

SUMMER CLIENT NEWSLETTER

SMOOTHING THE INVESTMENT RIDE

It seems a long time ago now, but on 15 June last year, the FTSE 100 index reached 6,732.40. That was before the credit crunch crunched and Northern Rock was rocked. This year the Footsie sunk down to a low of 5,150.6 on 16 July – a fall of over 23% in just 13 months. UK shares have since rallied a little since then, but it is a brave person (or a fool) who claims to be sure the worst is over.

If you have money to invest, the uncertain outlook may tempt you to leave your cash on deposit or lock into some of the attractive fixed rate bonds on offer. However, such a strategy has its own risks. Stock market volatility is not a one-way street, however much it might seem like it at present. When share prices recover, the move up can be very fast.

Research undertaken by one of the UK's largest fund managers, Fidelity, shows that *not* being invested in shares – even for only a few days – can hit overall returns hard. For example, over the last 15 years to 30 May 2008, just missing the best 30 days of UK stock market performance would have reduced the average net total annual return from 8.89% to 1.64%. Similar results apply to investment in the US and main European markets.

There are several ways in which you can keep your exposure to share-based investments, but limit the risk of capital losses:

Capital Protected Growth Plans At their simplest, these plans offer you a return linked to a stock market index (eg FTSE 100), but with 100% capital protection at the end of a fixed term. From time to time National Savings & Investments offer a version of this plan (called the Guaranteed Equity Bond), but because it is structured as a deposit with all returns are subject to income tax, it is not tax-efficient.

There are many variants on the growth plan. For example you could choose a plan that offers a fixed rate of return provided the index does not fall or one that gives a return that is a multiple of the index performance, subject to a cap.

Regular Investment One way to take advantage of market volatility is to make regular investments of a fixed amount. The mathematics is quite simple: you will buy more shares/units when prices are low and fewer when prices are higher. Over a period of a few years, the result can be that the average price you have paid is lower than the average price for the period because your investment has been weighted towards cheaper prices.

The effect, known as 'pound-cost averaging', is widely recognised but for some reason does not receive the attention it deserves. It can also be applied to lump sum investments. For example, rather than investing, say, £12,000 as a lump sum, you could drip feed your investment over a year at £1,000 a month.

Absolute Return Funds In the past few years several major investment managers have launched absolute return funds, some of which are primarily invested in shares and share-related instruments. As the name suggests, these funds aim to provide a positive return regardless of market conditions. The track record so far shows that the goal of absolute returns has proved achievable by some managers, but a challenge for others.

ACTION

For your existing investments, the best course of action is probably inaction. If you are a long term investor, disinvesting now implies you will be reinvesting later on. That means running the risk that you miss those key performance days mentioned above, as well as incurring the costs of reinvestment.

For new investments, there are a range of options to limit possible future losses, although as a quid pro quo, you may also end up restricting your future gains, too.

Don't panic! Before you take any investment action, do ask us for advice.

ANOTHER PENSION PLAN

Government initiatives on pensions have been regular feature of the 21st century. There has been the launch of the stakeholder pension, a reworking of the state second pension, the introduction of pensions tax simplification and a major working of the basic state pension.

The next episode will begin when the latest Pensions Bill completes its passage through parliament this autumn, making it the third Pensions Act to reach the statute book in five years. The Pensions Act 2008 sets the framework for the next major development in pension provision: personal accounts.

Whether you are an employer or an employee, personal accounts could have important consequences for you. The key features of personal accounts are:

- All employees aged between 22 and State Pension Age will be automatically enrolled unless their employer provides suitable pension provision. Employees can opt out, but if they do so they will be re-enrolled every three years or on changing employer.
- An employer will have to contribute to their employees' personal accounts unless the employer already makes at least similar contributions on their behalf to another pension arrangement.
- The employer contribution will be 3% of employee earnings between about £5,500 and £36,400 a year (in 2008/09 terms) and the employee's contribution will be 4% (plus 1% tax relief) making a total of 8%. The exact bands will be determined nearer the start date (likely to be in 2012) and full contribution levels will be phased in over three years.

- Personal accounts will be operated independent of government, although at this stage there is heavy government involvement in the development of the Personal Accounts Delivery Authority (PADA).

The logic behind personal accounts is the need to boost retirement provision for low-medium earners with little or no current pension provision. The element of quasi-compulsion is not without controversy, because for a minority of employees the pension that they gain from their contributions to a personal account will be matched by the state benefits they lose by having a higher retirement income.

ACTION

If you can see yourself contributing to a personal account – as an employer or an employee – it could well be that you should not be waiting for the government to prod you into action. There are plenty of pension options available now, nearly all of which offer more investment choice and benefit flexibility than personal accounts are likely to.

The personal account will be the universal pension default option. If you want something that is more truly ‘personal’, talk to us.

A NEW ACADEMIC YEAR

October marks the start of the new academic year for most universities. In England, that means an increase in the maximum university fee to £3,145 a year. In theory universities do not have to charge the maximum, but in practice very few do not: to date the need for finance has suppressed any competition to attract new students.

Under the English system – there are different student support rules in the other parts of the UK – neither you nor your student child has to find the £3,145 of fees up front. Instead the fees are paid by way of a loan, which does not carry interest but is index-linked. The loan for fees sits beside the loan for maintenance, which can be as high as £6,475 a year for a London student living away from home (see table).

2008/09 Student Maintenance Loans			
Living	Studying in	Maximum full year loan*	Maximum final year loan*
London	London	£6,475	£5,895
Away from Home	Outside London	£4,625	£4,280
At Home	Anywhere	£3,580	£3,235

*25% means-tested and reduced by £1 for each £1 of maintenance grant received up to £1,260.

The combined maintenance and fee loan starts to be repaid once the student ends their course and is earning £15,000 a year or more. The repayment rate is 9% of earnings over £15,000 a year so, for example, a graduate earning £24,000 a year –

around the average graduate starting salary – will repay his debt at the rate of £810 a year (£9,000 x 9%). That will do no more than match index-linking for £17,609 of debt at the current (June 2008) inflation rate of 4.6%. Many graduates will have a higher debt after three years of tuition fees and maintenance loans.

The loan repayment, which is usually operated through the PAYE system, is tantamount to a 9% tax, so until their loan is repaid, graduates face effective tax rates of 29% and 49%. Add in national insurance contributions and the typical graduate employee pays a marginal 40p or 50p in the pound to the government.

The potential burden of debt for new graduates is substantial – well into five figures – and could take many years to clear. There is now a maintenance grant of £2,835 a year for new students, but it is means-tested against parental ‘household income’ above a £25,000 threshold. If a new student’s household income is more than £60,005 there is no maintenance grant.

ACTION

Planning for the costs of university is now more important than school fees planning for many families. However, the strategy will usually be to give the graduate sufficient capital for the start of their working life and, possibly, a deposit towards their first home rather than immediate repayment of student debt. Inflation-linked borrowing is cheap money – the ‘interest’ cost is still less than base rate and well below the typical mortgage rate.

If your child – or grandchild – is destined for university, call us for a discussion about planning their finances. As with school fees, it is never too early to start.

INFLATION RETURNS

The June inflation figure came as a surprise to many. The annual rise in the retail prices index jumped to 4.6%, while the government’s chosen inflation target, consumer price inflation, hit 3.8% against a target of 2%. The next few months are likely to see higher figures, if only because a year ago prices were virtually unchanged between June and September 2007.

If you are a higher rate taxpayer, 4.6% inflation means that you have to earn 7.67% gross interest from bank deposits just for your cash to retain its purchasing power. If you are a basic rate taxpayer, the corresponding interest goal is 5.75%.

An Inflation Checklist

- When looking at investment returns, allow for inflation as well as tax.
- Think about building inflation protection into your pension to avoid a steadily falling standard of living in retirement. But be warned, an inflation proofed pension annuity can cost over 60% more than its non-increasing counterpart.
- Check that your life and health insurance cover has kept pace with inflation. For example, if you had life cover of £100,000 five years ago, it needs to be £119,581 today to maintain purchasing power.
- Should you be increasing your regular savings? To match £100 a month saved in January 2000, you would need to be putting aside about £130 a month now.

ACTION

If your financial plans have not been reviewed for a few years, inflation may have left them in need of repair. They should certainly be reviewed.

Talk to us about updating your financial planning for 2008.

TAX RETURN TIME

If you do not want to use the internet to file your 2008 tax return, remember that you must now submit your return by 31 October 2008 or face a penalty. File by internet and you can still procrastinate until 31 January 2009. However, given HMRC's systems problems this January, leaving it until the last minute is not to be recommended.

If you have not received a tax return (or a reminder to file online), that does not mean you have nothing to do. If you had a new source of income or realised capital gains above the £9,200 annual exemption in 2007/08, you must tell HMRC by 5 October 2008.

ACTION

Don't ignore your tax responsibilities. One sure way to increase your chances of becoming a 5 star HMRC 'customer' is to miss a filing date.

DIVIDEND YIELDS

Falling shares prices have grabbed the headlines regularly this year, but there is a flip side to the declines that receives less attention: rising dividend yields. At the time of writing, the average dividend yield on UK shares, as measured by the FTSE All-Share Index, was 4.3%.

This figure is a net return for basic rate taxpayers, so the after-tax income from shares today is *more* than the net income from a deposit paying base rate (5% gross). Usually the opposite is true – the income from shares is lower than from deposits because:

- Shares offer scope for capital growth, which deposits do not; and
- Over the long term dividends have risen in line with inflation, whereas deposit income generally moves up and down with bank base rates.

The current reversal is due to two factors:

- Share price falls have driven up dividend yields;
- A few companies – notably the banks – are likely to cut or even stop paying dividends in response financial conditions.

ACTION

If you want to invest for income, think about placing some of your money in share-based investments. Whereas this used to mean a sacrifice in immediate income, for now the opposite could be true.

For advice on equity income funds and a comparison with your other income options, please call us.

Past performance is not a reliable guide to the future. The value of investments and the income from them can go down as well as up and you may not get back the amount that you originally invested. The value of tax reliefs depend upon individual circumstances and tax rules may change. The FSA does not regulate tax advice. This newsletter is provided strictly for general consideration only and is based on our understanding of law and HM Revenue & Customs practice as at July 2008. No action must be taken or refrained from based on its contents alone. Accordingly no responsibility can be assumed for any loss occasioned in connection with the content hereof and any such action or inaction. Professional advice is necessary for every case.