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Unit trust or insurance product?

Investors are often presented with a bewildering range of product choices. One critical choice is whether an investment should be done using specialised investment products, such as unit trusts, or insurance products, such as life assurance. Here's an overview of the key decision criteria.

Investment objectives

The first principle of all investment decisions is to see that investments match investors' needs. Generally, products should match an investor's objectives, risk profile, timeframe and help diversify their overall portfolio.

- Investors whose critical needs are short term should not invest in risky products designed for long horizons (unless their short term needs have already been handled)
- Those with an unsure job situation, unclear future earnings or general financial uncertainty should defer long-term involvement in any investments
- Those with an overriding wealth accumulation need should not consider protection (insurance) products unless they really need the benefits of protection
- Where individuals have both protection and investment needs, they must consider whether a single product or separate products meet these needs. If this comparison is difficult or complex, they should seek advisers who are familiar with both types of products.

Investors looking for income should only rarely buy products for capital growth or vice versa.

- At the extreme, some products, such as annuities, are usually designed for income, and could provide no capital preservation at all
- Receiving regular income or dividends, as opposed to capital gains, may have tax disadvantages
- At the other extreme, some products are designed only for capital growth and never pay out an income stream, although parts of the investment may be sold to simulate "income"

Surrender value

Often overlooked, surrender value is an important consideration, and early surrender of some products can have a heavy negative impact on investment returns

- Investments in shares or unit trusts, have surrender costs even if it's only the realisation of upfront commission or sales charge. These could be anything from 1-5%. Some unit trusts, especially those with fixed tenures, have explicit redemption charges.
- Fixed deposits have a surrender cost, possibly as high as 90 days' interest.

The products with heaviest surrender losses are life assurance policies. In almost all cases they do not provide good value for money as short-term investments:

- Many life assurance products offer nil or very low surrender values for the first year or two
- Even after this initial period, surrender values are much lower than maturity benefits for much of the term of the investment
- Long-term endowments have lower early surrender values than short-term endowments
- Investment-linked insurance products have better encashment values than life policies with bonuses (profits)

Early surrender values are of little concern to investors committed to fixed savings goals but they should bear in mind that any “forced sale” could be costly. It's a real problem: UK statistics show that up to 50% of endowment (insurance) policyholders surrender within the first six years. It is this aspect of long-term policies that often prompts financial advisers to recommend separating life assurance protection from investment needs.

Charging and commission structure

Charging and commission structures vary tremendously from product to product. Generally, investors should be aware of the following guidelines:

- Direct investment in stocks or bonds is usually cheaper than through packaged products, such as unit trusts and insurance
- The costs of fixed deposits or other “zero charge” products are concealed in the interest rates advertised, or the charges may be levied on an annual basis under a higher management fee
- Unit trust sales charges are as high as 5.5% at banks, but the same product can be had for as low as 1% at online portals.
- Initial commission on life insurance policies could be 30-40% of the annual premium, with payment spread over 16-38 months. Initial commission could be as high as 70-80% for 25-year endowments.
- Commission on annuity contracts is typical 2% of purchase price

Historically, ongoing annual management charges are roughly:

- Life assurance: 1.5-2%
- Actively managed unit trusts: 1.25-2%
- Tracker unit trusts: 0.5-1%
- Pension policies (in the UK): 2.5%

Charging and commission structures are subject to frequent change, and initial fees may be negotiable in some cases. Investors should try to compare on a like-for-like basis and remember that the net return to the investor is ultimately the key concern – a low charging product that makes losses is always less desirable than an "expensive" product that returns consistent gains.

Risk and accessibility

Different products have different levels of risk, and clearly any product purchase should be consistent with an investor's risk tolerance.

Some products impose significant delays before redemption money can be accessed, so it's important that potential investors understand these terms. For example, fixed tenure products may only trade once a month after the launch period. Likewise, 90-day savings accounts may require a three-month notice period. And as discussed above, easy access may come at the price of high surrender costs. Hence, it's important that individuals have an easily accessible emergency fund before they enter into any investment with a substantial lock-in period.

Tax treatment

Different products have different tax treatments, both in terms of how the product itself is taxed, and how the end investor is taxed on the proceeds. Usually capital gains avoid any tax liability, which is an advantage for any product delivering the returns as a price gain.

In Singapore, income tax is chargeable on dividend income. Because of tax offsetting, in some situations the total returns to investors can actually be higher than the headline total returns. This is because investors can claim some of the withheld tax. For example, Schroder Singapore Trust, a unit trust investing in local stocks, does not pay tax on dividends. Instead it receives dividends net of withholding tax (as any other investor would) and pays out the same net amount to its unit holders (in effect, the fund is transparent for tax purposes).

So investors with personal marginal tax rates lower than the current corporate tax rate can get a refund on the tax difference for the dividend. This allows them to enjoy a higher effective dividend (a new tax system eventually will remove this benefit as shareholders will not be able to claim tax refunds on dividends received).

Other products may do things quite differently. For example, Franklin US Government Fund, a unit trust investing in US mortgage-backed bonds, declares dividends on a quarterly basis at the fund level. This income is from the "passthroughs" of the underlying securities, which have a constant monthly cash flow from mortgage repayments. Holders of this fund receive the full dividend because there is no withholding tax on the fund's foreign securities. But the individual investors must declare the dividends for taxation, which would probably lower their overall return.

Some insurance plans allow you to receive all proceeds tax-free. For example, those bought under the CPF Minimum Sum Scheme. Similarly, investors should also look at whether a product is available for purchase using Supplementary Retirement Scheme (SRS) money. If it is, it could have significant tax advantages over a similar product that is not under SRS.

Conclusion

It's worth doing your homework or getting unbiased advice, as there is a lot more variability in products than many investors imagine. Often a product suitable for one person is unsuitable for someone else with almost identical needs, except for a key difference. For example, an endowment insurance policy could be ideal for someone with the intention and means to keep up regular contributions for 15 years or more. But the same plan could be the wrong choice for an investor who has a high chance of surrendering the policy after only a few years.

We believe that, generally, low-cost products designed to meet a specific need have advantages over combination products with an overabundance of features. And we think it's always a good idea to separate needs (investment, insurance) during your planning, although that doesn't rule out a single product choice when you implement.

So...unit trust or insurance product? Depends on your precise needs, but generally low cost unit trusts have the edge as pure investments, especially for short-term investing. For those who can stick with an investment for the long-term, whether an insurance product is best depends on whether you need the extra protection, and if that benefit is cost-effective bundled or separate.