SCOTTISH WIDOWS
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official pensions and investment provider

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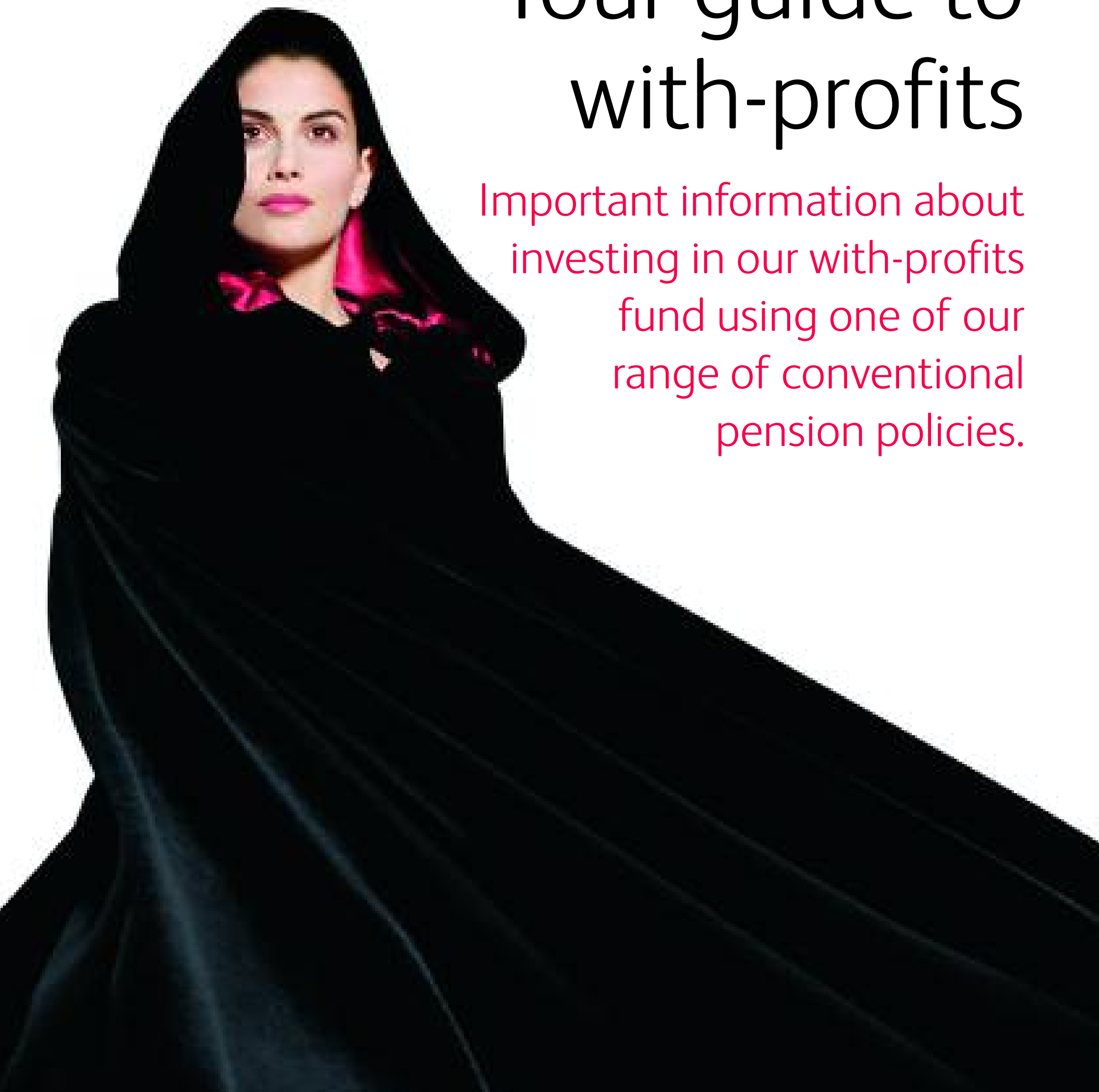
Your guide to with-profits

Important information about investing in our with-profits fund using one of our range of conventional pension policies.



We have written this guide to give you more information about investing in our with-profits fund through one of our ‘conventional’ pension policies or plans. These include the following types of policies:

- Executive Pension Policy
- Free Standing Additional Voluntary Contributions (FSAVC)
- Pegasus Executive Pension Plan
- Pegasus Early Leavers Plan
- Pegasus Plus Pension Plan
- Personal Pension Plus
- Personal Pension Policy
- Section 32 (Buy Out) Policy
- Top Hat Policy

The type of policy you have will be set out in the original documents that you were given when you took out your policy. Policies are often referred to as plans but for simplicity we will call them policies in this guide.

This guide explains how your with-profits pension policy works. You should read through all of this document as it contains important information about your policy, but here is a brief summary.

When you invest your money, it is pooled with the money invested by many other policyholders in part of our with-profits fund. What you get back from your policy depends on the fortunes of the with-profits fund, in particular how well the investments have done in the relevant part of the fund. Your with-profits policy:

- has guaranteed minimum benefits at the times explained later in this guide;
- may have bonuses added to these guaranteed minimum benefits; and
- will normally be cushioned from the daily ups and downs of the stockmarket (we call this ‘smoothing’).

After meeting its obligations, the with-profits fund will over time be distributed in full to with-profits policyholders. Our aim is that different groups of policyholders receive their fair share of the fund.

This guide is a summary of a longer, more detailed, document called our Principles and Practices of Financial Management (‘PPFM’). We have tried to make sure that this guide accurately reflects the PPFM. But the PPFM will apply if there is any difference between the information in it and the information in this guide.

The full PPFM is on our website at **www.scottishwidows.co.uk/PPFM**, or you can ask us to send you a copy. Our address is given at the end of this guide in the section “How can I get more information?” Also at the website are some ‘Questions and Answers’ that can help you check what sort of policy you have.

The PPFM will apply where there is any difference between the information in it and the information in this guide.

Contents

We've set out the information in this guide as answers to the following questions.

For many of the policies covered by this guide, the with-profits fund was just one of the investment choices we offered. It is possible that only some of your money is invested in the with-profits fund. The documents you were given at the start of your policy will tell you if you were given this choice of alternative investments. This guide only covers the with-profits part of your investment.

It may be that your policy is held by the trustees of a pension scheme set up by your employer. If this is the case, you may well still find this guide useful but where we say 'you' we will often mean the trustees acting on your behalf.

Throughout the guide we've assumed that you make all of the payments that are due while your with-profits investment continues. You may have stopped paying into your policy but not yet retired. If so, your guaranteed benefits will be lower than they originally were. However, we will add bonuses to your policy using the same rates of bonus that we use for other policies.

What is meant by with-profits?

We use the term ‘with-profits’ to mean a type of investment. It provides medium to long-term growth potential with some guarantees (see “What are the guarantees?” on page 4). By medium to long-term we mean investments that last at least 5 years.

Your money is pooled in our with-profits fund with the money invested by many other policyholders. Your investment will stay in the with-profits fund until one of the following happens:

- you retire and take a pension from your policy;
- you transfer your policy to another company, or another policy with us;
- you die; or
- you change from with-profits by switching your investment to other funds (not all policies allow this).

When you started to invest we gave you a guarantee that in certain circumstances we would pay you at least a minimum amount. A description of this guarantee and the circumstances when it applies is in “What are the guarantees?” on page 4. We may increase your guaranteed amount by adding regular bonus. We may also add final bonus to your policy when you retire. Further information on bonuses is given in “What types of bonus may be added to my policy?” on page 5. When guarantees do not apply, the amount you could get is worked out differently (see page 9).

Our approach to managing our with-profits fund can change from time to time. It’s not exactly the same for all types of policy.

The with-profits fund

The with-profits fund invests in a mix of assets such as company shares, property, bonds and cash deposits. Bonds are a type of loan, usually to the Government or companies. You may have heard Government bonds referred to as gilts. The proportion of the with-profits fund that is put into each of these different types of asset will vary over time. The mix of assets can be different for different parts of the with-profits fund.

While shares and property have usually risen more in value than bonds and cash over long periods such as 20 years, the return has also been much more variable. One year the investment may do very well, but the next could see a big fall in value – this is often called ‘investment risk’.

We may also use ‘derivatives’, which are specialist forms of investments. We apply strict controls over how we use derivatives and use them to reduce investment risk. For example, some derivatives give the with-profits fund the right to buy or sell assets at a fixed price at a future date.

Your group

When managing the with-profits fund we often look separately at different groups of policyholders. The group you'll be in will depend on the type of policy that you have and when you started it.

The shareholders

Scottish Widows plc is a 'proprietary company'. This means that we have shareholders. Our shareholders receive the charges that we make on policies like yours and in return meet the cost of looking after your policy. They also get a payment each year equal to one ninth of the value of the bonuses that we add to policies like yours. However this payment comes from a part of the with-profits fund specifically set up, when Scottish Widows demutualised in March 2000, to cover it. The payment does not affect what you get back from your policy.

What are the guarantees?

Your policy has some guarantees. When the guarantees apply your policy will have a minimum value. This is a minimum amount and we may pay out more than this. Some policies guarantee a minimum amount of the cash that you use to buy a pension. Other policies guarantee an amount of pension.

The times when the guarantees apply are different for different types of policy. They will usually include the retirement date you chose when you started your policy. Your policy documents will say when this date is. The documents might call it, for example, 'selected pension date' or 'normal retiring date'.

Some policies have other guarantee dates as well. You can find out if this applies to your policy by checking the 'Policy Provisions' or 'Special Provisions' in your policy documents. In this guide, for simplicity, we have called all the dates on which the guarantees apply for your policy the 'guarantee dates'.

The guarantees do not apply at other times.

If your policy started in 1983 or later, and has a single guarantee date called a 'selected pension date', you may be able to change it if you tell us early enough.

Another type of guarantee may also apply. It is commonly called a Guaranteed Annuity Rate or GAR.

Guarantee annuity rates

Many of the policies covered by this guide provide a choice at a guarantee date between a guaranteed cash sum and a guaranteed pension. In other words the right either:

- to use your retirement cash sum to buy a pension at a guaranteed rate; or
- to give up some of your pension to provide a cash sum on fixed terms.

It may apply to some or all of the with-profits part of your policy. We refer in this guide to either of these rights as a 'GAR' – a guaranteed annuity rate. A GAR can increase the pension you get from your policy. Please note that to benefit from this you will have to take a certain type of pension. For instance you may have to take it in yearly instalments rather than monthly. Your policy documents will tell you what type it must be.

In some policies we guarantee an amount of pension but do not guarantee a cash alternative. These policies do not have a GAR.

If your policy has a GAR, then when you tell us that you are thinking about taking retirement benefits from your policy we will send you a leaflet. We'll also send it to you before your main guarantee date. The leaflet will explain how and when you can get the benefit of the GAR in your type of policy.

What types of bonus may be added to my policy?

Three types of bonus may be added to your with-profits policy. They determine what you will be able to get back when guarantees apply. They are:

- regular bonus, sometimes called 'reversionary bonus', which may be added at the end of each year as permanent increases in the guarantees that apply to your with-profits policy;
- final bonus, sometimes called 'terminal bonus', which we may add on top of those guaranteed amounts; and
- interim bonus, a small amount of additional regular bonus which we may add alongside any final bonus.

We adjust levels of regular bonus once a year. We usually adjust levels of interim bonus once a year as well, and rates of final bonus twice a year, but we may sometimes change them at other times.

Future rates of bonus are not guaranteed.

Different groups of policies and policies that started in different periods (usually different years) will have different levels of final bonus.

If your policy started in or after 1983, you may have increased the guaranteed benefit of your policy from the initial amount. You could have done this either through additional single payments or by increasing any regular payments you make. In these cases, the rate of final bonus we apply is similar to that for a policy that started at an average of the times the changes were made to your policy. A separate rate will apply to the benefits bought by single payments from any that were bought by regular payments.

Benefits added to policies on or after 15 February 1999 are treated slightly differently. These benefits have a different rate of regular bonus from earlier benefits. Also, each added benefit has a separate rate of final bonus (instead of an average rate as explained above).

How do you decide the bonuses?

Regular bonuses and final bonuses have different purposes, and we decide them differently.

Regular bonus

The size of the regular bonus depends mainly on what bonuses we have already added to policies, past investment performance and what we expect in the future. When setting a rate of regular bonus we consider the relevant guaranteed benefits of all policies that receive that bonus. We aim to set the regular bonus rate so that there is scope in the future for final bonuses if the relevant assets of the fund provide steady growth. We may set rates at a lower level than this when it is necessary to limit losses to the with-profits fund.

We expect higher-risk assets to give a better, but less predictable, return over the long term. If we were to set rates of regular bonus at higher levels, we'd have to invest more of the with-profits fund in more predictable lower-risk assets (see "Investment performance" on page 11). We would then expect to have less to pay out to policyholders.

We may raise or lower rates of regular bonus in several stages. There could be no regular bonus in some years.

Interim bonus

When we set rates of interim bonus, we set them at levels similar to the levels of regular bonus we expect to set at the end of the coming year.

Final bonus

We choose 'sample policies' to be representative of the policies in your group. Different sample policies represent policies that started in different periods (usually different years). We set a 'target payout level' for each sample policy. If we are using more than one sample policy for any year, we use an average of the results from the individual sample policies.

We then compare this target level with the corresponding guaranteed amount and pay a final bonus if the target level is bigger. In other words, we aim to 'top up' what policyholders get to reflect the sample policies' target levels.

If the value of the guaranteed amounts has been increased because of a GAR then we ignore this increase when working out the top up. This usually results in a higher final bonus.

In some policies we guarantee an amount of pension but do not guarantee a cash alternative. This means there is no GAR. For these policies we use the expected cash value of the guaranteed pension when working out the top up. A fall in interest rates, or an increase in the average time we expect people to live, increases that value and tends to reduce the final bonus. A rise in interest rates or reduction in expected future lifetimes tends to increase the final bonus.

To help us to work out the target levels we:

- take the 'asset share' of the sample policies (see "Asset shares" on page 10);
- increase it so the final bonus includes the investment returns we expect to earn between when we set the final bonus and when policy payments are made;
- make the adjustment for the smoothing of recent investment returns described below, which gives us a 'smoothed asset share'; and
- make a small reduction towards the cost of the extra amounts we expect to pay from time to time because of guarantees.

We may add a further small amount to the final bonus which results from our demutualisation. The current level of this amount can be located on the with-profits section of our website.

Overall, we aim that total payouts over many years are at least equal to the asset shares. The extra value from the GARs that policyholders take up will come from a separate part of the with-profits fund called the 'Additional Account' (see "What are the risks of investing in the with-profits fund?" on page 12).

Smoothing

With-profits investing includes a special feature called 'smoothing'. The stockmarket goes up and down daily and can move a lot in a short space of time. We aim to smooth out some of the effects of these short-term peaks and troughs. We only consider movements in the last two years. So smoothing will not lessen the effects on your return of longer-term changes in the stockmarket.

Smoothing is complex and more details of our approach are in our PPFM.

We constantly monitor investment conditions, and may change levels of final bonus at any time. For instance, we'd consider a change if asset shares move more than 15% away from the smoothed asset shares we had used for the current bonus rates. We'd also consider a change if it was necessary to limit losses to the with-profits fund. We may limit the smoothing when setting final bonus rates to reduce the likelihood of a further final bonus change within the following six months.

Final bonuses can sometimes change very significantly, even within a few months, in spite of smoothing.

What if I die before taking my pension?

The with-profits guarantees don't apply if you die before you take your pension. If you die your policy will usually pay the amount you would have got if you had chosen to move your policy from with-profits (see page 9).

However, it is possible that if you die before taking your pension we would just return all the payments made into the policy. This may apply if your policy is held by the trustees of a pension scheme set up by your employer. Your policy documents will tell you what form of death benefit your policy has.

What if I decide to move my policy from with-profits or cash it in on a date when guarantees don't apply?

You can choose to make a change that results in your investment leaving the with-profits fund at a date when guarantees don't apply. This may happen because you decide:-

- to retire before or after the guaranteed date;
- to transfer to another policy with us or with another company; or
- to move your investments from the with-profits fund to another investment fund (only a few policies allow you to do this).

Whatever the reason, we will still aim to give you fair value for your investment. However, there is no minimum guarantee of what your policy will pay and you will not get anything for the guarantees you are giving up. In particular GARs usually don't apply if you move out of with-profits in any of the circumstances covered by this section of the guide. So you could lose the benefit of the GAR (see "What are the guarantees?" on page 4).

Our approach is as follows, although some exceptions are explained at the end of this section.

We look at sample policies that are of a similar type to yours. They have similar starting dates and periods still to go to the main guarantee date.

We set target levels in much the same way as when guarantees apply (see "Final bonus" on page 7) but there are two differences:

1. The smoothing we use is different. The most important difference is that we only consider stockmarket movements over the last six months. This means that there would be a much quicker fall or rise in the amount that you could get back if there is a large fall or rise in the value of your group's part of the fund.
2. We adjust the target levels so that:
   - the closer a policy is to its guarantee date the closer the target level is to the target level we would use for a policy at its guarantee date; and
   - the target level is reduced for policies that are further from their guarantee date.
     The reduction is typically 5%.

Further details of these differences are set out in our PPFM.

We may add a further small amount to the final bonus which results from our demutualisation. The current level of this amount can be located on the with-profits section of our website.

Our aim is to maintain a fair level of payouts to everyone investing in the with-profits fund. We usually adjust target levels every six months. However, we constantly monitor investment conditions and may change them at any time. This would change what you would get. For instance, we'd consider a change if asset shares differed by more than 5% from the smoothed asset shares that were used to set current policy values. We'd also consider a change if it was necessary to avoid excessive profits or losses to the with-profits fund.

For some types of policy, what you get back is worked out rather differently. This is because the terms set out in the documents for these policies are different from those of other policies.

For instance, policies that were originally held by the trustees of an employer's pension scheme usually only ever have one guarantee date. For later retirements, we'll automatically move your policy out of with-profits on that guarantee date. When you wish to take your pension you will get the cash value we'd have paid at the guarantee date, plus interest.

Another example is for policies that were originally held by the trustees of an employer's pension scheme and started before 1984. Depending on the terms of your policy, you may get some benefit from the GAR if you are taking a pension from your policy. This could apply for a pension that starts before the guarantee date or for one that starts after it. The leaflets that we provide before you start your pension give details.

What affects how much I might get to buy a pension?

Asset shares

Asset shares help us decide the bonuses and the fair payments when guarantees don't apply. The way this works is described earlier in this guide. Very broadly, asset shares are an accumulation of the amounts invested. So when deciding what an asset share would be, we look at the following three main factors:

- the amounts invested in sample with-profits policies (see below);
- when they were invested; and
- the past investment performance of the 'relevant assets' (see "Investment performance" on page 11).

We also make adjustments for:

- the charges we have made to cover the cost of managing your policy;
- taxation;
- a regular ‘capital fee’ (a 0.3% a year deduction from the asset share); and
- any profits and losses from ‘business risks’ that affect asset shares (see below).

The capital fees are added to a special account kept separate in the with-profits fund called the ‘Additional Account’. Most profits and losses from business risks, other than those from providing death benefits, don’t affect asset shares for your type of policy. Instead, they are added to or taken from the Additional Account. More information on business risks and the Additional Account is given in “What are the risks of investing in the with-profits fund?” on page 12.

We track asset shares of the with-profits fund for sample with-profits policies. We track them separately for the different groups of policyholders, including your group. We track them for policies that were started at different times and that have different periods to run.

Investment performance

This guide sometimes refers to ‘relevant assets’. These make up the part of the with-profits fund whose investment performance has an important effect on asset shares and therefore on what you will get back. The performance will depend on, among other things, how much of the relevant assets are made up of each of the different types of asset. The mix of the relevant assets can be different for different groups of investors.

We hold part of the relevant assets for your group in higher-risk assets such as shares and property, to try to achieve higher returns. The rest is in lower-risk assets, such as fixed-interest bonds issued by the Government or by companies, and cash deposits that earn interest.

The performance of different types of asset varies considerably over time.
So we may change the mix of the assets with the aim of:

- getting the best possible long-term performance; and
- making sure that the with-profits fund can always meet its guarantees.

When doing so we allow for support from some of our assets outside the with-profits fund, following guidelines set at the time of the demutualisation. This means we can invest more of the relevant assets in shares and property. (See also "What is the capital support for the with-profits fund?" on page 13.)

We include information about the mix of assets within the PPFM section of the Scottish Widows website. You'll therefore be able to see how we review and change the mix of the assets over time.

What are the risks of investing in the with-profits fund?

Your with-profits investment, by being part of our with-profits fund, is exposed to 'investment risk'. This is the risk that the value of the relevant assets of your group can fall as well as rise. It is possible that if you could get back less than you invested. There are other risks known as 'business risks'.

Any profits or losses arising from the business risks, other than those from providing death benefits, would normally not affect the asset shares of policies like yours. Instead they would be paid into or taken from the separate part of the with-profits fund known as the Additional Account. This Additional Account was set up when we demutualised on 3 March 2000 to cover such things. Anything left over in it would be paid out as extra final bonus to the remaining policies that were started on or before 3 March 2000. If the Additional Account is not sufficient to cover losses arising from business risk, any later losses would be met firstly from assets outside the with-profits fund. However in extreme cases some losses could be shared among all the with-profits policies that were started before we demutualised.

The main business risks to the Additional Account come from the guarantees and smoothing of the payments that we make to other with-profits investors. When we apply smoothing and guarantees, we increase what we pay some policies. This leaves less in the with-profits fund for the other policies. On the other hand, when we pay some policies less because of smoothing it leaves more for the other policies.

The Additional Account is also exposed to smaller business risks, including the following:

- the with-profits fund's profits and losses from the non-profit policies that were transferred into it in March 2000, when we demutualised or that are set up when with-profits pension policies are converted to pensions at retirement; and
- the cost of compensation paid to the holders of policies sold by Scottish Widows before demutualisation, if any are shown to have been mis-sold.

The policies covered by this guide are unlikely to share in the profits and losses from policies that were started after we demutualised in March 2000, and vice versa.

There are naturally risks associated with your policy that apply to other sorts of investment and not just to with-profits policies. Those other risks, such as the risk that the taxation of pensions may change, would also apply to other ways of saving for your retirement. This guide deals only with risks that are directly associated with your policy being invested in our with-profits fund.

What is the capital support for the with-profits fund?

We aim to hold enough assets in the with-profits fund to provide a fair level of payouts to the current investors in the fund. While we could hold some extra assets as 'working capital' in the fund, most of the working capital will be held elsewhere in the company.

Working capital provides support for the with-profits fund as and when it's needed. The support helps us to maintain the mix of assets that we describe in "Investment performance?" on page 11. It also helps us to meet our aim of maintaining a fair payout to everyone investing in the with-profits fund.

For more on how all this works, see our PPFM.

The PPFM will apply where there is any difference between the information in it and the information in this guide.

How can I get more information?

If you're still not sure about your with-profits investment, you should speak to your financial adviser or contact us direct. If you wish to contact us you can write to us at:

Scottish Widows
PO Box 902
15 Dalkeith Road
Edinburgh
EH16 5BU

Or you can call us on 0845 845 0845. We're open from 8am to 6pm Monday to Friday and from 9am to 12.30pm on Saturday. We may record and monitor calls to help us improve our service.

We'll write to you if we make a change to our approach to managing our with-profits fund that might have a significant effect on your plan. We'll also write if we change any of the 'Principles' in our PPFM. We'll normally include a replacement guide.

If you've any other with-profits investments with us that aren't covered by this guide, we'll send out your guide or guides for them.

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