



AUTUMN 2011 PROFESSIONAL NEWSLETTER

ANNUITY PURCHASE – A CRUCIAL DECISION

Those people who are approaching retirement should be very concerned. They are facing having to accept a very low return on annuity purchase. This is caused by the “perfect storm” of volatile stock markets and plunging annuity rates. And all this is set against the prospect of rising inflation which will not be helped by the Government’s decision to extend their quantitative easing measures in an attempt to boost growth within the economy.

What this means is that it is even more important for those people who are coming up to retirement to shop around for the best annuity rate available. This will include:

- Utilising the open market option to choose the best annuity rate available on the market (many investors, through inertia, stick with the current provider who is most unlikely to offer the best annuity rate).
- Picking an enhanced annuity if they suffer from poor health. Rates paid under enhanced annuities will be considerably better than standard life annuities. A number of life offices now offer such enhanced annuities.

Subject to these two very important considerations, a person who is approaching retirement and wishes to maximise income should consider three important questions; when is the best time to buy an annuity, what type of annuity is most appropriate and which annuity option is best suited to his/her personal circumstances.

Annuity timing

The timing of annuity purchase depends on three key issues.

There is little point in delaying if a person needs income immediately because he/she will only be eating into savings. If the value of the pension fund has fallen because it is invested in equities, the investor faces a difficult decision because equity prices could fall even further. However, a person might be tempted to delay purchasing in the hope that annuity rates will improve in the future.

In this respect, whilst it is true that long-term interest rates may rise in the coming months, the full benefit of any increase may not be passed on to investors as insurance companies are slow to raise their rates and may hold a margin back to allow for ever increasing life expectancy as well as the increased risk of investment default.

Therefore, those who defer their annuity purchase in the hope that rates will increase may well be disappointed. Also, if an annuity purchase is deferred the annuitant will miss out on immediate payments and may not recover this lost income in the future even if annuity rates rise.

Alternatives to guaranteed annuities

At times of low annuity rates it is more important than ever to consider the alternatives to the traditional guaranteed annuity. One of the drawbacks to guaranteed annuities is that they do not provide protection against future inflation unless an escalating annuity is chosen. But the downside of choosing an escalating annuity is that the starting income can be up to 40% lower. Also, guaranteed annuities are inflexible so it is not possible to change the payments if future circumstances change.

The alternatives to guaranteed annuities fall into two categories - flexible annuities and income drawdown. The advantages of these options include the potential for future growth, income flexibility and investment choice. The disadvantages include the risk that future income could fall if investment returns are lower than expected.

Which annuity is right for you?

Most people can work out if it is better to have a single or joint life annuity or whether it is better to have level payments or escalating payments. Also, as we explained at the beginning of this article, more people (but not everyone) are aware that it is important to shop around for the best annuity because rates can vary by up to 40% from company to company. In addition, if you smoke, are taking prescription medication, or have been in hospital recently you may qualify for an enhanced annuity of up to 40% more than the standard annuity.

Of course, it's one thing to shop around for the best annuity rate, but it remains of fundamental importance that you buy the type of annuity that is most appropriate for you.

ACTION:

For many people it will be best that they discuss their relevant income requirements with a financial expert who can advise which type of annuity is appropriate and find the best one in the market place.

Call us for more information.

INVESTING IN VOLATILE MARKETS

Investors who put lump sums into equity-based individual savings accounts (ISAs) at the end of the last tax year are likely to have seen a substantial amount wiped off their value in the past couple of months. This demonstrates the risks of one-off investments when markets turn volatile. In turn, this brings into focus the question of whether a regular savings strategy can deliver less risk than a lump sum investment in the months ahead.

Between March 1 and the April 5 deadline for 2010/11 ISAs, almost £1bn was invested in stocks and shares ISAs according to the Investment Management Association - the highest sum for nine years. Many of those who committed the full ISA allowance as a lump sum just before the deadline would have seen their investment fall by 20 per cent at the height of the August volatility.

If those investors had drip-fed the same amount into a 2010/11 ISA instead, they would have had less to lose, and more to gain – as data demonstrates that, historically, regular monthly investments have proved more profitable in falling and volatile markets.

However, over longer periods, evidence suggests that lump sums are more profitable - largely because markets have generally risen in the long term, and lump-sum investors are fully invested from the start. Data from the Association of Investment Companies show that, over 10 years to the end of June 2011, £50 a month - a total of £6,000 - drip-fed into the average investment trust was worth £10,057, while a £6,000 lump sum invested in June 2001 grew to £11,855.

When market volatility is high, though, switching to a drip feed (regular investment) strategy offers two clear advantages:

(i) **Overcoming timing difficulties**

When stock markets have significant rises and falls on a regular basis, timing a lump-sum investment becomes fraught with risk. Timing the market is incredibly difficult.

Even when the market is trading at a historical low valuation, a lump-sum investment can fall further, and take longer to recover its value. Investing monthly eliminates the risk of losing 5-10 per cent of the total investment in a matter of days.

(ii) **Pound-cost averaging**

When prices are falling, regular savings can buy progressively more shares or fund units each month, and fewer when prices are rising. In any market, apart from a prolonged bull run, this means a regular saver can end up holding more shares or units than a lump-sum investor who bought at the outset, and at a lower average purchase price. As a result of this pound-cost averaging effect, the regular saver can make more profit.

For investors who have already committed lump sums this year, regular saving can also provide an affordable way to invest a little more at lower prices - to make up losses and improve overall performance.

Despite these persuasive arguments, in the aftermath of the recent market falls, now may not necessarily be the best time to make regular investments. A number of specialists believe that drip-feeding is much more important when markets are high and could fall, than when they are already low. So what's the solution?

Well, much depends on the type of investment and the circumstances of the investor. For the more professional and seasoned investor a lump sum will get money into the market now, while it's cheap, even though they have to accept that further falls are possible. To provide an element of security investments could be split into a lump sum followed by regular savings over several months to give some protection against further market falls. On the other hand, novice investors are probably better off drip-feeding into the market.

Of course, market volatility is linked to the capital value of stock markets. In order to avoid full reliance on equity exposure, it can be useful to try to capture strong dividend yields through equity income funds. In a falling market, dividends provide some sort of buffer against losses, because yields rise as share prices fall. Both UK and international equity income funds may be appropriate in such circumstances.

Another important aspect in a volatile market is to choose funds with the flexibility to change their asset allocation in order to produce consistent returns.

Finally, it is one thing to invest and achieve income and capital growth. However, if those returns are highly taxed, this will affect the bottom line for the investor. In these circumstances, some thought should be given to the tax wrapper in which the investment is held.

ACTION:

Call us for more information on how your clients can maximise investment returns in the current volatile investment climate and make sure those returns accrue in a tax-efficient environment.

THE JUNIOR ISA – THE PRE-GRADUATE FUNDING SOLUTION?

The highly publicised increase in tuition fees to up to £9,000 per annum that a number of universities will adopt next year will place considerable financial pressure on parents with school children aspiring to go to university. Any tax-efficient "pre-uni" savings that can be put in place will therefore help. The introduction of the Junior ISA (JISA) from 1 November 2011 will bring some cheer to parents who are deeply concerned as to how their children (or more precisely they) will be able to fund the costs of a university education or repay the accrued borrowing. So what does a Junior ISA offer?

The general rules that apply to a JISA are as follows:-

- A child who is UK resident and under age 18 and does not have a Child Trust Fund (CTF) account is entitled to have a JISA. A child born before 1 September 2002 or after 2 January 2011 who was entitled to a CTF would not be able to have a JISA.

- A JISA can receive contributions of up to £3,600 per annum – these would normally be payable by parents or another relative. The annual limit increases by CPI from April 2013.
- A JISA can be invested in cash funds or stocks and shares in any mix provided that total annual contributions do not exceed £3,600.
- A JISA will not suffer tax on capital gains and investment income (although the tax credit on dividends cannot be recovered).
- At age 18 the JISA will be converted into an adult ISA in the child's name.
- The JISA cannot normally be encashed until the child gets to age 18 but at that time the child is absolutely entitled.

The imminent availability of the Junior ISA comes at a very opportune time, given the huge concern about financial provision for children. First, there is the issue of tuition fees. Following the Government announcement that universities can charge up to £9,000 per annum for tuition fees from next year there is obvious parental concern. A number of universities have announced that they will make this full charge and, of course, that is not the end of it because the maintenance costs of the child must also be factored in. And there's also loans of £5,000 or so that can be taken each year to fund the "cost of living" or "maintenance".

The more onerous borrowing conditions, such as deposit levels and income multiples, when combined with escalating house prices, has also made it more difficult for an adult child to borrow money for house purchase. A substantial outstanding student loan will not help the position or, if there is a loan, a substantial sum for a deposit may help. The point is that having available tax-effective cash is better than not!

Parents (and grandparents) may therefore be keen to give financial support to their children/grandchildren. And the earlier they can put financial planning in place, the easier it will be to deal with these financial burdens in the future. What can they do?

Well, this depends on whether the individual is using a programme of regular savings or is able to make a one-off payment. For parents, it will frequently be the case that regular saving is the only option. For grandparents, lump sum investment may also be an option.

As far as provision by parents is concerned, they will normally have to resort to a programme of regular savings and now, as far as the tax-efficient ISA is concerned, they have two options:-

(1) Junior ISA

As mentioned above, the JISA will enable a parent to invest up to £3,600 per annum.

The obvious benefits of the JISA are that it is tax free and that parents (and other relatives) can contribute up to a total of £3,600 each year. In the case of parental contributions, because the £100 parental settlor income tax anti-avoidance rule will not apply, income arising in the JISA will never be assessed on the parents and will, in effect, accrue tax free.

The downside is that there is no control over the child's access to the fund at age 18 and, of course, he or she may not then be university material! Even if he/she is, there could be some worry over the child using the JISA to fund a gap year trip for example.

Parents who are concerned about this point could consider keeping any investment in their own name until the child attends university. This would be achieved by investing in an ISA in their own name – in effect an “adult” ISA.

(2) “Adult” ISA

The ISA is still the main method of investing savings with freedom from income tax and capital gains tax without giving up the flexibility of access to the underlying investments.

The tax efficiency of an ISA is that investments have scope to accumulate in value at a faster pace. The earlier a programme of ISA savings is established the better. Of course, because here we are looking at an ISA in the name of the parent or grandparent, they will automatically be able to exercise control over the time of encashment of the ISA and the then distribution of the ISA proceeds. Assignment of an ISA, including assignment into trust, is not permitted.

ACTION:

If you have clients who are interested in making future financial provision for their children, call us for details on the type of ISA that we believe will be appropriate for them. We can also discuss with you potential alternative strategies that deliver tax efficiency but also more flexibility and control.

RELEVANT AND HELPFUL FOR EMPLOYEES

Many employers have key people whose death or illness will impact on the profitability of the business. For such people keyperson insurance exists to enable the company to provide itself with financial protection at such a difficult time.

But what about the keyperson's family and dependants? They will probably also have severe financial challenges to address at such time. For such people help is at hand in the shape of a Relevant Life Policy.

This is a policy which is taken out by an employer on the life of an employee on a single life basis and to an age not exceeding 75 and written in trust for the employee's family. This means that in the event of the employee's death, a substantial cash sum can be made available quickly for the employee's family. And that's not all – there are considerable tax benefits.

For example:-

- the employer will get tax relief on premium payments because they will be treated as a qualifying trade expense;

- the employee will not be assessed to income tax or National Insurance on the premiums paid;
- the death benefits will be free of income tax and are likely to be paid free of inheritance tax; and
- neither the premiums nor the death benefits will have any impact on the employee's annual allowance or lifetime allowance for pension purposes

For employers, such an arrangement can also act as a substantial employee benefit for attracting quality employees to a business.

ACTION:

Please call us for more information on this attractive and increasingly popular form of planning.

50% INCOME TAX – PLAN WHILE YOU CAN

There has been some speculation recently as to the future of the top 50% income tax rate.

This has been fuelled by reports by economists that a 50% top income rate does not help the prospects for economic growth and a comment by the Institute of Fiscal Studies that a tax rate of 50% actually has the effect of reducing inflows to the Treasury.

The Government has not made a positive statement either way about the future of the 50% tax rate. But, despite this, it is unlikely to be with us for the long term.

This means that the 300,000 or so people who are affected by this tax rate should make “hay while the sun shines” in an attempt to make tax-efficient investments or take planning action. The following springs readily to mind:-

- Pay the maximum you can to registered pension plans. In particular, maximise unused relief for the last 3 years. Contributions attract tax relief at the marginal rate(s).
- Invest in investments that restrict taxable income – such as single premium investment bonds (non-income producing yet with a 5% tax-deferred annual withdrawal facility available) and capital growth orientated unit trusts/OEICs.
- Invest in tax-relievable investments – VCT (30% relief) and EIS (30%) subject to the usual limits. Obviously consider any investment risk first.
- If you are married and your spouse has allowances available or pays a lower rate of tax, consider transferring investments to him/her. But make sure the most appropriate investments are transferred.

- If you own a small company, retain profits in the company and pay the lower rates of corporation tax rather than income tax. Consider pension contributions by the company.

ACTION:

Call us for further information on any of the above planning points.

This document is for general consideration only and consequently we cannot accept any responsibility for any loss as a result of any action taken or refrained from as a result of the information contained in it. The Financial Services Authority does not regulate general taxation or trust advice.

If you have any questions or require further information please do not hesitate to contact Stephen Watson on (01872) 225885 or enquiries@watsonfrench.co.uk