed must provide for the establishment of a fund to be applied in defraying the expenses of the administration of the trust and for regulating the application of that fund. While no statutory power has been granted to the Board of Trade to prescribe the scales of expense charges generally, the Board has nevertheless effectively exercised regulatory powers for the last twenty years.

20. The requirement of the Board of Trade under the First Schedule of the Prevention of Fraud (Investments) Act 1958 is that a management fund must be set up, under the control of the trustee, to cover administration expenses for the unexpired duration of the trust. This was a reasonable requirement when, in the early days of unit trusts, the manager made a once and for all charge for expenses at the time the units were sold to subscribers. This charge was intended to be sufficient to cover all the initial and future expenses and in these circumstances the Board of Trade rightly required that part of the charge for expenses should be set aside in a special fund—not under the control of the manager of the trust—for future expenses. It was felt that without this requirement there was a risk that the whole of the expense charges received less the initial expenses might with an unscrupulous manager be brought into profit for the benefit of the manager in the first year with the result that there would have been no funds available to meet future expenses of management and of the periodical distribution of dividends.

21. With a single charge for management expenses, it became very difficult to assess what charge should be made and as a precaution there was a tendency for a trustee to require very full provision to be made for future expenses. No doubt it is because of these difficulties that it is the modern practice to make separate provision for future management expenses by empowering the manager of the trust to receive each year, in addition to the initial service charge, a recurrent management charge expressed as a percentage of the market value of the fund. Thus the manager gets the initial service charge direct from the unitholder and the recurrent management charge from the fund. In view of this change in the practice of the managers of unit trusts, the Jenkins Committee expressed the view that the setting up of a management fund for future expenses should not be a statutory requirement, and it may be that the Board of Trade will relax their requirements on this point.

22. Until 1957, it was not the practice of the Board of Trade to authorize a new unit trust or an extension or conversion of an existing

one if the initial service charge exceeded 2% (or $3\frac{1}{4}$% if the manager paid commission to agents) or the recurrent management charge exceeded $\frac{1}{2}$% per annum of the fund. For a unit trust having a 20-year term, the total charges amounted to $13\frac{1}{4}$%. In 1957 representations were made to the Board by the managers of unit trusts that the charges were too low, particularly the initial service charge, which made it difficult for the smaller trusts or those newly established either to operate profitably or to take advantage of recent increased interest in unit trusts by expanding sales by means of more intensive selling techniques.

23. As a result of these representations, the Board agreed to vary the permitted charges by an upward revision of the initial charge and an equivalent reduction in the recurrent management charge allowing for interest at $3\frac{1}{2}$% per annum. The revised charges allowed the initial service charge to be increased to a maximum of 5% if combined with a reduction in the recurrent management charge to $\frac{3}{8}$% per annum.

24. We do not propose to discuss the desirability of block offers : it is certainly no secret that unit trust managers do not like block offers at fixed prices—their Association said so when giving evidence to the Jenkins Committee. If they could find a way to increase their funds without block offers, unit trusts would give up the practice without regret. Their difficulty is, however, to sell enough units to make their operations economic. Successful block offers afford an economic method of securing the expansion of the trusts.

25. The present system by which expense charges are imposed by unit trusts seems logical for non-recurrent lump sum subscriptions. When, however, this same system—with the same charges—is applied to subscriptions received by a unit trust on a regular savings basis (e.g. monthly), further considerations apply. The special features of regular subscriptions as opposed to non-recurrent lump sum subscriptions are :

(i) The average annual subscription per unitholder will be smaller than the average non-recurrent lump sum although the total subscriptions paid over a period will probably be larger.

(ii) Each unitholder's stake in the funds of the trust increases gradually as further subscriptions are paid, instead of remaining constant (apart from changes in the market value of the fund) as in the case of non-recurrent lump sums.

The effect of (i) is, of course, that the initial service charge available out of the first annual subscription will not cover the initial expenses and consequently part of the service charges received subsequently is required to liquidate the initial expenses. The obvious solution is to make a higher service charge in the first year and a smaller one thereafter for renewal expenses, although this might be detrimental to sales, but the Board of Trade requirements described in paragraph 23 effectively rule out this solution for a regular savings plan. The success of block offers in recent years has come to the aid of the managers of unit trusts because the initial service charges received on sales exceed the expenses with the result that the managers have largely avoided showing in their accounts what the actuary would call a new business strain.

26. Similarly the effect of (ii) is that the annual recurrent management charge, expressed as a percentage of the market value of the fund, will be insufficient to cover running expenses in the early years of a regular savings plan and too large in the later years, although the average throughout the term of the unitholder's membership may turn out to be right, depending on the length of membership.

27. The combined effect then of the traditional unit trust method of imposing charges for expenses when regular subscriptions are paid is that there are strains in the earlier years—due to both initial expenses and maintenance—which are not recouped until the later years. These strains fall entirely on the manager and must be financed out of his profits or out of his capital. To compensate for bearing these strains, he should strictly charge for the financing costs of them in determining his charges for expenses. In practice, expense charges are controlled by the Board of Trade and we suspect that unit trust managers budget for expenditure in any year by reference to the expense loadings which they expect to receive in that year, having regard to block offers.

28. When an investment in a unit trust is linked with life assurance, the expense loadings will depend on the organizational structure of the arrangement. The present position seems to be that generally unit trusts still make their normal charges whether or not the purchase of the units is associated with life assurance. In addition, a further deduction is made to cover the costs of mortality and the expenses of the life assurance—frequently the life assurance cover is reassured with an established life office.

29. In view of the different approaches required for determining the expense loadings for a unit trust operating on traditional lines and for a unit trust linked policy, the principles involved when deciding on the expense loadings are considered in two parts. Paragraphs 30 to 42 below deal in general terms with the expense loadings for a

unit trust without life assurance cover. In paragraphs 43 to 47, we consider—again in general terms—the allocation of expenses between a life assurance company and a unit trust for a unit trust linked policy.

EXPENSE CHARGES FOR UNIT TRUST WITHOUT LIFE ASSURANCE BENEFIT

30. The charges normally made by unit trust managers for expenses are:

(i) The initial service charge included in the Board of Trade offer price for newly created units and expressed as a percentage of the total value (including stamp duty, stockbroker's commission, etc. and instrument duty) of the underlying securities.

(ii) The recurrent management charge expressed as a percentage of the market value of the fund from time to time and deducted from the gross income of the fund before the half-yearly distribution is made to the unitholders.

A margin analogous to the initial service charge on newly created units under (i) above is normally taken by the manager on the repurchases and resales of existing units. This margin is implicit in the spread which he maintains between the offer and bid prices as has been discussed in paragraph 12.

Expense charges for non-recurrent lump sum subscriptions

31. The expenses of the manager of a unit trust can be analysed much on the same lines as those for a life assurance company. Thus, the expenses can be divided between those connected with the sales of units and those connected with the subsequent management of the units already sold.

32. For simplicity, we shall consider first a unit trust which accepts only non-recurrent lump sum subscriptions and will then consider how our approach would be modified to investigate the expense charges required for unitholders who make regular subscriptions at periodical intervals (say monthly). For non-recurrent lump sum subscriptions, the expenses might be divided on the following lines:

Initial expenses	*Recurrent annual expenses*
Publicity	Trustee's fees
Records of units purchased	Calculation and distribution of half-yearly dividend
Preparation and issue of certificates	Accounting, postage, etc.
Accounting, postage, stationery, etc.	Management of investments
Investment of new money	Calculation of daily price of units
Agents' commission	

Salaries, auditor's fees and general overheads such as fuel, light, rents, etc. could be apportioned equitably between the different types of expenses.

33. The manager of the trust will have to consider what his total expenses are likely to be in relation to the volume of sales which he hopes to attract each year and the likely expansion in the future. He will also have to consider what the average amount of the lump sum investment from each unitholder is likely to be which, of course, will depend partly on the minimum subscription allowed by the rules of the trust. Having made these estimates, what might be called the crude initial service charge and the crude recurrent management charge can be calculated by dividing respectively the estimated initial expenses per contract and the estimated recurrent annual expenses per contract by the estimated average lump sum investment per contract which the manager expects to receive. Obviously, as his estimates may be wrong and also because he wishes to make a profit, the manager would be justified, when fixing his final rates for the expense charges, in adding a margin for profit which can also be regarded as a margin for contingencies.

34. Within the limits permitted by the Board of Trade, the trust deed can be amended to allow charges for expenses to be modified if circumstances warrant it. Obviously there would be no difficulty with a downward revision if the manager felt that he was making too much profit. If, however, he felt that an upward revision was necessary, it might be reasonable to increase the initial service charge for new units, but for existing unitholders at the date of the revision it would be difficult to increase the recurrent management charge. When expenses increase with inflation, it seems probable that the average size of new subscriptions made by unitholders will also increase, and this would act as a hedge to a greater or lesser degree for the manager against the expense charges for new unitholders becoming inadequate. The investments of unit trusts are normally held in ordinary shares, and over a long period there is a tendency for these to appreciate with inflation although not necessarily by the same amount. Hence to some extent the manager has a hedge against inflationary increases in the annual management costs, since the recurrent management charge is based on the market value of the fund.

Expense charges for regular monthly subscriptions

35. The categories of expenses are much the same as for non-recurrent lump sum subscriptions except that certain expenses

which are " once and for all " for lump sum subscriptions will be recurring. Broadly speaking, the categories of expenses for which a charge is required are :

(*a*) The initial expenses of procuring and setting up the contract.

(*b*) The recurrent annual expenses of collecting monthly contributions and purchasing units, reinvestment of half-yearly dividends in the purchase of further units if the subscriber requires this, and payment of commission.

(*c*) The recurrent annual maintenance expenses, e.g. calculation of half-yearly dividend, half-yearly statements to unitholders, calculation of daily price, etc.

The expenses under (*a*) and (*b*) can be covered in the initial service charge which is expressed as a percentage of each net subscription, and the expenses under (*c*) can be set off against the recurrent management charge which is expressed as a percentage of the market value of the fund. If subscriptions are stopped at any time and the units not encashed, the expenses under (*c*) will continue.

36. In order to arrive at suitable levels of expense charges to quote, the approach would be very much on the lines suggested for non-recurrent lump sums, except that it would be necessary to make an estimate of the average period over which a unitholder was likely to make regular subscriptions having regard to withdrawals. It would be important not to overestimate this average period and the term selected should err on the cautious side.

37. Once the likely average annual subscription S and the average term t have been estimated, the crude initial service charge per £100 subscription will be of the form $100\left(\frac{\mathrm{I}}{\mathrm{S}\ddot{a}_{\overline{t|}}}+\frac{\mathrm{R}}{\mathrm{S}}\right)$ where I represents the estimated initial expenses per contract and R represents the recurrent annual expenses per contract of collecting subscriptions, etc. (i.e. expenses under categories (*a*) and (*b*) above). The crude recurrent management charge can be arrived at by calculating what percentage of the accumulated fund in respect of the unitholders' subscriptions will be required to produce over the average term t the estimated annual recurrent management charge M per contract (i.e. expenses under category (*c*) above). A good approximation to this percentage can be obtained by using an expression of the form $\frac{100\mathrm{M}a_{\overline{t|}}\times i}{\mathrm{S}(t-a_{\overline{t|}})}$ on the assumption that the dividends are reinvested each

year to purchase further units, or $\frac{100Ma_{\overline{t}|}\times i}{S(\ddot{a}_{\overline{t}|}-tv^t)}$ if the dividends are paid in cash to the unitholder each year.

38. After the unit trust manager has estimated the crude rates of initial service charge and recurrent management charge which should be imposed for both non-recurrent lump sum subscribers and regular subscribers and he has decided what margins should be added to cover profits and contingencies, the charges for the various types of subscriber should be compared to see whether it is reasonable to make the same charges for all types of subscriber. If the charges required differ appreciably as between one type of subscriber and another, we feel that a possible solution would be for the unit trust manager to specify the maximum charges required but to make a reduction for certain types of subscriber. One of the crucial factors in estimating the expense charges required is the average size of subscription assumed. Since many of the expenses do not vary directly with the size of the subscription, the unit trust manager will make a profit on subscriptions larger than the average and a loss on subscriptions smaller than the average. Following traditional life assurance practice, it would seem appropriate to vary the expense charges according to the size of the subscription, although this course does not appear to have been adopted by unit trust managers. In practice, sliding scale charges would be relatively easy to operate in the case of the initial service charge but would introduce considerable administrative difficulties if a similar system were applied to the recurrent management charge.

39. It is instructive to examine in the case of a unitholder who makes regular subscriptions for varying periods and reinvests the dividend income received from the trust in the purchase of further units what proportion of his annual subscription is effectively required to cover the expenses and profit of the manager of the unit trust. In Appendix 2, comparative figures are shown for a unit trust which makes an initial service charge of $3\frac{3}{4}\%$ and deducts $\frac{3}{8}\%$ from the gross annual income of the fund for the recurrent management charge. Table 1 of this Appendix shows, on the assumptions stated therein, that the gross recurrent management charge represents in the 5th year about a further 2% of the unitholder's net subscription (after deducting the $3\frac{3}{4}\%$ initial service charge) in that year and grows to over 7% in the 15th year and to over 10% in the 20th year. However, while the unit trust manager receives the recurrent management charge gross, it can be regarded as being borne by the unit trust holder net of tax since it is a charge against the gross investment income of

the trust for income tax purposes. Hence, from the unitholder's point of view, the figures quoted above can be reduced by the standard rate of income tax. If the recurrent management charge is expressed as an equivalent level percentage of the net annual subscription payable by the unitholder throughout his membership, it can be seen from column (3) of Table 1 of Appendix 2 that the additional charge over and above the basic initial service charge of $3\frac{3}{4}\%$ would be about $2\frac{1}{4}\%$ gross for a subscriber who subscribes for 10 years, rising to about $4\frac{1}{4}\%$ per annum additional for one who subscribes for 20 years. Again these percentages are gross and from the unitholder's point of view they can be reduced by income tax at the standard rate.

40. In addition to the initial service charge and the recurrent management charge on the subscriptions payable each year, the manager also usually receives the initial service charge of $3\frac{3}{4}\%$ when the dividend is applied to purchase additional units, and Table 2 of Appendix 2 shows that this is equivalent to another $\frac{3}{4}\%$ per annum of the net annual subscription for a subscriber who subscribes for 10 years, rising to about $1\frac{1}{2}\%$ for one who subscribes for 20 years.

41. Effectively then, on the assumptions stated in Appendix 2, the total of the initial service charges and the recurrent management charges expressed as a percentage of the net annual subscription payable would be as shown in the table below. This table shows the effective gross level equivalent of all the charges for expenses expressed as a percentage of the net annual subscription and also the net equivalent level percentage allowing for the fact that from the unitholder's point of view the recurrent management charge is a charge net of income tax. For comparison purposes, the table below also shows the expense loadings in a non-profit endowment assurance annual premium for a life aged 35 next birthday at entry as approxi-

Period over which subscription made	Unit trust expense charges as a percentage of net subscription		Non-profit endowment assurance expense charges as a percentage of gross premium less expense loadings	
	Gross	Net	Gross	Net
Years				
10	6·7	5·9	10·4	6·5
15	8·1	6·9	12·4	7·8
20	9·6	8·0	14·4	9·0
30	12·8	10·3	18·4	11·5

(In the columns headed "Net", income tax has been allowed for at 7s. 6d. in the £.)

mate percentages of the net annual premium after deduction of the expense loadings. The column headed " Net " shows the effective charge to the unitholder or the policyholder, whereas the column headed " Gross " shows the effective amount received by the unit trust manager or the insurance company to cover expenses.

42. The expense loadings for the endowment assurance allow for £2% initial commission on the sum assured and $2\frac{1}{2}$% renewal commission on the premiums as well as the full procuration expenses of a life office, and hence it would be expected that the gross expense loadings required by the insurance company would be greater than the gross loadings received by the manager of a unit trust, but, because the unitholder has to bear gross the unit trust manager's expenses which are related to the initial service charge, effectively the proportion of his annual subscription which is required for expense charges is not very different from that required under a non-profit endowment assurance. In many cases the initial service charge imposed by unit trust managers is 5% combined with a recurrent management charge of $\frac{3}{8}$% per annum, and in the case of these trusts the effective charge to the unit trust subscriber would be rather greater than to the policyholder under a non-profit endowment assurance. For higher ages at entry, the expense charge percentages for the non-profit endowment assurance would be lower than those shown above. The relationship between the expenses of a unit trust and a life assurance company for a unit trust linked endowment assurance is discussed in the following paragraphs.

EXPENSE LOADINGS FOR UNIT TRUST LINKED ENDOWMENT ASSURANCE

43. We feel that for the purposes of deciding what charges for expenses are required, it is not the best approach to consider the life assurance as a fringe benefit added to a unit trust investment. When an organization offers a unit trust linked policy to the public, we prefer to consider it as a life assurance policy where the investment of the funds of the life office is made in a unit trust. The operations of the life office will be the same as that of any other life office, except for the fact that its investment problem will be very much easier, since it will merely have to invest its funds in a unit trust. Hence the expenses of the life office will be very much the same as those for traditional full premium business except for the following :

(*a*) There will be virtually no investment expenses since units will be purchased in bulk from the unit trust.

(*b*) Dividends received from the unit trust will require to be allocated to policyholders.

(*c*) Possible differences in commission payable to agents.

(*d*) The Board of Trade may put restrictions on the selling organization which will be reflected in the loading included. At the time of writing this paper, the Board of Trade have relaxed their restrictions on the selling of this type of business.

44. If the expenses relating to procuration of new business, collection of premiums, payment of commission, etc. are borne by the life assurance company, the corresponding expense loadings in the premiums can be calculated net of tax at 7s. 6d. in the £. If any of these expenses are regarded as being borne by the unit trust and are included in the initial service charge made by the unit trust manager, then the proper course is to charge them gross to the policyholder. It is true that these expenses are set against the initial service charge within the accounts of the unit trust manager, but it is only any profit on them which is subject to tax. This still applies when the units purchased by the life assurance company are resales by the unit trust manager of existing units ; as we have commented earlier, although the manager receives no initial service charge on resales of existing units, he endeavours to make a jobbing profit on the repurchase and resale of these units which is analogous to the initial service charge on newly created units and which is similarly treated in his accounts. However, the recurrent management charge is payable out of the gross investment income of the trust itself before tax, and therefore any expenses regarded as being paid out of the recurrent management charge are effectively borne by the policyholder net of tax.

45. If the expenses which are properly related to the life assurance company are excluded from the unit trust charges, the unit trust itself will require to bear only the investment and trustee's expenses, management expenses and the cost of the half-yearly distribution to the life assurance company. Since, however, the unit trust will have no procuration expenses and will receive bulk purchases from the life assurance company and similarly will be able to pay dividends in bulk to the life assurance company, the expenses of the unit trust will be much reduced in comparison with a unit trust operated on traditional lines. When, therefore, life assurance is linked with a unit trust, it should be possible for the unit trust to reduce its service and maintenance charges and, because of the tax relief on the expenses

allowed to the life assurance company, the over-all effect should be to reduce the cost of expense charges to the policyholder.

46. One of the items which might be a source of difficulty in allocating costs between the life assurance company and the manager of the unit trust is the cost of advertising and publicity. If the sole aim of the advertising campaign is to sell a life assurance contract, the investments in the units of a unit trust being regarded as a subsidiary matter, it can be argued that the advertising expenses are only properly expenses of the life assurance company and no part of the cost should be regarded as the expenses of the unit trust. On the other hand, it may be argued that part of the publicity expenses should be allocated to the unit trust, particularly if the advertisement is designed to attract the normal type of investor as well as those who wish to effect a life assurance contract. It would, therefore, seem reasonable that only a portion—probably the larger portion—should be regarded as an expense of the life assurance company and the balance as an expense of the manager of the unit trust. If this division is accepted, it would result in a substantial reduction in the initial expenses charged against the unit trust manager.

47. For the reasons already mentioned in paragraph 43, it is evident that the initial service charge and the recurrent management charge required by a unit trust manager for units not linked with a life assurance policy are not appropriate and some reduction should be made in these charges in respect of the units sold to the life assurance company. This could probably be dealt with by the unit trust manager selling units to the life assurance company at a discount. Provision would have to be made in the trust deed to allow for this and it should be noted that where a unit trust sells units at a price lower than the current offer price, the Board of Trade require this to be stated in a certificate attached to the periodical accounts.

Section III

EQUITY LINKED ENDOWMENT ASSURANCES

Part A

TYPES OF CONTRACT

48. In his paper in *J.I.A.* vol. 88, W. G. Bailey describes in some detail the actuarial considerations involved in various types of equity linked contracts which were available in 1962. Since then,

there has been a vast growth in the unit trust movement and in the number of equity linked life assurance schemes, but in general they follow with minor alterations the types described by Bailey. The most comprehensive and concise guide to the many schemes on offer is *Unit-Linked Assurance*, published annually by Unitholder Publications Ltd., who also produce the monthly magazine *Unitholder*. The 1966 edition of this annual handbook lists details of thirty-seven unit linked life assurance schemes currently in operation, associated with ninety-one unit trusts. These contracts can vary considerably in points of detail but the principal types can be classified broadly into three groups, the main features of which are set out below. This paper is concerned with Categories A and B but we have included Category C for the sake of completeness—it accounts for only three of the contracts listed in *Unit-Linked Assurance*.

Category A

49. The most common type is where a fixed proportion x of the office annual premium P is used to cover mortality and the expenses of the life office, and the balance $(P-x)$ is invested in the units of a unit trust, the net dividends thereon as they fall due being reinvested in the units. The initial service charge will be required by the manager of the unit trust in respect of the units purchased, so that the amount invested in the underlying securities of the unit trust will be less than $(P-x)$. The proportion x may vary with age at entry and the term of the policy. At maturity, the value of the units purchased or the units themselves are handed to the policyholder, subject to a deduction for any contingent liability to capital gains tax. On death before maturity, the benefit consists of (*a*) an amount equal to the cash value of the units purchased or the units themselves (subject to any deduction for capital gains tax) and (*b*) the total of the premiums remaining unpaid. A guarantee of a minimum value at maturity is only rarely given, and if so, the guarantee is usually of an amount of the order of $n(P-x)$ where n is the term of the policy. The guarantee is therefore of a low amount which does not take account of the accumulation of units from dividend distributions. On early withdrawal, following the practice in the regular subscription savings plans of unit trusts, the surrender value is generally the value of the units purchased (subject to any deduction for capital gains tax) but with a small deduction of perhaps one month's subscription, and no specific effort is made to deal with

the strain on expenses or any negative mortality reserves which may have arisen.

50. This type of contract has the great advantage of simplicity and fits in well with the established procedures of unit trusts with regular subscription savings plans. It is simply a regular subscription savings plan for an annual saving of $(P-x)$ with the addition of a decreasing term assurance, and possibly a minimum guarantee, purchased by an annual premium of x.

51. Under a variation of the above type of contract, instead of the proportion of the annual premium invested in units each year being constant, it varies with duration, the amount being low at the early durations and increasing thereafter. As before, net dividends as they fall due on the units purchased are reinvested in the purchase of further units. The life cover decreases according to a predetermined schedule and x in the expression $(P-x)$ varies with duration, but no additional point of actuarial principle is introduced. The choice of this type of contract eases the problem of the new business strain and it becomes more appropriate to pay out the full value of the units purchased (subject to any deduction for capital gains tax) on withdrawal at the early durations. Moreover, the increasing proportion invested in units each year may encourage long term saving.

52. Under all these contracts, the guarantee of the life office is limited to mortality and expenses unless a guarantee of a minimum amount payable at maturity is given. Even in the case where the proportion of the premium invested in units varies with duration, the office makes no investment profit or loss.

Category B

53. With this type of contract, the dividends distributed by the unit trust are retained for the benefit of the life office, and corresponding adjustments are made in the premium scale and in the form of benefit. The more usual type of contract in this category takes the form of an endowment assurance under which the sum assured is payable in the units of a unit trust, the amount invested in units each year being equal to the sum assured divided by the original term of the policy. At maturity, the policyholder receives the units (or their cash value) subject to any deduction for capital gains tax. On death before maturity, the benefit consists of (*a*) the units purchased (or their cash value) subject to any capital gains tax deduction and (*b*) the balance of the nominal sum assured not at that time invested

in units. Most of the contracts in this category guarantee a minimum payment on death or maturity equal to the nominal sum assured. A further variation allows for reversionary bonuses which are payable in addition to the units on death or maturity. As, under this type of contract, the life office is to some extent dependent on the dividend income received from the unit trust, the inclusion of bonuses which are not guaranteed in the scheme appears natural. The exchanging of future income for future benefit or reductions in cost and the employment of the bonus concept are more life assurance concepts than unit trust concepts, and from the list of such schemes in *Unit-Linked Assurance* it would appear that the prime mover in designing the schemes is more often a life assurance company than a unit trust manager. Surrender values are not usually available until at least one or two years' premiums have been paid.

54. Under this type of contract the life office effectively guarantees interest, mortality and expenses—and also capital if a guarantee of a minimum sum assured is allowed.

Category C

55. Whereas with the contracts described under the two categories above, the investments in units are built up gradually from the premiums and, under Category A, also from the reinvestment of the income, in this type of contract a loan is made by the life office to the policyholder at the outset for investment in the units of a unit trust. The units are held by the life office as security for the loan which is repaid by an ordinary annual premium endowment assurance. The life office does not advance 100% of the value of the units purchased, but perhaps 80%, and the policyholder subscribes the remainder at the outset. Interest on the loan is charged at a fixed rate, but the income on the units purchased is the property of the policyholder.

56. There is one contract somewhat analogous to that described above but different in form. Under this contract, the policyholder secures an immediate interest in a block of units and is required to pay under an endowment assurance a first premium equal to 20% of the cost of the units and thereafter a level premium over the balance of the term of the policy. In contrast to the position described in the preceding paragraph, the income from the units is the property of the life office and allowance for this is made in the premium scale. Investment choice is restricted to two unit trusts, while under the contracts described in the previous paragraph a wide choice is given ; this difference is understandable, since if the life office has no interest in the investment income receivable from the underlying units, it can

allow the policyholder a wider range of unit trusts from which to make his selection.

57. Under these contracts, it is important for the policyholder to effect his policy at a time when stock market price levels are depressed, since all the units are purchased at that one point of time. This is in contrast to the schemes described in Categories A and B where "pound averaging" gives some protection against unfortunate timing.

Part B

ORGANIZATIONAL STRUCTURE AND TAXATION

Introduction

58. The structure of the organization within which an equity linked endowment assurance should be issued depends a great deal on whether the prime mover is a unit trust or an existing life office. A unit trust entering this field must either set up its own life assurance company to issue the life contracts or arrange for an existing life assurance company to issue policies with investments in the units of the unit trust. If it sets up its own life office, it normally reassures the mortality risk and at least part of the life policy expenses with an established life office. Normally, a unit trust management will wish for sales reasons to use one of its existing unit trusts whose name is already known to the public. A new or existing life office may either associate with an established unit trust or it can set up its own unit trust. The life office itself can act as the unit trust manager and, of course, it would have to conform with all the Board of Trade requirements for unit trusts : an entirely separate body would have to act as trustee. A new life office might wish for sales reasons to associate itself with an existing unit trust whose name was better known to the public, whereas an existing life office, relying on its own reputation to assist its sales promotion, might prefer to manage its own unit trust. As a further alternative, a life office could offer a contract with the premiums invested in a special fund, providing the same benefits as under a unit trust linked policy and run on unit principles, without actually setting up a unit trust as such. The investments of the special fund could be held in a separate wholly-owned subsidiary assurance company, possibly reassuring the mortality and expenses with the parent company, or the appropriate investments could be earmarked within the existing life and annuity funds.

59. The life office may thus either invest in the units of a unit trust or make its own direct investments without the intermediary of a unit

trust. Furthermore, the life office may transact only this type of business (e.g. a new life office or a wholly-owned subsidiary company of an existing life office) or it may hold the investments as part of the existing life and annuity funds. There are thus two choices which produce four possible cases as follows :

(1) A separate life office investing in the units of a unit trust.
(2) A separate life office investing directly in securities.
(3) An existing life office which transacts traditional forms of life business investing in the units of a unit trust.
(4) An existing life office which transacts traditional forms of life business investing directly in securities.

All these possibilities are open to an existing life office which can set up a separate wholly-owned subsidiary company if it wishes. (1) and (2) only are available to a new life office and (1) and (3) only are available to a unit trust management which wishes to enter this field. Regardless of the organizational structure, all the investment profits are passed to the policyholders, and there is therefore no question of any investment profit accruing to the unit trust manager or to the life office promoting the scheme (except in the special case of the Category B type of contract mentioned in paragraph 53 where dividends are retained by the life office, in which case the life office has a degree of interest in the experience of the investments). The organizational structure should not cause a great deal of variance in the cost of the death cover to the policyholder, and essentially the best structure to adopt in any case should depend on three factors—taxation, expenses and sales appeal. We have already referred briefly to sales appeal and the four cases listed under (1) to (4) above will first be examined in relation to taxation and then in relation to expenses and other general considerations.

Taxation

A separate life office investing in the units of a unit trust

60. Apart from the question of capital gains tax on realized profits, there are not any special taxation problems due to transacting this type of business for a newly established life office with no general or pension annuity fund. If all the investments of the life office are held in the units of a unit trust, it will have no direct liability for capital gains tax so long as it does not have to realize units. The unit trust will be liable to tax on any capital gains (less losses) realized upon the switching of its investments and will, as mentioned in paragraph 16, issue a capital gains apportionment certificate to the

life office stating the amount of the net capital gains which may be added to the cost price of the units for the purpose of assessing the liability of the life office to capital gains tax when it realizes units. If, for any financial year, there is a contraction in the total number of units issued by the unit trust, the unit trust will obtain relief on its liability to capital gains tax in accordance with Section 67(2) of the Finance Act 1965 as explained in paragraph 18. This relief to the unit trust does not, of course, give any relief to the life office which, if it realizes units, will be taxed on the difference between the amount of the proceeds realized on the sale of units and the cost price of the units with the addition of the value of any capital gains apportionment certificates.

61. When a claim or a surrender arises under a unit trust linked policy, either units are transferred to the beneficiary (usually on payment of the 1% *ad valorem* stamp duty) or the cash equivalent is paid. If the life office transfers some of the units held by it in its life fund to the beneficiary, this will be regarded as a disposal for capital gains tax purposes and consequently, whether it transfers units or realizes units to pay cash, it will incur an immediate liability to capital gains tax on any appreciation of the units. However, so long as the life office is expanding, it can avoid the realization of existing units by using part of its new money for claims where payment is required in cash, thus avoiding any immediate liability to capital gains tax. It is also possible that it can avoid the immediate liability to tax where a beneficiary requires the benefit in the form of units by purchasing new units in the beneficiary's name from the unit trust. Nevertheless, in whatever form the claim is paid, there will be a contingent liability for capital gains tax and some deduction should be made from the proceeds of the policy to allow for this and the amount so deducted should be set aside in a capital gains tax reserve. The amount set aside need not be the full liability at the date of the claim and should allow for the fact that the fund is likely to expand in the future so that payment of capital gains tax will be postponed. It is interesting to note that, in the case of one unit trust linked endowment assurance, no deduction is made for capital gains tax when a claim arises if the assured pays an extra premium of 10s.% per annum of the sum assured.

62. The capital gains on units discussed in the previous paragraph basically represent appreciation on the underlying securities of the trust. Although it is possible for the life office to defer the realization or transfer of units, and therefore to defer the payment of the capital gains tax thereon, when the unit trust switches the underlying

investments, capital gains tax will be payable immediately by the trust on any gains realized. Effectively switching activity by the unit trust transfers the life office's contingent tax liability on the units purchased to an actual tax payment by the unit trust on the underlying securities. The level of switching activity is therefore an important factor for the life office to consider when deciding how much to deduct from the proceeds of policies to allow for the contingent tax liability on the units. In the extreme case where switching activity is so high that all capital gains are immediately realized by the unit trust, the life office will have no contingent liability and no deduction need be made from the proceeds of policies, since the tax paid by the trust will already have reduced the value of the policy proceeds by reducing the value of the units. It may be noted that an optional guarantee of the form mentioned in the previous paragraph would be open to objection on this account unless the unit trust management is independent of the life office, and even if this condition is satisfied, the value of the life office guarantee depends on the switching activity of the trust.

63. If a unit trust has investments in any overseas country, the taxation position will depend on any D.T.R. agreement in force with that country, but, in general, the trust sets off the overseas tax deducted from the dividends received against its own liability to corporation tax and the gross dividends declared by the trust are paid out of the net residue. It deducts United Kingdom income tax at the standard rate from the dividends declared, and therefore in general it is more advantageous from a taxation angle for a life office to hold overseas investments direct rather than through the medium of a unit trust. For example, every \$100 dividend declared on a United States industrial common stock may be worth \$62·50 net to a life office investing directly but only \$37·50 net if it invests through a unit trust. This brief exposition of course deals with marginal income, assuming that management expenses have already been fully set off against other income.

A separate life office investing directly

64. If the sole purpose of the life office is to issue equity linked policies, again there are not the special taxation problems arising from the aggregation of funds which exist if the life office also transacts other types of business. Regarding capital gains, the fund will be liable to capital gains tax on realized investment profits (less losses) and some deduction should be made from the proceeds of

policies to allow for the contingent liability to capital gains tax on unrealized profits. On the question of overseas investment revenue, it has already been mentioned in the previous paragraph that it is better for a life office to hold overseas investments direct than through the medium of a unit trust.

An existing life office investing in the units of a unit trust

65. We now consider the case of an established life office which already has combined life and annuity funds, the latter showing a profit for taxation purposes. The Inland Revenue will not normally permit segregation of the assets of the different funds and instead, for taxation purposes, all the investment revenue and realized capital gains are divided between these funds in proportion to their respective mean valuation liabilities. If the office invests in the units of a unit trust, these investments will be treated for tax purposes like any other investment of the office. Part of the income derived from the units will be apportioned to the annuity funds, and some other income which would otherwise have been apportioned to the annuity funds will be allocated to the life fund, which will be the larger for the inclusion of the unit trust linked policies. Provided the annuity funds show a taxable profit, at the margin investment income will be taxed as additional profit in the annuity funds or as additional investment income of the life fund. It follows, therefore, that the increase in interest income arising from investment in the units of the unit trust will suffer tax at the rate of $37\frac{1}{2}\%$ regardless of whether, for taxation purposes, part of it is allocated to the annuity funds. Hence the interest income of the investments in the units of the unit trust will bear tax at the same rate as if it could be taxed separately from the main funds. This exposition has, for simplicity, ignored D.T.R. investments. In so far as the addition of the investments in the units of a unit trust in the life fund results in a reduced allocation of revenue from D.T.R. investments to the annuity funds, less tax will be paid, and *vice versa*.

66. An apportionment will be made between the funds of any realized capital gains caused by the sale of units by the life office, and in this paragraph we ignore the complications arising from the switching of investments by the unit trust and the consequent capital gains apportionment certificates. Any increase in realized capital profits allocated to the annuity funds will result in an increased tax liability unless these additional profits can be reserved for the annuitants, which seems unlikely. This increased tax liability will arise

not only because profits in the annuity funds are taxed at $37\frac{1}{2}\%$, whereas by the Finance Act 1966 capital gains in the life fund are taxed at only 30%, but also because realized capital profits in the annuity funds are related to book values whereas those in the life fund are regulated by the pooling provisions of the Finance Acts 1965 and 1966. A larger allocation to the annuity funds will arise only if the rate of realized profit (expressed as a percentage of the total valuation book values of the unit trust units purchased and of the total valuation book values of the investments of the main funds respectively) is greater on the sales of the unit trust units than on sales of investments of the main funds : if the rates are the same, there will be no increased allocation to the annuity funds and if the rate is less for the unit trust units than for the main funds, the allocation to the annuity funds will be less than it would have otherwise been and more of the gains will fall to be taxed in the life fund. So long as the portion of the funds representing the investment in the units of a unit trust continues to expand, it is likely that for a long time the rate of realized profit (as defined above) from the realization of units will be less than that derived from switching investments of the main funds and that accordingly a greater part of the total gains will be taxed in the life fund than otherwise would have been the case.

67. The procedure in respect of capital gains tax paid by the unit trust on switching profits will be as explained in paragraph 16, and the life office will receive a capital gains apportionment certificate showing the amount which may be added to the cost price of the units for the purpose of assessing liability to capital gains tax when units are realized. For the proportion of the realized profit allocated to the life assurance fund, the capital gains apportionment certificates can be used in the normal way, but they cannot be taken into consideration for assessing the tax liability on the proportion of these profits allocated to the annuity funds.

68. The position regarding unrealized profits will be the same as in the case of a separate life office investing in the units of a unit trust and an appropriate deduction should be made from the proceeds of policies to allow for this contingent liability.

69. In general, the transaction of the unit trust linked business is not likely to result in more tax being paid in respect of the existing business of the office; if anything, the tendency will be to reduce this liability. Also, in general, we do not foresee any great difficulty arising in practice in allocating for the internal book-keeping purposes of the office the tax paid on realized gains between the unit trust life fund, the ordinary life fund and the annuity funds.

An existing life office investing directly

70. The taxation considerations (including those on D.T.R. investments) arising from the aggregation of the life and annuity funds for tax computation purposes are very much the same for an existing life office which earmarks investments in a special fund for the equity linked policies as for an existing life office which invests in the units of a unit trust. An important difference, however, arises on the switching of investments. If the investments are made in the units of a unit trust, the unit trust pays the capital gains tax and the value of the units is reduced by the amount of capital gains tax paid. Hence the special fund effectively bears the capital gains tax paid immediately through the reduction in the value of the units already purchased and, on a later sale of units, it is able to avoid double taxation of the capital gains by the system of capital gains apportionment certificates. The underlying investments held within the unit trust are quite separate from the corresponding securities held directly by the life office, so that the switching activities of the unit trust have no impact on the investments held directly by the life office. When, however, the life office holds the investments of the equity linked policies directly, the system of aggregation of the life and annuity funds for tax computation purposes requires that part of the realized profits on switching will be immediately taxed in the annuity funds at $37\frac{1}{2}\%$ so long as they are showing a profit. Furthermore, the pooling provisions of the Finance Act 1965 may have the effect that the tax paid by the life fund is higher ; this would apply on the sale of an investment of the special fund if the pool price of the existing holding of that particular investment was lower than the price at which it was purchased for the special fund. Thus the taxation on realized profits may have an inhibiting effect on switching of investments to which we make reference later. A suitable deduction should be made from the proceeds of policies to allow for the contingent liability to capital gains tax and this question is discussed in paragraph 74.

Expenses

71. Where a unit trust is involved in the structure, there will be expenses incurred which a life office need not incur. These expenses cover items such as paying the trustee, making distributions of income, valuing the funds regularly and publicizing the results, and keeping a record of the capital gains tax arising on sales of investments applicable to each unit holding. An established life office considering whether to set up a unit trust or whether to earmark investments in

a special fund may consider the procedures involved with a unit trust rather troublesome, more so than would established unit trust managers who are accustomed to them. On the other hand, from the viewpoint of established unit trust managers using an existing trust as the basis for the life contract, procedures such as valuing the trust are already carried out and the additional work is minimal.

The Choice of Organizational Structure

72. Where the initiative for the introduction of an equity linked contract is from a unit trust management, obviously the only question for the management to decide is whether to set up a life assurance company themselves or whether to arrange with an established office to transact the business. We therefore require to examine only the point of view of a life office considering whether to invest in the units of a unit trust or to make direct investments.

73. If an existing life office invests in the units of an established unit trust, it loses control of the investment of its policyholders' funds unless it is represented on the unit trust management. This is an important factor to consider, as to a large extent by promoting the policy the life office is acting in the position of a quasi-trustee of the policyholders' money and must therefore bear some responsibility to see that the funds are invested responsibly. On the other hand, by setting up its own unit trust, the life office acting also as manager of the trust will have complete responsibility for the investment of the funds, subject to the overriding supervision of the trustee which must be an entirely separate corporation.

74. If a life office makes investments direct, it can avoid the additional expenses involved in the establishment and management of a unit trust. If an established office wishes to invest direct by earmarking investments for the equity linked contract in a special fund, it must consider the likely effect on investment policy of the aggregation of the life and annuity funds for taxation purposes. If it is possible to make the investments of the special fund in stocks completely different from those in the main funds, no special difficulties arise from the aggregation of the funds for tax purposes. In practice, the majority of the investments of the special fund will already be existing holdings of the main life and annuity funds. The disadvantage of combining the special fund with the main funds is that the office may feel inhibited from selling an investment because of tax considerations. With growing funds and a liability to tax on realized profits both in the life fund and the annuity funds, the more an investment appreciates, the greater will be the inhibition

on selling for tactical reasons. However, it is perhaps possible to overstate complications arising from the tax position. In general, the method of assessing the amount on which tax is to be paid on realized profits does not alter in total the amount of tax which will eventually be paid on the assumption that there is no change in the method of assessment or the rate of tax: it merely alters the incidence of the payment of the tax, although this, of course, may involve a considerable loss of interest if it brings forward appreciably the date on which the tax would otherwise have been paid. The life office might decide to ignore the distortions in the tax computation which may arise in the incidence of the payment of tax, in which case it could debit the special fund with the capital gains tax as if it were a separate entity for tax purposes. If this in practice turns out to favour the special fund, the deduction from the proceeds of the equity linked policies for the contingent liability for capital gains tax on unrealized profits might be adjusted to take into consideration the effect of the aggregation of the funds for tax purposes on the incidence of the total tax liability of the funds.

75. As an alternative to the investments of the special fund forming part of the main life and annuity funds—whether the investments of the special fund are made in the units of a unit trust or are made direct—a life office could form a wholly owned subsidiary company to hold the investments of the special fund and to transact the business of the equity linked contract. This method avoids the taxation complications arising from the aggregation of the existing funds and the taxation position would be the same as that described for a new life office. If there is a guarantee of a minimum sum assured, it would be desirable to obtain the guarantee of the parent company. A disadvantage of a separate subsidiary company in the case where investments are made direct might be that separate Board of Trade returns and accounts would be required, whereas for general policy reasons the office might prefer to treat the equity linked policies simply as a separate class of business by earmarking investments in the main life fund, with the greater flexibility which this would give the office in the event of any unforeseen factors arising which merited special treatment.

Part C

GENERAL OBSERVATIONS

76. This paper is primarily concerned with the management problems connected with unit trusts and the issue of equity linked policies.

Before an institution commits itself to offer any equity linked contract, the first important question is to decide whether the issue of these contracts is desirable from the viewpoint both of the particular institution concerned and the public generally. We therefore consider it appropriate to make some observations on the subject before concluding our paper.

77. One of the criticisms made against the traditional forms of with-profits policy arises because the normal practice of life offices has been to retain capital profits in reserve with the result that if the office invests in equities which appreciate in value substantially, the policyholders whose premiums are used to make the investments receive no benefit *directly* from these capital profits. It is during a period of heavy inflation, such as this country has experienced since the last war, that this system becomes subject to criticism. Some life offices have distributed a small proportion of the capital appreciation to the with-profits policyholders, but it is not usually possible to distribute a large proportion because, in the event of severe depreciation, there is no power to reduce the benefits under existing contracts. To the extent that capital appreciation is realized, it may be reinvested in other types of security with less risk of loss of value, but there are considerations of tax and long term investment policy involved, and unless an office is prepared to abandon investment in equities completely, this is not a solution to the problem.

78. Life assurance contracts are expressed in money terms and if a life office has a moral duty to endeavour to protect its with-profits policyholders against inflation, this duty must rank after its legal contractual duties. The paramount duty of a life office is to meet these contractual obligations and its investment policy must be subordinated to this consideration. This is not to say that a life office by its investment policy should not endeavour to make with-profits contracts as profitable as possible for the policyholders. Investment in ordinary shares over a period of years may go some way to mitigate the loss in real values, but the basic problem is to devise a means by which the benefit of any appreciation or depreciation can be distributed to or can be borne by those whose reserves are represented by these investments. In the absence of an acceptable solution to this problem in so far as the traditional business is concerned, the issue of a policy where the proceeds are linked closely to the investment results of a special fund does not seem to be objectionable provided that the policyholder fully understands the nature of the policy and how it differs from the more usual forms of with-profits contracts.

79. In the past there has been over a long period some degree of

correlation between equity prices and the cost of living index, but experience of the past also shows that over periods of 10 or 20 years the degree of correlation can be very small or even negative. In any case, equity prices are far more volatile than the cost of living index. There is a danger arising from the fact that the experience of those who have been involved in investment at any period since the end of the last war has been gained during a period of predominantly rising equity prices. Even the most cautious of them may be influenced in their thinking by the innate belief that equity prices will rise at a similar rate over the next twenty years. Clearly it is important to recognize that there were special factors operating in the post-war period and the assessment of the future—always difficult—must take into consideration the very different circumstances which will operate over the next twenty years—political, social and economic.

80. If, therefore, this type of contract is to be issued, we believe that possibly the most important aspect to consider is the sales promotion. While, until a few months ago, the Board of Trade did not impose any restrictions on the selling of equity linked policies unless the policy was tied to the units of a unit trust, the Board has now relaxed its restrictions on the unit trust linked policies so that all life assurance companies are treated alike. This relaxation by the Board of Trade puts a greater responsibility than ever on those who sell this type of contract. It is important that the policyholder should not only be aware of the risks inherent in investment in ordinary shares but that he should know how the policy differs from traditional forms of life assurance business. The life office cannot just assume that their salesmen are knowledgeable about the vagaries of the equity market. The salesmen should receive a short course of training on the equity market and the life office should lay down in broad terms what should be said to each prospective policyholder. These policies will also be sold to the public by agents of the life office over whom the office has no direct control and the main safeguard to the life office will be contained in the literature issued. We have wondered whether it would not be in the best interests of the institutions if a kind of " British Standard " were laid down by an appropriate responsible body requiring that, before an equity linked contract is issued, certain statements about the type of policy should be issued in writing to the policyholder. Perhaps this is going too far, but it would act as a deterrent to over-aggressive sales techniques. We do not believe that the traditional forms of with-profits policy have failed—far from it. It would be a mistake if, because of the desire for something new, the equity linked policy gradually replaced the

traditional type of policy. There is a need for both types, but we would expect to see only the marginal part of a policyholder's savings put into an equity linked policy.

81. Throughout this paper, we have referred either to a " unit trust linked policy " or to an " equity linked policy ". If either of these types of policy is issued, the investments are made in units of a unit trust or in equities. By effecting the policy, the policyholder has agreed that his premiums should be invested in this way. The final decision to effect the policy must be his and thereafter he will rely on the managements concerned to invest his premiums wisely. He may have chosen a specialist unit trust which invests in a particular class of equity and again, provided that the special features of this particular class of equity have been clearly explained to him, he can have no complaint if the final results of his policy do not come up to his expectations. Another form of contract which may have considerable attractions to a life office is where the proceeds of the policy are linked to the investment results of a special fund (or unit trust) but where there is no commitment to invest the whole of the funds at any time in equities or in a particular class of equity. This type of fund allows complete freedom of investment policy and enables the management to use its own judgment on the timing of purchases or sales in each sector of the market. With this type of fund, the emphasis is on quality of management and the policyholder is backing his faith in management, more so than in the case of the usual type of unit trust or equity linked policy.

82. Some of the disadvantages of the types of policy discussed in this paper disappear from the policyholder's point of view if a minimum sum assured is guaranteed on death or maturity. The discussion on Bailey's paper showed that there was a divergence of opinion as to whether a guarantee such as this should be given. Those opposing the guarantee stressed the risks involved and thought that a policyholder should not expect to have the best of all worlds. A life office which transacts orthodox life assurance business can immunize itself against the effect of changes in interest rates on fixed interest stocks and is justified in departing from an immunized position by, for example, investing in equities only if by so doing it can do better over a period than by investing in fixed interest stocks. For an equity linked policy, an office cannot immunize itself if it gives a guarantee against depreciation in equity prices. If it decides to grant this guarantee, it must make some estimate of what the cost of the guarantee could be and make an appropriate charge in the premium. In adverse circumstances, this guarantee could prove

very expensive and we feel that, unless the sum guaranteed is fixed at a very low level, the risk should not be borne by a new life office established purely to promote unit trust policies, but should be reassured with another company which is willing to accept risks of this nature. On the other hand, an established life office with large funds could give the guarantee, provided of course that an appropriate charge is included in the premiums, but in the last resort it is the guarantee given by the funds of the orthodox policyholders which will be supporting the charge made in the premiums for the guarantee. If the charge included in the premiums turns out to be more than adequate, the profit, or a portion of it, should be given to the orthodox with-profits policyholders since, if it turns out to be insufficient, the cost would have to be borne by those policyholders.

We have endeavoured in this paper to discuss some of the problems connected with unit trusts and equity linked policies which we think may be of interest to actuaries. Our views on unit trusts, particularly those expressed in Sections I and II, are intended to be an analysis of the problems as an actuary would see them. We have not attempted to cover the ground so fully dealt with in Bailey's paper and the subsequent discussion : on the contrary, we have tried to concentrate on different problems.

APPENDIX 1

FIRST SCHEDULE TO THE PREVENTION OF FRAUD (INVESTMENTS) ACT 1958

Matters for which Trust deeds pursuant to Unit Trust schemes must provide

1. For determining the manner in which the manager's prices for units on a sale and a purchase respectively, and the yield from the units, are to be respectively calculated, and for entitling the holder of any units to require the manager to purchase them at a price calculated accordingly.

2. For regulating the mode of execution and the issue of unit certificates, and, in particular, for securing that no unit certificate shall be executed or issued in respect of rights or interests in any property until steps have been taken, to the satisfaction of the trustee, to secure that the property will be vested in him or, subject to any prescribed conditions, in a nominee for him approved by the Board of Trade.

3. For prohibiting or restricting the issue by or on behalf of the manager of advertisements, circulars, or other documents containing any statement with respect to the sale price of units, or the payments or other benefits received or likely to be received by holders of units, or containing any invitation to buy units, unless the document in question also contains a statement of the yield from the units.

4. For securing that any advertisement, circular or other document containing any statement with respect to the sale price of units or the yield therefrom, or containing any invitation to buy units, shall not be issued by or on behalf of the manager until the trustee has had a reasonable opportunity of considering the terms of the document, and shall not be so issued if, within a reasonable time after the document first comes under his consideration, he notifies his disapproval of the terms thereof in writing to the manager.

5. For the establishment of a fund to be applied in defraying the expenses of the administration of the trust and for regulating the application of that fund.

6. For the audit, and the circulation to holders of units, of accounts relating to the trust (including accounts of the manager in relation to the trust and statements of his remuneration in connection therewith).

7. For requiring the manager (subject to any provisions as to appeal contained in the deed) to retire from the trust if the trustee certifies that it is in the interest of the beneficiaries under the trust that he should do so.

In this Schedule the expression " units " means securities (described whether as units or otherwise) which may be created in pursuance of the unit trust scheme, and the expression " unit certificates " means certificates of the acquisition of such securities.

APPENDIX 2

EXPENSE CHARGES EXPRESSED AS A PERCENTAGE OF THE NET ANNUAL SUBSCRIPTION

In the following tables, the following assumptions are made :

(*a*) that a unit trust makes an initial service charge of $3\frac{3}{4}\%$ of the net annual subscription (i.e. gross subscription less the service charge) and a recurrent management charge of $\frac{3}{8}\%$ per annum based on the market value of the fund from time to time ;

(*b*) that a subscriber makes regular annual subscriptions and that interest income on the subscriptions is reinvested in the purchase of further units ;

(*c*) that there is no appreciation or depreciation on the investments and that the fund earns interest at $3\frac{3}{4}\%$ net per annum after deduction of the recurrent management charge.

TABLE 1

Recurrent management charge expressed as a percentage of the net annual subscription

Period over which subscriptions are paid (1)	Recurrent management charge in last year expressed as a percentage of the net annual subscription (2)	Recurrent management charge expressed as a level percentage of the net annual subscription throughout the period (3)
Years	%	%
5	2·0	1·2
10	4·4	2·2
15	7·3	3·2
20	10·7	4·3
30	19·7	6·6

TABLE 2

Initial service charges paid in respect of reinvestment of the net income expressed as a percentage of the net annual subscription

Period over which subscriptions are paid (1)	Initial service charge on reinvestment of income in last year expressed as a percentage of the net annual subscription (2)	Initial service charge on reinvestment of income expressed as a level percentage of the net annual subscription throughout the period (3)
Years	%	%
5	0·8	0·4
10	1·7	0·8
15	2·7	1·2
20	4·0	1·6
30	7·4	2·5

SYNOPSIS

The aim of the paper is to discuss some of the problems relating to unit trusts and to the issue of annual premium endowment assurance policies with benefits linked to unit trusts or equities.

SECTION I describes the background to unit trust operations including the main requirements for Board of Trade authorization.

SECTION II analyses expenses of administration and patterns of expense loadings. It compares the traditional life assurance approach to expense loadings and normal unit trust practice.

SECTION III describes the main broad types of assurance linked to unit trusts or equities now in force. It discusses the organizational and taxation considerations involved in issuing such contracts and the desirability of doing so.

DISCUSSION

Mr. G. A. Kingsnorth, introducing the paper, said :—It was with some diffidence that Mr. Grant and I decided to submit this paper to the Faculty, because we were very conscious of the fact that the range of problems that we wished to cover could not really be regarded as involving very much in the way of actuarial techniques. Nevertheless, with much encouragement from the immediate Past President, Mr. Anderson, to whom we are grateful, we felt that the subject was of considerable topical interest and that it was right to give members of the Faculty an opportunity to discuss it. One of the difficulties in writing a paper of this nature is really to decide what to put into it and what to leave out. It already runs to 37 pages and two appendices, and for the length of it we do apologize. We realize that there are a number of important matters, such as taxation, which we have only dealt with in rather general terms, and others perhaps of a more detailed nature which we have omitted altogether.

The paper is confined to a consideration of unit trust and equity linked endowment assurances by annual premiums. You will see that we have not discussed equity linked policies by single premiums, nor have we touched on the subject of variable annuities. What we have tried to do is to cover the management problems which would have to be considered if a unit trust or a life assurance office wished to consider entering this field. You will see that it is not until the very end of the paper that we discuss the desirability or otherwise of this type of contract, and we would not like you to think that because we have left it to the end we regard it as an unimportant part. We do regard it as an important section of the paper and we hope very much that some part of the discussion will dwell on this aspect of the problem.

Now, there are just three or four points of detail. On page 34 we discuss expenses and we make a comparison of the expenses of a unit trust with a non-profit endowment assurance. What we should like to emphasize, in case we have not made it clear in the paper, is that the expenses for the unit trust are purely for the purchase of units without any associated life assurance—that is the point to bear in mind—whereas the endowment assurance expenses allow for the full new business organization of an established office with branches and inspectors and, of course, they allow for the fact that the rate of commission payable by a life office is very much higher than the rate of commission payable by unit trusts. One point about the table at the bottom of page 34 and Table 2 of Appendix 2 : in our calculations we have assumed that the initial service charge is made by the unit trust manager on the reinvestment of the interest income on units purchased to date. It has been pointed out to us since writing the paper that one or two unit trusts do not follow this practice where a unitholder or a subscriber agrees at the outset to the reinvestment of his interest income —I believe they are called accumulation units—and in the case of these unit trusts they do not make the service charge on the reinvestment of the interest income.

Again, on page 33, we suggest that it might be appropriate for unit trust managers to introduce a sliding scale of charges for expenses which vary according to the size of the contribution. We have noticed since writing this paper that at least one unit trust has introduced this feature in a block offer.

And the last point that we want to mention is on this question of taxation and the aggregation of a special fund—a unit trust fund or an equity linked fund—with the main life assurance and annuity funds of a life office. We understand that in the case of one office which started to issue a variable annuity contract about eight years ago they did achieve segregation for tax purposes subject to some amendments being made to their articles of association. Certainly, about eighteen months ago, we made similar enquiries and the Revenue could not see any way in which we could achieve segregation for tax purposes short of setting up a separate office such as a subsidiary company.

Mr. G. M. Murray, opening the discussion, said :—I should like to thank Mr. Grant and Mr. Kingsnorth for providing such a timely contribution to the Faculty literature and I should also like to congratulate them on the excellent reference tool they have provided for anyone concerned with the management problems connected with unit trusts and the issue of equity linked policies. As far as possible, the authors have avoided the ground already covered by Mr. Bailey's paper and the subsequent discussion, thus giving us two papers which cover the subject of these new contracts very comprehensively.

The authors' general observations rightly state that the first important question is to decide whether the issue of these contracts is desirable from the viewpoint both of the particular institution concerned and the public generally. I, personally, have no doubts about their desirability from the viewpoint of the general public. If we believe in and wish to operate a capitalist society, then the best way to ensure the success of that society is to have as wide a range of people as possible participating in the equity market. I am sure that a government which promoted and encouraged wider share ownership would feel less inclined to deprive ordinary shareholders of any benefits they derived from their investments, and indeed would have less pressure put upon it to do so, since more people would have a vested interest in that area of the market. A mechanism which allows small savers to invest their money over a wide range of stock exchange and other securities is the unit trust and, as can be seen from the figures in Table 1, interest in these trusts has been more than nominal. In fact, it is surprising how these funds have continued to grow during 1966 in spite of the fluctuations in, and outlook for, share prices. The main sales point about traditional with-profits contracts is the value of the bonuses on maturity, and the life assurance element is very much a secondary consideration. Life assurance companies have, therefore, already strayed from the relatively narrow path of their principal business into the wider avenues of savings contracts. This is a natural extension but, since policyholders receive little direct benefit from capital profits, traditional contracts incur a certain amount of valid criticism during a period of sharply rising equity prices. If only because of the tax concessions granted to assurance company contracts, the next logical step is the issue of a policy where the proceeds are closely linked to the investment results of a special fund. The desirability of these policies from the viewpoint of the particular institution concerned will, however, be influenced to a large extent by the proportion of its existing business which has been written on a with-profits basis. Nevertheless, the new policies will allow the institution to retain business which would otherwise be lost, while at the same time giving it access to an entirely new market. It is also possible that this new market could be a source of traditional business not at present being tapped. Agreeing, as I do, with the authors' statement that there is a need for both types of contract, I am sure that the survival of either or both will depend on their merits and not only on a desire for something new, as seems to be suggested at the bottom of page 51. However, tonight's paper seems assured of a wide and prolonged interest as these new contracts become increasingly acceptable to the life offices.

The authors have referred throughout most of the paper to a " unit trust policy " or to an " equity linked contract ". It is not until paragraph 81 that they mention a form of contract where the proceeds of the policy are linked to the investment results of a special fund where there is no commitment to invest the whole of the funds at any time in equities or in a particular class of equity. The majority of people who invest in these new contracts have as their aim the best possible return on their relatively small regular savings payments. I feel, therefore, that contracts which are tied to a particular area of the market have evaded this requirement of the small saver and have been sold under the cult of the equity. The small saver thinks he is paying for expert investment guidance but, since no investment manager would agree to investing all of his funds in one area of the market regardless of the economic outlook, I consider managements which issue contracts tied to investment in equities display a certain weakness by not attempting, as far as possible, to avoid general falls in equity prices. I strongly believe that the funds of these new contracts should be able to take advantage of sound investment prospects in areas of the market other than ordinary shares. This will inevitably lead to performance comparisons between the various competing funds, a trend already in progress but likely to accelerate considerably. Healthy competition is a welcome factor, but the danger lies in performance focusing attention on investments with very short term appeal and little intrinsic value, and leading eventually to stock trading rather than proper investment. This trend is already very apparent in the United States and there may be some unfortunate mishaps before the sheep are separated from the goats.

If it is accepted that life offices entering this new field should take wide powers over the direction of their investments, then it is almost certain that the organizational structure will be on the lines of case (2) or case (4) which the authors detail on page 42. It seems highly unlikely that responsibility for such powers would be handed over to outsiders, and by promoting such a contract the offices have a moral obligation to retain control of the investments—as the authors have pointed out—even with a policy linked to a unit trust. I also dislike cases (1) and (3) on tax grounds, since the possibility of having a large proportion of the funds invested in unfranked income could be a distinct disadvantage within a unit trust, even although the authors have demonstrated that case (3) might result in less tax being paid by the office in respect of its existing business.

Having narrowed the organizational structure to either case (2) or case (4), I am unable to resist the unfettered attractions of case (2). Capital gains calculations are already complicated enough without trying to operate the investments of a special fund within the structure of the existing life and annuity funds. I agree with the authors that it is possible to overstate the complications arising from the tax position, and too much emphasis has already been placed in many quarters on the inhibiting effects of the capital gains tax, but nevertheless the headaches foreseeable under case (4) are formidable. It is quite unrealistic to contemplate investments of the special fund in stocks completely different from those in the main funds. The suggested disadvantage of case (2) that separate Board of Trade returns and accounts would be required hardly seems justified and appears to be an excuse for cloaking the activities of the special fund under the same blanket which covers the present operations of the main funds, combined with a reluctance to expose the special fund to the anticipated rigours of the market-place.

Continuing to work my way through the paper from back to front, the next stage in the development is a decision on the type of contract to be issued. The authors have given us details of the three main types of contract which are presently available. I do not propose to discuss the variations which exist among the numerous possibilities but I am sure that the greatest opportunity exists with the simplest policy. I favour the first type of contract described under Category A, as it is easily understood, easily explained by whoever is selling it and concentrates primarily on the investment aspect, with a simple decreasing term assurance attached. Although the guarantee of a minimum amount payable on maturity seems a natural requirement if a life office is transacting this type of business, I feel it is an unnecessary refinement. These new policies are not suitable for family protection in the event of early death, but nevertheless provide a sum payable on death which, for a little over half the term of the contract, will be greater than the premiums paid in, regardless of equity price fluctuations. On survival to maturity date the assured is himself faced with the problem of variations in equity prices, a problem which he acknowledged when entering the contract. If prices are unduly depressed at maturity, then presumably the sum assured could be left on deposit with the company until they recover. To pay out a guaranteed sum in excess of the market value of the units allows the assured to reinvest the proceeds of his policy and also to gain from the recovery in prices.

The authors have covered the position of expense loadings in respect of unit trust schemes very comprehensively, but, of course, under the type of scheme suggested in cases (2) and (4) there would be no need to consider the regulations laid down by the Board of Trade for unit trusts, and net expenses would be appropriate with the life element probably reassured with the parent company in case (2). Unfortunately exception (*a*) of paragraph 43 will no longer hold, not only because investments will not be purchased in bulk from a unit trust, but also because a separate investment team would have to be formed, as it is unlikely that the investment department of the parent company could cope with the management of the new fund should the policy prove to be successful.

One great unresolved difficulty seems to be the proportion of claim benefits to be held back to cover a contingent capital gains liability. Since the benefits under a life policy are not subject to capital gains tax, it is certainly inappropriate to pay out the full market value of the units before tax as no relief can be claimed in cases where the benefits are less than the amounts paid in, as is possible with unit trust investment. To deduct the full amount of the liability is being over-cautious in view of the probable deferment of payment of the tax and the consequent benefit to new entrants of income earned on this contingent tax reserve. The degree of activity within the fund is also relevant, as the authors have pointed out. Thus, if the assets of the fund are turned over in one year the full liability to tax should be deducted from any claim, but if only 10% is turned over each year, is 80% of the liability the appropriate deduction, assuming an average term of 5 years for turning over the fund and 4% interest earned on the tax reserve?

Finally, I shall turn to the problem of sales promotion which the authors believe is possibly the most important aspect to be considered. As they state in paragraph 80 it is important that the policyholder should not only be aware of the risks inherent in investment in ordinary shares but he should also know how the policy differs from traditional forms of life assurance business. Most of us are probably aware of the critical publicity which certain investment fund linked policies have been receiving recently. Policies are being sold on the performance of unrelated funds with no allowance made for the reinvestment of income and a minimum of information on where the funds are being placed. In these cases a large proportion of the first premium is used to pay commission and barely half remains to be invested for the benefit of the assured. Aggressive sales techniques are successful in obtaining a large amount of business, but where fundamental factors are played down it virtually amounts to a confidence trick. As equities can show considerable price variations and as aggressive sales techniques can channel more than a marginal part of a policyholder's savings into these new contracts, I do not think it is going too far to suggest that an appropriate responsible body should lay down a kind of "British Standard" before these contracts mushroom. A "British Standard" will eventually be produced in any case but it is better that from the outset the traditional life companies should not only act in the best manner but be seen to do so. Special courses of training for salesmen and the broad terms of what should be said to prospective policyholders are admirable suggestions and, in addition to sales literature and policies clearly stating the terms and conditions of the contracts, I think full details of the investment portfolio should be published each year.

I have thoroughly enjoyed reading this paper and, as I said earlier, I am sure it will continue to be widely read after this evening.

Mr. J. D. Campbell.—The conclusions to which my remarks will lead will be the ends of chapters, as it were, and not the conclusion to the book itself. This is because the views I wish to express are formed from the perspective of a life office investment manager's seat and, although this perspective is of considerable relevance to the subject of the authors' paper, it is only one angle on it.

The image I have of British insurance is that it is the world leader. By tradition and as part of our national heritage, Scotland has a worldwide reputation for sense, sagacity and rectitude in financial affairs. So much of the British nation's potential wealth and reserves seem to have been squandered in recent times that I would view it as imperative that the life assurance industry strains every nerve and sinew to act with circumspection and to uphold its reputation and the most worthy of its traditions, especially as the life assurance industry is the largest by far of the institutional investors depicted in Table 2 on page 18. We lead by size, we lead by tradition, and we should wield a substantial amount of influence.

The growth of unit trusts and equity linked assurances in the United Kingdom has been in an extravagantly inflationary period. We cannot be certain that inflation will continue; that, even if it does, equities will, or will be permitted to, provide a proper hedge. Political tendencies and actions are unpredictable; taxation may be adverse. An economist may say you cannot negative the advantages accruing to equities in the long run. Maybe. But can we be certain ? We can be sure of very little. This is the foundation of insurance business: a business where, nevertheless, absolute security of the policyholder's contract is the basic task and this is why " spread " is of such vital importance in investment. If you subscribe to an equity linked assurance, you give up—at your peril, it seems to me—the principle of spreading your risk as between one type of investment and another. I feel that in the life assurance industry we should very properly hesitate to contemplate this. The authors warn that even the most cautious of post-war investors could be influenced in their thinking by the belief that equity prices will rise at a similar rate in the future as in the past, not that much of a sustained rise has been seen in the 1960's. As individuals, hindsight shows that we can perform rather weakly at times while events are strong and not in our control. That is why we accept spread as a principle to avoid deluding ourselves. The lessons suggested by the authors to be given to our salesmen are bound to include a statement that the investment manager has no unique and precise intimations about the future. Then you will tell the salesman that we must have spread. It is the only conclusion if you are investing and not speculating.

Now, why are we tempted with equity linked assurance to sacrifice spread ? Spread, that is, as between one type of investment and another. I have no doubt that, as at the present day, it is primarily because the policyholder or investor thinks, or is persuaded to think, that we will have inflation for ever and that whatever happens to equities, much worse will happen to fixed interest. This is wrong. It is wrong because there is a price for everything and I suggest that the right and proper approach to be adopted in inflationary conditions is to insist that the rate of interest must reflect the inflation which is experienced. $2\frac{1}{2}\%$ Treasury Stock at 100 and $2\frac{1}{2}\%$ Treasury Stock at 37 are not the same article. If anyone is in any doubt whether I am correct in my assertion that equity linked assurances have grown mainly on the back of inflation, then I think he should ask himself why we have not had gilt-edged linked assurance.

The inflationary treadpath that has landed the U.K. in so much trouble must have the life assurance industry, whose stock-in-trade is money, as its inveterate and constant opponent. There seems to me to be a serious weakening in this resolve in the philosophy underlying the issue of equity linked policies, especially if they are sold as inflation hedges. You will have noticed that the Government is reported " off " the idea of a state unit trust—rightly, in my opinion, in so far as it would have represented surrender by the authorities to the idea that inflation is inevitable. If the life assurance industry does not remain dogged in its opposition to inflation I have no clear idea who else will. So, we must not accept inflation : we must fight it. Some of you will feel that we may perhaps from time to time lose some rounds in the fight, but I say we should protect ourselves by seeking fully compensating levels of interest rates. If we cannot get high enough interest rates, then, from an investment viewpoint, we should invest short-term until we do or refuse to lend. This is a logical if perhaps not altogether practicable conclusion.

Despite wide-spread scepticism towards the efficacy of an incomes policy in this country, the seed of an idea must have been planted in many minds. The tree which may grow from that seed will be hoped to sprout rational branches, one of which would represent the control of inflation, branches which will produce healthy leaves made of stable money. I also have the thought that actuaries in the life assurance industry would presumably wish interest rates to conform more than they have done to the relative stability exhibited by mortality rates. This could happen if inflation were eliminated. So let us keep up the good fight.

I would sum up my remarks as follows :

(1) Equity linked assurances sacrifice investment spread as between one type of investment and another which is a momentous step to take, I believe in the wrong direction, especially for the investment of life office funds where the legal fulfilment of contract is so dominating.

(2) Equity linked assurances have arisen in large part because it is believed that equities are a hedge against inflation, an inflation which will go on and on. These two assumptions about the future are questionable, but in any event fully compensating levels of interest rates are the proper defence against inflation. Equities have their place as part of a balanced portfolio. This leaves plenty of scope for judgment of where the balance lies.

Mr. J. L. Anderson.—In this gathering the traditional with-profits life assurance policy will not lack for supporters and I would be the last to suggest that this contract has had its day. In fact, I am sure that in many cases it is still the best contract for the regular saver. The insurance industry must however guard against two dangers. First, the danger of our telling the public what we think they ought to want instead of paying attention to what they say they do want. It is our job to satisfy public demand for particular types of contract, always provided—and the provisos are very important—that the contract is basically a sound one and that its terms are made sufficiently clear to the public. Second, we must be sure that the arguments which we put forward to justify the traditional contract are sound in the particular context to which they are applied.

One of the strongest arguments in favour of the traditional with-profits contract is that the proceeds are not directly dependent on the level of the market prices at the time, and this is undoubtedly an advantage if the primary object of the policy is to secure a lump sum of an amount which can be estimated with a fair degree of accuracy in advance, but frequently endowment policies are effected not so much to secure a lump sum as to build up capital which can be invested in income-producing securities. Now, if the policy matures at a time when interest rates are low and fixed interest securities are therefore high or when equities are standing at a high level, and if the proceeds of the contract do not depend on market levels at the time, it follows that the resulting income will be depressed by the low interest and dividend yields which are obtainable; and the same argument applies in reverse to the proceeds of an investment linked policy (I use the term " investment linked " on purpose because these contracts need not necessarily be purely equity linked policies). If the proceeds of an investment linked policy at maturity are depressed because of the low level of market prices, it follows that there is a better-than-average chance of obtaining a good yield on new investments made at that time. This, I realize, is a gross over-simplification of the situation, but the argument is logical all the same.

I would, however, support what a former speaker has mentioned, that it is desirable that any investment linked contract should contain an option to the policyholder to leave his money in the fund, so that if the policy matures at an unfavourable moment—in other words, when prices are depressed—he does not need to realize at the time but can delay realization until a more favourable moment. From the standpoint of the office, this is not an option in the usual sense of the word because, at the end of the day, the policyholder will get his share of the fund, neither more nor less. An extension of this idea, of course, would be to grant annuity options taken in the form of investment linked contracts.

At the present time, I believe that the traditional type of policy has a very good chance of showing better results on maturity than will be obtained under an investment linked policy, but those of us in the industry should not blind ourselves to the fact that this is partly due to the participation of these new policies in profits from existing reserves. Quite apart from questions of equity, I doubt if this is a good thing for the industry. It enables it to protect itself against the full blast of competition from other types of saving and, furthermore, it can lead to the ridiculous situation in which an office is inhibited from selling new with-profits business on the scale it would like because of the danger that this might reduce the bonus earned by the fund as a whole below the level which is being used for illustrative purposes.

In recent years there has been a tendency to pay out more generous bonuses to existing policyholders, but this can only be a partial solution until the problem of dealing with capital profits is seriously tackled.

The main reason for my intervention, Mr. President, is to suggest to Members, perhaps particularly to younger Members, that there is a considerable field for research here to try and find the best type of with-profits contract in modern conditions and the best way of distributing surplus to existing members. I hope that some of the younger Members will take up this challenge and will not regard computers and data-processing as the only fields deserving research.

Mr. A. C. Stalker.—This paper tonight is a very comprehensive exposition of the management problems arising from equity linked business. I would like to make one or two particular points about the paper and then move to some of the more general considerations which have already been discussed.

First of all, I do not think the four categories mentioned by the authors on page 42 are exhaustive, because the authors appear to feel that, in categories (1) and (3), where the life office is investing in the units of a unit trust, such investment should be automatically passive, whereas it can certainly be active as regards timing. However good the management of a unit trust is, it is not always the best possible investment at all times.

Secondly, I would like to expand a little on the question of a guarantee for unit trust or equity linked business. All without-profit business is more correctly described as guaranteed business than as without-profit business. Consequently, the guarantee under an equity linked policy should first be compared with the equivalent guarantee under a similar without-profit contract. In every case it will be found to be at a much lower level—rightly so, because the equity linked contract has an element of profit participation denied to the without-profit policyholder, and in the light of that I think that the guarantee is a much more worth-while feature of such contracts than the authors believe. The second point about a guarantee is that a great many of these contracts are being issued to what I would call the "financially semi-literate" section of the population. Many of these people are feeling their way into equity investment, venturing out of the small saver's securities for the first time, and therefore there should be a trapeze net to protect them if their policy should mature at an unfortunate interlude in the market.

Coming towards more general matters, I feel that this popularity of these contracts with small investors, with small savers, implies that a special sales force should be recruited to market these policies outwith the normal selling organization of a life office and that this selling organization like, for instance, the pensions selling organization, should be given a special training, a very special training, on investment subjects.

Lastly, I would like to consider one or two of the implications for existing offices that the success of these policies has caused. The first is that, in spite of the record bonuses of recent years, offices have not given value for value in real terms, and a quite large section of the population feels that they want to attempt to get value for value by other means. This has led them to prefer the investment managements of the unit trust movement for these policies to the investment managements of offices. Secondly, there is the question of allocation of premiums for various matters. Even where non-level deductions are made from premiums for mortality, expenses and other costs, in the case of these new equity linked policies, there has been introduced a new degree of accountability and disclosure which has led at early durations at any rate to higher surrender values being available for policyholders than is the case with traditional policies.

Mr. L. W. G. Tutt.—In introducing the paper now being discussed, and which has very wide interest, Mr. Kingsnorth mentioned that he would not mind if some part of the discussion were to consider the latter part of it. May I therefore contribute some remarks which are prompted, in the main, by the authors' statements in paragraph 77?

Without precisely specifying whether the term relates to realized profits alone or includes appreciation in investment values, there is a suggestion by the authors that life offices do not normally distribute capital profits. If profits are to be distributed to participating policyholders, is there any specific justification for withholding one source of surplus, particularly in times when this source may be relatively highly significant? On the other hand, do prudence, long term equity and security have even more relevance?

I am not certain about the criticisms of life offices in this respect to which Mr. Grant and Mr. Kingsnorth refer and which Mr. Murray also mentioned, but in the group pension sphere, not specifically excluded and therefore presumably included by the authors, it is true to say that the matter is sometimes commented upon : but, in this particular branch, life offices are not the only fishes in the sea.

The types of group pension contract transacted by British life offices are numerous ; amongst them are to be found those which are directly related to capital growth. Examples include a non-profit policy under which the pension which would otherwise be secured by a premium paid at a certain date is ratioed by the numerical value of a specified share index at the retirement date to its value at the time of payment. Additionally, there is the deposit administration type of policy under which the appropriate annuity account is increased by growth factors reflecting variations in the market values of certain quoted securities. It is noteworthy that such types of policy are not with-profits policies at all. Is there any significant relevance in this and the authors' suggestion that it is not usually possible to distribute to any marked extent capital appreciation under with-profits policies, the converse being tacit?

But, reverting to the authors' suggested lack of feasibility of the joint association of participating contracts and allowance for capital growth, it is of course possible in the British life office group pensions market to obtain a type of with-profits policy under which the chargeable rate is dependent upon an index such as the yield on stipulated long-term securities. But is this typical ? Is it true to say that under British group pensions with-profits contracts in general there is a tendency for the emergence of investment capital surplus to be delayed? If this is so, are there any aspects outside the direct sphere of the issuing life office which indirectly impinge? Is it of any interest to a life office whether group pensions schemes transacted by it are solvent or not? By solvency is meant whether on termination pensions actually promised for service to date have actually been purchased. Do we regard the information as, for example, is required in the United States under the 1958 Welfare and Pensions Disclosure Act as relevant or desirable ? Furthermore, do we think that there is any point of substance in, for example, the consideration of some North American accountants that, for financial statements of the operating company, pension accruals and purchases need to be concurrent ? If we do think so, do we consider that it is at all obligatory on a life office to be helpful in such matters and would this lead away from a conception of equity which involves pensions being largely built up by bonuses—cash or reversionary—under a system of distribution involving a delayed emergence of investment capital surplus ? Additionally, would it be consistent with a system under which the assets relating to with-profits group pensions contracts are aggregated from an investment account aspect with the assets of other classes, or do consistency and desirability both suggest appropriate asset segregation ?

Mr. D. G. Kellock.—In the financial columns of *The Times* newspaper earlier this month unit trust and equity linked assurances were referred to, and I quote : " as having filled an important gap in the insurance world and, for that matter, the world of equity investment, taking advantage, as they have, of the special tax position of insurance funds ". This raises a question which has long interested me and I am grateful to the authors tonight for affording me the opportunity of mentioning it. It is simply this : where do the life insurance offices stand in this matter of taking advantage of the special tax position of insurance funds ? For this is something which in the past they have not done. They have refused and continue to refuse to issue contracts which would be of undoubted value to policyholders, which could be transacted at rates of premium attractive to the offices and to the issue of which there is no legal impediment whatsoever. What has happened, of course, is that private arrangements in restraint of trade have been come to with various government departments whereby the offices have agreed not to do certain things which the law allows. I see no sign of a change of heart in this matter and, therefore, I see no future for the types of contract here described as far as the life offices are concerned.

How long will it be, Gentlemen, before some nameless civil servant whispers what *The Times* has already thundered, namely that these contracts take advantage of the special tax position of insurance companies, and he will no doubt add, " Will they please stop doing it ? " : and unless I misbelieve the evidence of the past thirty-five years, of course all members of the life offices associations will stop doing it, and in doing so they will leave a gap to be filled possibly by some of the foreign-controlled companies which are already transacting an increasing proportion of the life assurance in this country. It is, of course, possible (as was rather hinted in *The Sunday Times* only yesterday) that legislation is already being contemplated which would forbid or severely limit the issue of policies of this kind. If that is the alternative, in my view it is the lesser evil. Either way, as I say, I see no future in this country for policies of this type.

Mr. J. Plymen.—As I am not connected with a life office, I speak as a customer rather than a supplier of insurance. I feel that these equity linked policies have a very considerable superficial appeal: it is just a matter of arithmetic that you arrange to apply £100 a year towards units, you get £16, 10s. tax relief, you pay £83, 10s. and you pay £10 on life assurance and get £90 worth of units. You are getting about 22s. for 20s. An ordinary life policy provides similar benefits, but the result is nothing like so obvious, and I think that there is no doubt that these policies are in real demand and that somebody is going to satisfy this demand.

If a life office is thinking whether to compete with this scheme, I believe that there is only one type of policy to consider and that is the straightforward contract where you are buying the units on a savings plan. Other schemes whereby you have policies with sums assured payable in units and where you have guarantees and things like that—they are all trimmings which are difficult to understand, and I am sure the main sales appeal is from the straightforward policy. The contract has to be linked with a unit trust that is quoted every day so that the policyholders can watch its progress. I think that is part of the appeal of the scheme.

The question is, are the leading offices going to be interested in providing facilities for this Category A contract involving a unit trust? In my opinion, speaking rather crudely, the acid test is, what is the office going to get out of it? The offices, transacting ordinary life policies, get considerable contributions to their surpluses from the investment profit. If they transact contracts which give no investment profit, I feel they ought to get some benefit in another direction. I would like to ask the authors: "Does the market in this type of policy admit of an above-average profit on the term assurance side of the contract?" I think it ought to. Alternatively, if the office does not see a really good profit from the term assurance side, can it contemplate running a unit trust and making some money out of that? That, again, is a possibility. The fact is that I do know of at least one office that years ago took a substantial participation in the capital of a unit trust and sold it at an enormous profit years afterwards. An office can, after all, run a unit trust with great efficiency and considerable savings compared with independent operators.

Finally, I would like to reinforce what has been said before about the need for spread. On a recent visit to America, I called on a large American mutual fund. This one has an unfortunate constitution in that its money must be invested in just one industry. That is, of course, a highly undesirable arrangement, and these people have found that out, because they are now getting to the maturity of ten-year contracts where, despite the ploughing back of interest, they are giving back to their unfortunate subscribers less than they paid in, and they are finding their subscribers naturally rather reluctant to renew contracts!

Mr. F. S. Jamieson.—I have no practical experience in the operation of unit trusts or equity linked policies and am not therefore competent to comment on the bulk of the paper. To a layman like myself, however, it does give an extremely clear review of the regulations and practical problems involved. I have read it with great interest and have learned a lot from it and would like to convey my thanks to the authors, as I am sure would many other Fellows and students. I shall, however, confine my very brief remarks to the " General Observations " section at the end of the paper.

During the last few years we have been able to find out for the first time through the statistics which the Board of Trade publish quarterly, as a result of the recommendations of the Radcliffe Committee, exactly how insurance companies have distributed the investment of their new money. As regards ordinary shares, the percentages invested by life funds in these in 1963 was 21 : in 1964 it was 23 : but in 1965 it fell to 11. The figures for 1966 are not yet, of course, available but the percentage will probably be slightly higher than in 1965. There appears to have been a certain upsurge of interest in the equity market in the first quarter of 1966, but the percentage for each subsequent quarter has decreased steadily. Having quoted these statistics, I think that the line of my comment must be fairly obvious to you. One may argue, I suppose, as the authors do and as Mr. Anderson did, that, if the public insist on following the cult of the equity, one might as well jump on the band wagon and give them a vehicle in which to do this. I myself, however, would prefer not to encourage actively a cult with which life offices themselves are, in the present investment climate, becoming increasingly disenchanted, even with the stringent selling safeguards set out in paragraph 80 of the paper. And, in concluding, I would say that some of the advertisements for equity linked policies which I have seen in the press recently certainly fall very far below the high standard set by the authors.

Mr. A. D. Shedden.—Till recently, life assurance companies selling traditional forms of policy only have been somewhat on the defensive in combating the claims and attractions of unit trusts in general. The current period of deflation with its attendant fall in equity prices and the prospect of little or no growth in the next few years has, of course, enhanced the merits of the normal with-profits policy. This served to remind many of the dangers of equity investments as distinct from the well-publicized advantages.

At the beginning of their paper, the authors mention the success of the American mutual funds. These are at present under attack and the recent Report of the Securities and Exchange Commission on Mutual Funds singles out the evils of high initial commission, excessive management fees and low initial surrender values. All these produce excessively large profits, it is claimed, particularly as the fund grows. It should perhaps be mentioned that life assurance offices in the past and in the present have often been accused of introducing very low initial surrender values. We all know that we can justify this. I would have thought that in many respects a mutual fund that was similarly organized could also justify a low initial surrender value.

The American assurance companies do not have the advantage of British companies' ability to invest a substantial portion of their funds in equities and, moreover, face the anomaly that their industry is tightly supervised by government on the grounds that government must protect the small man from his ignorance of the meaning of complicated policies of assurance.

On the other hand, the mutual fund industry appears to enjoy considerable freedom. Life companies over there, however, have been able to argue fairly successfully that it is not fair to compare a policy of assurance with a purely investment contract. Apart from its guaranteed advantages, a life assurance policy is generally a much more flexible instrument than the usual mutual fund policy. It can also be shown that it is not necessarily cheaper to buy term assurance and invest the difference between the endowment assurance premium and term assurance premium, since the term portion of an endowment assurance contract costs considerably less than it would as a separate contract. These arguments apply to a considerable extent in the United Kingdom although, because of the concentration of sales in endowment assurance business, encouraged by tax considerations, comparison here has to be largely based on investment considerations, particularly since an assurance company issuing an equity linked contract would presumably attach to such policies level or decreasing term riders if required. As the authors point out, the expenses of such an arrangement are not likely to differ much from a conventional contract, especially if the actual investment is not made through a separate unit trust. Because of the Board of Trade limits on expenses, there are not the same grounds for complaint as prevail against a mutual fund as far as expenses are concerned, although the normal practice of charging renewal expenses based on the size of the fund seems basically unsound, as the expense charges are not directly related to the way in which costs are incurred.

In American and in Canada mutual funds and similar institutions such as trust companies have been very successful in attracting smaller pension funds to invest in equities rather than go to an insurance company and have little or no benefit from equity investments. The pension fund, of course, will usually buy pensions on retirement from an established assurance company and forfeits any guarantee which might be given up to retirement date by an assurance company. To combat this trend, assurance companies have extended the deposit administration principle to equity investments and special permission has been obtained to set up 100% equity funds segregated from the rest of the company's assets in order to satisfy the employer who wishes to put a portion or all of his pension contributions into equities. No such trend is happening here, as far as I know, perhaps because deposit administration techniques are not so widely applied as in America. However, it is possible that this could be a future development, in which case companies here might wish to set up a segregated fund in order to compete.

From what the authors have said, the only way an established office can allocate assets specifically to such business so as not to affect its other business would be to establish a subsidiary company. This may not be too onerous, although one can foresee more than one subsidiary company being established—for instance, one to provide equity linked assurance contracts to individuals and another for pension business.

Mr. G. L. Melville.—I would just like to make one point about disclosure which has been mentioned before tonight. It seems to me that a life office issuing a traditional type of policy, offering mortality, expense and interest guarantees, is perfectly entitled to argue that it should not have to disclose its investment performance and its other performances during the year, and issue a balance sheet valuing investments at cost price, say. But when it comes to the offering of an equity linked life assurance policy, the interest risks, capital appreciation and income appreciation are all transferred to the policyholder, and I do not think that a life office can properly argue in that case that it should not disclose fully its investment practices. I would criticize any life office who argued against this for that reason. I think that if an existing life assurance company were to establish an equity linked life assurance company subsidiary, it should be very careful to have a method—daily, weekly or monthly—of valuation applying to the investment portfolio. It should be careful to publicize the results widely and to see that the policyholders in that type of company were regularly made aware of the value of their policies.

Mr. G. T. Pepper.—I also am a guest and although I am a Fellow of the Institute I am outside the insurance field. Some of the discussion tonight has centred on the criticisms of the traditional life office endowment assurance policy. One senior member of the Faculty has already challenged the younger generation to do some researches into ways in which capital profits could be distributed. Can I suggest, please, that there is another drawback of endowment policies into which research is also required? If one is advising with which office to take out an endowment policy, it is very unfortunate that those offices with probably the best investment policy also happen to be those offices which are likely to grow fastest. One strongly suspects that when such offices are deciding how much profit to distribute as bonuses, the free reserves of the office are likely to be kept in line with the growing fund. In other words, some of the profits, instead of being distributed to the past generation and present generation of policyholders, are being diverted to the office itself. So my plea to the younger generation is: can research also be done into ways and means for life offices' reserves to be kept in line and accumulated at the same rate as the growing funds, without prejudicing the bonuses of the past generation of policyholders?

Mr. D. W. A. Donald, closing the discussion, said:—Officially I am asked to close this discussion, and in the sense that I am the last speaker from the body of the hall this is what, in a technical sense, I am doing. Yet the authors have the right to reply to my comments and to what has gone before and I must be careful not to usurp their privilege. But my comments and the authors' reply will not be the last words on this subject, and the discussion will be closed in fact only by future experience and the results obtained under equity linked contracts effected now.

In a sense, this discussion tonight is only one of a series of discussions on the question of such contracts. The authors have shown clearly how such contracts can be organized and the complications which they may bring in their train. They have provided a clear answer to the question: How can this be done? I am sorry they did not perhaps disclose quite so fully as Mr. Kellock did what their answer would have been to the more fundamental question: Should this be done?

It is almost forty years since the opening shot in this series of discussions was fired. At a discussion before the Institute of Actuaries in 1928, a leading economist of the day, Mr. R. G. Hawtrey, was moved to say that "there ought to be a special kind of with-profits insurance with an understanding that it was to be based on ordinary shares." The circumstances in which he spoke were not unlike those in recent years. Gilt-edged yields were then being described as historically at their peak: first-class ordinary hares, for example those of investment trusts, were yielding less than debentures of the same classes, and ordinary shares had doubled their prices in a period of about five years. Even those who are more normally associated with poetry or the drama than with economics were seized of the fever. T. S. Eliot, for example, was writing in 1927: "Everything is in question, even the fundamental dogma of modern society that debentures are safer than common stocks." At almost the same moment, a professor of economics was asking in a discussion—not in this identical hall but in the then premises of the Faculty: "Why is it that 'ordinaries' have been so much undervalued until quite recently?" It is true he went on to say: "At present . . . the position is being reversed and we are now finding that many 'ordinaries' have been pushed up to a figure that makes the yield on them absurd, absurd in that these companies will have to give extraordinarily high dividends if they are to justify the values at which their shares stand."

If these gentlemen were here tonight they might be excused for feeling that this was just about where they came in forty years ago. Are we to put it to the credit of the actuarial profession that they were not then carried away by the spirit of the times? Mr. Murray and Mr. Anderson would say: "No, certainly not." Mr. Campbell and others would have reservations. The actuaries of those days had no doubts. They were not carried away, and thereby they saved the short-term savers, who might have taken out Mr. Hawtrey's special kind of with-profits policy, from bitter regrets that they had not stuck to conventional policies of assurance. Do we say, on the other hand, that it is typical of the caution and reserve of our profession that it is only within the last decade or so that we have taken up the challenge? I do not know, but I am clear on one difference from 1927, and that is that, when the plea for these policies was made then, it was made on the grounds that investment in equities would be more profitable than investment in fixed interest securities, not on the grounds that insurance companies somehow owe their with-profits policyholders a duty to protect them against changes in the value of the currency in which their contracts are expressed. To my mind, that is pernicious nonsense. That duty lies fairly and squarely on the shoulders of the government of the day. The prudent man may observe that successive governments of this country, over the last twenty years, have consistently shirked this duty and order his affairs accordingly. It is not, in my view, any part of the duty of a life assurance company to be a monkey's paw pulling the chestnuts out of the fire for a favoured few. Mr. Campbell would, I think, agree with me there, although Mr. Stalker took an opposite view, which I do not share.

This seems to me a fundamental point and I think it has given rise to a good deal of confusion in the public mind. We are not discussing tonight whether ordinary shares are better investments for insurance companies or pension funds than fixed interest securities, and even if this could be demonstrated it would not follow that it was true for an individual. An insurance company, by its nature, is not an investment trust, even though much of the money it receives can be regarded as saving rather than as the cost of life cover. The whole principle of insurance is surely that of the pooling of risks undertaken in the knowledge that, in financial terms, some policyholders—those who make their claims at the right moment—will get better value for their money than those who do not, although both classes would be less well off had they not been insured. The principle of the investment trust or the unit trust is that everyone has an identifiable share in certain assets and that the value of this share at any given time, in relation to what he paid for it, is independent of and unaffected by the shares of other persons acquired at different times and under different circumstances. He bears the losses or enjoys the profits of his investment according as the timing of his purchase may have been good or bad. The life assurance company tries to maintain broad equity as between successive generations of policyholders. Possibly, as Redington has suggested in the discussion on Springbett's paper, the scales are tilted too much towards new entrants, but the need to preserve some balance is inherent in assurance business. At the moment, insurance companies must be contemplating their holdings of ordinary stocks—worth, so far as market prices mean anything, considerably less than their value a year ago. It is not likely that any papers will be submitted for discussion next year on how the resulting depreciation may most equitably be shared by way of special negative bonuses among existing policyholders. That, possibly, highlights the difference between the companies and the individual in their approach to the problem of capital profits. The companies are no doubt satisfied that their holdings are intrinsically sound: that they are producing an appropriate return on the premiums invested. Over a given short period the yield may have been disappointing or even non-existent, but that fact is of little moment compared with the future prospects of these holdings. As Mr. Anderson made very clear, the investor who can take the same long view can share their confidence, but what is a short period to an assurance company may seem a long time to an individual. The fortunate man who can take this view, who is not concerned with the immediate return on the money he has saved when his policy matures, may welcome the idea of a policy which is not expressed in monetary units. But, if he does need the money, then he can take no comfort from the future prospects of the shares in which his money is invested, as compared with the hard reality of the value the market puts on his investments at the time he has to realize his holding. The yield he might obtain over, let us say, a twenty-year period might be very much less than a life office would consider it had earned over the same period from the same investments, the reason being that the company would value the holding by discounting the future income at the same rate of interest as it used to accumulate its outlay, whereas the man would look at the capital value which the market would give him for that income. The two answers may be very different. This, unfortunately, has been obscured in a period when profits, not losses, have been the order of the day and when the distinction between what is good for the institutions and what is good for the individual has been confused. This is not to argue against equity linked contracts. It is merely to doubt whether they have much to do with insurance and here I am firmly on the side of Mr. Kellock. I think it is not being too cynical to say that if, as in Canada, no income tax rebates were given on life assurance premiums, there would never have been any suggestion that such policies should be on offer by insurance companies. As Mr. Plymen said, they are a means of buying units cheaper than investing the money directly, and I think it is only that fact that has led to the demand by the public for an equity linked contract. If this is thought too strong, because it was, after all, in America that the equity linked insurance contract was first sponsored, we should remember that there it was on offer to a relatively sophisticated section of the community and, perhaps more important, it was confined to benefits which were payable over a long period and, therefore, less liable to be affected by market fluctuations than the endowment type of policy which is the best seller in this country. Many speakers tonight have stressed that investment linked contracts are dangerous, unless they are fully understood by those effecting them and that they cannot safely be offered to the unsophisticated. I think that we over-estimate the intelligence of the public if we attach too much importance to what we think they want. I am not swayed by the argument that if we do not give them this someone else will be there to fill the gap, and here I would respectfully differ from Mr. Anderson. If the B.B.C. had been established under a less strong character than Lord Reith and had given the public what it wanted, we would not have a broadcasting service that is the envy of every other nation today. I think sometimes we must be allowed as experts to express an opinion on whether what the public is said to want is really good for it and, if we decide otherwise, to decline to cater for it and to attempt to make it difficult for others to gratify the desire. There is the further point that even a sophisticated public may not find it easy to resist the blandishments of salesmen. Now, I suppose in life offices we like to think that we have a certain degree of control over what our outside staff say. I think we do, but there can surely be few here tonight who have never had cause to shudder at what has been put on paper by one of their representatives about bonus prospects of their own or other offices. If we have that difficulty, how much more must it concern the unit trusts ? For once I regret the custom that individual companies are not named in this hall. I should have liked to mention some recent entrants to our ranks whose methods of sales promotion can bring no credit to the insurance industry. However much we talk about a " British Standard " for methods of quotation, about training of salesmen and careful control, we come down to individuals in the end, and in these days of competition we are likely to see a new operation of Gresham's Law—the lower driving out the higher. Whatever methods the reputable organizations may use, there will always be some who will go beyond reasonable bounds, and there is a very real risk of large numbers of the public failing to realize the promises made to them. We may hedge our quotations about with the usual caveats, but will the public heed them? After all, it is only a matter of little more than a week ago that *The Times* in its financial pages was recommending its readers to buy with-profits conventional policies on the basis of the best bonus " estimates " now current. If a sophisticated financial journalist can believe this, what hope is there for the lay public ?

In my view, equities have become linked with life assurance either directly or through unit trusts because of the tax advantages for savings and, further, in my view, this is a pity, because insurance companies have, by and large, a reputation for safety and respectability and, as Mr. Campbell indicated, the public may very well assume that some of this will rub off on the unit trusts which they have taken under their mantle of respectability.

Tonight's discussion has not given a conclusive answer to the question of what is the best method of operating investment linked policies (assuming that it is to be done at all, on which I hope by now that my own views are clear). Are we to choose some particular unit trust and let it do the worrying or are we to do the investment work ourselves ? For the same reasons as have just been stressed I do not favour a well-known insurance company appearing to endorse the choice of one particular unit trust. If a presumably expert investor hitches his wagon to one particular star he cannot wonder if the less expert members of the public follow his example, in the belief that he knows better than they what he is doing. If then for some reason, quite outwith the control of the management of the insurance company, the particular trust it chooses puts up a worse performance than average, it would be difficult for that management to escape some feeling of moral responsibility at least for having possibly encouraged a larger number of people to back a loser than might have done so if the insurance company had not endorsed the particular trust. I do not like to be in a position in which a management, completely outside my control, could do something which might bring adverse comment on my own office. I should much rather make my own mistakes myself, and indeed if I were responsible for the investments of a company operating an investment linked contract, I should wonder what was wrong with my own abilities if I had to hand over responsibility for the choice of investments to some outside agency. Admittedly if we " do it ourselves " we risk comparisons of the results of our judgment with those of the other investment experts, but I hope we should trust our professional competence in this field to enable us not to fear such comparisons.

These seem to be the main points which have been made by others or which I should like to raise myself. I think it is true to say that the success of any paper in provoking discussion is in inverse ratio to the ease with which the closer of the discussion finds he can perform his task. Tonight, as is only too apparent, it has been difficult and that is a measure of the authors' success. We have had a wide-ranging, thought-provoking, informative, stimulating and, in the best sense of the word, argumentative discussion. To have provoked a response of such quality must be a real pleasure to the authors, and it is the greatest tribute we could pay to the quality of their paper.

Mr. A. T. Grant, replying to the discussion, said :—I shall not attempt to deal in detail with all the points which have been raised tonight, but, knowing full well Mr. Kingsnorth's views on the major issues, I shall seize on some of the highlights of the discussion and try quickly to paraphrase them.

I think I would start by going back to something Mr. Murray and Mr. Donald referred to. The key to this discussion in its broad context is the difference between insurance and saving. Over the years the insurance industry has done a good job in providing insurance. It has also done a remarkably good job in providing savings, and it is a measure of this that Mr. Anderson referred to the difficulties of getting rid of surplus. This is a great deal better than the converse, the difficulties if experience had not been so good. But it is this very difference between savings and insurance which causes a great deal of controversy between unit trusts and insurance companies. In savings, as exemplified, for example, by unit trusts, the principle of averaging or pooling of risks certainly applies in a spread of stocks or a spread of investments but it does not apply as between one generation and another. Thus we have Mr. Stalker suggesting that policyholders feel that they have not benefited fully from the profits realized in recent years, while Mr. Anderson refers to the difficulties of distributing all surplus.

I think that we should be quite clear in our own minds exactly what it is that we are in business to do. Are we, gentlemen, to the extent that we represent the insurance industry in this country, in business solely to provide death cover, solely to provide savings contracts, or both, and if the answer is both, what relative weight do we give to these two types of business ? Historically, of course, our life offices started with the aim of giving death cover; even in annuity contracts the emphasis was on mortality. Nevertheless, over the years life assurance has grown into a major savings channel very important to the national economic structure, and we cannot ignore the savings aspect, particularly in view of the preponderance of endowment assurances.

Indeed it is salutory to remember that if the life offices do not offer competitive terms on the savings element of traditional business such as endowment assurances, the public may decide to secure the necessary death cover through decreasing term assurances, effecting the savings element through unit trusts or other savings channels.

Mr. Kellock referred to the anxiety which the life offices feel that some civil servant in a back room in Whitehall will notice the tax relief granted on life assurance contracts and will have it stopped. Instead of adopting a supine attitude on this point, we should have thought the life offices should be pressing for a fresh savings charter. Please let us not be defensive about this. In broad economic terms we have the alternatives of encouraging savings or levying additional taxation, and of these two encouraging savings is much the more attractive. There is a strong case for encouraging all forms of contractual savings including unit trusts and life assurance and we should not be ashamed of any tax reliefs which are available.

Let me come back to the income tax point raised by Mr. Donald. It is true that premiums under unit trust linked assurances, like those under endowment assurances, effectively afford a $16\frac{1}{2}\%$ discount to policyholders paying tax at the standard rate of income tax. However, in fairness to our brethren in the unit trusts, I must refute the suggestion that unit trusts and unit trust assurances would not flourish but for this tax relief. As a matter of historical fact, the unit trusts were flourishing before they added life assurance cover to their savings contracts, and at least some of the early contracts which contained life assurance cover were so written that they did not provide tax relief. The tax relief must be welcomed by unit trust managers, but they do not depend entirely on it.

Mr. Donald feels that the life offices should not provide contracts linked to unit trusts or equities, even if some members of the public appear to want them, because the public do not always fully understand the dangers of such contracts and, as experts in this field, we should protect them from their ignorance. I would disagree with him on this point, because regardless of our personal preferences we do not have the power to make this choice for the consumer. There are powerful organizations now in the unit trust field, and they at least will certainly be prepared to supply any pubilc demand for unit trust linked assurances.

Mr. Donald, Mr. Campbell and other speakers have referred to the dangers of a policy of investing solely in equities. Although we have generally referred to equity linked policies or policies linked to unit trusts (which normally tend to be invested in equities) and worded the title of the paper accordingly, we certainly would want the investment management to be allowed wide powers of investment to take advantage of any investment possibilities which may present themselves. There are, of course, taxation points coming into this ; a subsidiary life assurance office with a specialized fund may be in a better position to change its investment policy than the normal established life office.

Mr. Campbell referred to the question of whether one ought to have an insurance policy linked to gilts. The legal and fiscal position of a gilt-edged unit trust is very difficult, because it is subject to corporation tax unless all the unitholders are tax-free charities or approved gross funds, and since this exemption was included as a late amendment in the framing of the Finance Act 1965, even in this case where all the unitholders are exempt from tax, the unit trust, if authorized, would be caught for capital gains tax. This may have been an accidental error in the drafting of the Act, but the only way for the trust to escape capital gains tax, given that all the unitholders are themselves exempt from tax, is to have an *unauthorized* unit trust and, under the Prevention of Fraud (Investments) Act 1958, such a trust is not allowed to advertise.

We welcome Mr. Plymen's comments regarding the profitability of unit trust assurances or equity linked assurances for the insurance company. We have grown accustomed to making profits from the investment of increasing life funds, over and above the interest rates assumed in our premium scales, either because of high interest rates and increasing ordinary dividends or from capital profits on equities: the mortality and expense profits have not been large. With these special contracts, any investment profit belongs wholly to the policyholder and the office must be content with any expense and mortality profit it can make. This point must be faced squarely, even in a mutual life office where it is always an open question to what extent the profit objective is important.

This is a form of business in which one can very readily get volume, but one must be careful to distinguish between volume and profit. It is possible, of course, to do what at least one office does and use what Bailey referred to as a " shadow portfolio ". In this case the office would sell a policy based on some index which may well be the unit price in a particular unit trust and then it would try to beat it with its own investment performance. For the particular office I have in mind, there is no necessity for it to invest its money in that particular unit trust. It simply pays its sums assured out in accordance with the experience of the unit trust and will make profits or losses according to whether the experience of its investments is better or worse than the unit trust. Obviously one can make losses in such a situation, but at least the structure is such that the office with good investment expertise can make profits from that expertise.

Mr. Murray asked what proportion of capital gains tax should be deducted from the proceeds of maturing policies to allow for the contingent tax due on unrealized capital gains. This is a point on which there are different views within the unit trust movement. At least one largish group have said to me that they consider this is something on which there will be competition as on other terms in the assurance contracts.

Mr. Murray also referred to the " British Standard " idea and Mr. Stalker has suggested that a specially trained sales force should be set up to deal with this type of business. Our worry is that the competition is in what the economist would call " a very imperfect market ", that is a market in which the customer is not fully informed on what the various vendors are offering. We are exercised on this point of control of sales force and British Standards. We must recognize that there are considerable difficulties facing the average life assurance salesman, honest though he may be, who has to put over clearly what is going to happen. He does not fully understand what may happen and what risks are involved, and it is tempting to suggest the use of a specialized field force. However this raises organiza-
t and economic problems. It is one thing to have a few pension

schemes experts dotted round the country prepared to dash a couple of hundred miles to a possible pension scheme contract where this may involve a lot of money. This is not quite the sort of thing one can do if somebody is thinking of taking out a £1,000 unit trust policy. The best practical solution may well be to issue approved sales literature and tell your sales managers: " Only say what is in that memorandum." In such a case it would seem sensible to subject sales literature to a British Standard vetting procedure such as we suggest.

One last point before I close. It is very difficult for a new office to become established in this country using the traditional net premium method for its published valuations, because of the considerable financing strain involved on new business. It may well be sensible for a new office to rely quite heavily on unit trust assurance business if only to get established as a sizable unit in the life assurance industry. Given this apparent size, it could then gradually build up traditional business. This may be one of the contributory factors explaining the large number of new unit trust assurance companies which have been formed. I would certainly regard it as quite important.

Mr. Geoffrey Heywood wrote:—I had hoped to be able to come to Edinburgh in order to contribute to the discussion on this paper, but unfortunately, in the event, this was not possible and, therefore, I must content myself with sending a written contribution.

I particularly welcome the paper, because it deals with a subject with which I have been closely connected for a number of years, and in which I am particularly interested. It is therefore most gratifying to find that actuaries are beginning to take an interest in the unit trust movement, because I am absolutely convinced that the movement will grow over the years in the future. It is now some 35 years since unit trusts first appeared in this country in 1931 and for the first 20 or so years of their history, that is until approximately the beginning of the Second World War, their progress was indeed fairly slow, but nevertheless built on very sound lines. During the Second World War there was little development, but since the end of that war there has been a considerable impetus in the unit trust movement in all its varying aspects. It has indeed gone ahead very considerably in recent years, but nevertheless, I believe, even at the present time, it is still very much in its infancy.

If one accepts that over the years in the future we shall live in an economy which must expand if we are to survive, and in an economy which must experience a certain, although we hope limited, degree of inflation, then it follows that direct investment in ordinary shares is a most appropriate medium of saving for all investors. This medium has been readily available to the man of considerable resources who has been able to invest directly in equities for very many years, and has also been able to afford to obtain investment advice from the best sources available. Investment in this way, however, has not been available to the small saver because his financial resources have never been sufficient, firstly to enable him to spread his investments over a large number of securities, which is essential, and secondly because he has not been able to afford to pay for the investment advice which is equally essential if one is to invest in the equity market. Both these requirements can and are made available to the small man by investment in unit trusts. I therefore take the view that when the small man has built up his cash reserve which is readily available in the event of a contingency, when he has taken out some life assurance as opposed to endowment, and when he has made arrangements to purchase his house, he then comes to the stage of investing any surplus funds, and the unit trust movement presents him with the ideal opportunity of making such investments.

It may be said that a similar opportunity is available to him in the field of with-profit endowment assurances, and while, as I have already indicated, I do not for one moment quarrel with the fact that the small investor should have adequate life assurance, it is more doubtful whether he should invest the whole of the balance of his savings in an endowment assurance policy. At least half, if indeed not the whole, of such savings should in my view be invested directly in a unit trust. Unfortunately, this does not happen in present circumstances, for a number of reasons. In the first place, the life assurance industry has been established in this country for the best part of two centuries, and although the small saver does not appreciate all the technical aspects of life assurance, he assumes, because of the history and because of the high regard in which the life assurance industry is held, that he should take out endowment assurances as a medium of saving. Secondly, if he does effect an endowment assurance policy, he is able to obtain considerable taxation advantages which are not available to him if he should invest directly in a unit trust. Thirdly, there are no restrictions on expenses in the life assurance field, and so the offices are able to promote their sales unhampered by the severe expense restrictions at present applicable to the unit trust movement and outlined in detail in the paper. The question of expenses is particularly relevant when it is remembered that, in industrial branch assurance, offices are able to pay for the cost of door to door collection, whereas it is impossible for unit trusts to offer such a facility.

In order to combat some of the problems of bringing unit trust investment to the small saver, the practice has grown up in recent years of interposing between the unit trust and the public a life assurance company, which thereby enables the saver to obtain the benefit of income tax relief on his savings and also offers some relaxation in the severe expense rules at present applying to direct investment in unit trusts.

Against the background of the present position of the unit trust movement which I have just described, I feel that it is in the interest of the small saver and indeed the economy generally that instead of unit trusts being governed by legislation which was never intended for them, namely the Prevention of Fraud (Investments) Act 1958, the whole position of the unit trust movement in this country should be examined with a view to the introduction of legislation governing unit trusts specially designed to meet their particular problems. As regards the unit trusts themselves, I think that they have a very big public relations problem in front of them. They have to convey to the small saver the facilities which they are able to offer and which are so very much in the small saver's interest—in fact they have to educate him in a short period of time in the way in which the life offices have educated the small saver over the long period of life assurance history.

It will be gathered that I am an enthusiast for the unit trust movement, because I believe so very much that it is in the interests of the small investor that he should have an opportunity to take an interest in ordinary shares, in the same way as the large investor has done for so many years. Nevertheless, I think that safeguards are necessary, because there is a danger that the movement might develop in mushroom fashion, and a large number of unsound unit trusts of a dubious nature might grow up in an effort to jump on what some unscrupulous people might discern as a particularly profitable band wagon. This would not be in the interests either of the small saver or of the unit trust movement itself, and I am most anxious that in any legislation which is introduced there should be safeguards to deter a growth in the unit trust movement of the type which I have just indicated.

As an aside, I would like to comment for a moment on the highly successful introduction some twelve months ago of what were known as family bonds. These bonds used a friendly society constitution to offer to investors an investment free of income tax and free of capital gains tax, although in accordance with the friendly society legislation such investments had to be limited as to 50 per cent. in ordinary shares and 50 per cent. in narrower range securities. This scheme gave to the small investor an opportunity to invest in equities in a most advantageous way, but because the case was put to the Government that surtax payers were presented with an attractive tax avoidance scheme, family bonds became a dead letter as from the 1966 Budget. With a limitation of £500 on the sum assured, any advantage to the surtax payer was minimal, and so I feel that by prohibiting the family bond scheme in the last Budget, the Government removed from the small man a most attractive investment medium and one which could, if allowed to continue, have contributed very greatly to the savings which we need for the success of the national economy.

In conclusion, it is evident from what I have said that I believe that unit trusts are in their infancy, that they have a great deal to offer to the small saver, and that in some 10, 15 or 20 years' time they will be a far more powerful force in the savings movement than they are at the moment. I hope, therefore, that actuaries will not ignore the powerful forces which are likely to sweep the unit trust movement forward, and that the life offices will recognize the great advantages of unit trust savings and will co-operate with them in the years ahead, rather than oppose them, in what must ultimately be a losing battle.

Mr. F. E. King wrote :—Following the discussion, it seems important to remember that an equity or unit trust linked policy is not a substitute for conventional life assurance protection, whether term, whole life or endowment assurance with or without profits.

What is being sold to the public is an investment in an agreed group of securities. In the development of unit trusts, the addition of life assurance has been a late and probably the least important innovation. Its attraction is not the life cover, but the tax relief afforded, and the additional frills introduced, such as the guarantee of the minimum sum payable, have been added to combat the disadvantages which a conventional life assurance salesman would point out.

As Mr. Donald stated, these contracts should only be taken on by proposers who have some knowledge of investment. When considering the advantages and disadvantages of setting up such a special fund, two future developments are possible.

Firstly, the law may change ; for example, in tax relief being granted on a wider form of regular savings. This might make this form of investment with life cover less attractive, and as the investment (as opposed to the cover) is emphasized, there is, in my opinion, a greater chance than under conventional life assurance of comparatively early discontinuance of contributions.

Secondly, an equity linked policy taken out by a proposer with some degree of knowledge of the problems of investment may cause him to take interest and hence become more sophisticated and knowledgeable and decide (particularly in times when share prices are rising) that he might gamble himself and invest directly in stated shares, rather than pay others to do it for him.

Before an office undertakes the transaction of this kind of business, I suggest they should consider (in addition to the other problems) whether they might, in a few years' time, be left with a small separate fund producing no new business, and have to wait for up to 25 or 30 years before it was ultimately extinguished.