Financial directions

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FINANCIAL PLANNING LLP

SPRING 2010

One year on...

"The only thing we learn from History is that we learn nothing from History" Georg Wilhelm Friedrich Hegel 1770-1831

One year on from the collapse of Lehman Bros and the start of the banking crisis there have been a number of television programmes and articles about the events leading up to it and much questioning about how it was allowed to happen. The really frightening thing is how many similarities there were between the high risks being taken by the banks, with their highly geared investments into sub prime mortgages and other sophisticated financial instruments, and the actions of a company called Long-Term Capital Management (LTCM) in the 1990s. The collapse of LTCM, just ten years earlier in 1998, was said to have nearly blown up the world's financial system. It was so big that the Federal Reserve Bank of New York took the unprecedented step of facilitating a bail out for fear that a forced liquidation might bring a total collapse of the world markets. Yet just ten years later it happened all over again!

There has been much talk about the bonus culture of the banks creating these problems. Whilst unpalatable to many these bonuses are not the cause, they are just a symptom. The cause is the irresponsible abuse of 'light touch' regulation, the low capitalisation that the banks have been permitted to maintain and the extraordinary lack of clarity around vast numbers of transactions in which they were involved.

This lack of constraint allowed the banks to make vast profits by taking ridiculous risks, world economies seemed to be enjoying unprecedented growth and governments basked in reflected glory.

Small wonder perhaps, that there seemed to be little incentive to question the viability of sustaining this growth. Have we learned the lesson this time? Probably not. Regulating these matters on a global basis is a massive challenge, because there will always be someone prepared to break the rules; but if it is not overcome it can only be a matter of time before it all happens again.

All this is very worrying for people who are trying to look after their money sensibly, whether by using the different means available to invest into shares, or simply by leaving the money in the bank. All types of investment carry different degrees of risk.

As and when inflation reoccurs, as it is almost bound to do in view of the country's massive debt burden, the purchasing power of money held on deposit will erode substantially. Cash on deposit, in the long term, is therefore not a risk free investment.

The most practical approach to this problem is to diversify your funds across a wide range of different assets. These can include investing into shares, bonds, properties and commodities. It is impossible always to be in the right place at the right time and it can be an expensive exercise trying to achieve it. Selection of an appropriate asset allocation and then rebalancing the portfolio from time to time reduces risk and improves performance.

We have worked out that if you put £100 into each of the eight asset classes eighteen years ago, then by the end of 2008, when markets were on their knees, you would still have a figure of £3194, which represents an average annual growth rate over the period of 7.99%. This is considerably in excess of the amount which would have been returned by a bank deposit account and more tax efficient. It shows a "real" return over inflation of approximately 4% per annum.

Assuming, for a moment, that you achieved the impossible and switched 100% of the funds every year into the asset class that transpired to be the best in the year following, then by the end of last year your £800 would have grown to a massive £152,842. An average of 33% per annum. On the other hand had you managed to get it completely wrong and switch into the worst performing asset class every year you would now be left with paltry £35. An average loss every year of 16%.

A really important observation that comes out of this exercise is that by simply investing the same amount into each asset class and then evenly re-distributing the balance each year, the volatility would have reduced and the average annual return increased to 8.66% pa The fact that the maximum potential return was 33% pa and the maximum loss 16% pa indicates that if a degree of tactical asset allocation is used when re-balancing, the potential rewards for getting it right are higher than the potential penalties for getting it wrong. Asset allocation pays such an important part in overall performance that we have been moving towards building in to our clients' portfolios more passive investments which replicate the different asset classes through index funds and exchange traded funds (ETFs). This is a more economical approach than managed investment funds and there are certainly strong arguments for adopting this approach as the core of an investment portfolio.

Are you making the most of your tax free savings?

From 6th October 2009, those aged 50 and over could invest a maximum of £10,200 in an Individual Savings Account (ISA). Of this total, up to £5,100 can be invested in a Cash ISA and the remaining balance into a Stocks & Shares ISA. Alternatively, you could invest the full £10,200 into a Stock & Shares ISA. The new limits will also apply to those who turn 50 on or before 5 April 2010. For everyone else the new limits will apply from 6 April 2010.

There are two types of ISA, a Cash ISA and a Stocks & Shares ISA. You can use your ISA to save cash or invest in Stocks & Shares, an ISA may be a good way of maximising tax efficiencies:

- **Interest on any savings held in a Cash ISA will be tax free**
- **Income and Capital Gains from an ISA are virtually tax free**
- **The Capital Gains tax saving is important too, especially when used together with the annual Capital Gains tax exemption (£10,100 for 2009/10)**

(The value to you of current tax relief depends upon your personal circumstances which may change in the future. Tax law and HM Revenue & Customs practise may change in the future to reduce the current favourable tax treatment of ISAs.)

ISA allowances can not be carried over from one year to the next so it is important, where possible, for you to use your full yearly allowance.

Where you are utilising your annual ISA allowance through a personally managed investment portfolio, it is worth checking whether your stockbroker or investment manager is making this as tax efficient as possible. People forget that equity based investments held through an ISA will have 10% income tax deducted at source which is non-reclaimable. However if fixed interest investments such as corporate bonds or gilts are held within your ISA, these are not subject to income tax and so will roll up completely tax-free.

Please note that all ISA investments are still subject to Inheritance Tax if applicable.

Should I buy my pension annuity now?

Good news, we have now seen a recovery in the stock market since its horrendous falls last year. This clearly has had a positive effect on our client's pension funds and they are now in better shape than say six months ago. Over the period and although still down, pension annuity rates have stood up reasonably well too. With this in mind, could now be a good time for people who are approaching retirement age to take their pension annuities?

It is very difficult to predict what the stock markets will do in the future and many talk about a double dip correction in 2010, as investors profit take and if 2010 economic forecasts are not borne out. Interlinked with this, our general view is that annuity rates are likely to go down again and so for those who hang out expecting rates to increase with age, they could catch a cold.

Two reasons for this view are:

Firstly, in an effort to stabilise the economy, the Bank of England has been buying gilts which has forced the price of gilts up, and driven the income payable down. As annuity rates are largely made up of this Gilt income, it has consequently put pressure on annuity rates and we expect them to go down.

Secondly, we are all living longer with the average 65 year old male living about five years longer than he would have done 20 years ago. This means that annuity providers now have to pay incomes out for longer and they will therefore have no choice but to cut back on the rates payable to new annuitants.

So what do we conclude from this? Well if you are thinking of retiring in the near future, then perhaps taking benefits sooner rather than later is the best decision. Just a thought...

If you have any queries on this or any other aspect of financial planning, contact Jason McGuigan on 01865 2611170 or email jmcguigan@critchleys-fp.co.uk

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Should I always take the tax free cash from my pension fund?

When you do retire with an accrued pension fund, you will normally be offered a tax free lump sum of typically 25% of the accrued fund. Clients who are seeking to maximise their retirement income often ask us whether they should take the tax free cash regardless and invest for income or just use 100% of the accrued pension fund to buy their annual pension. Whilst our answer will always depend on each individual's circumstances, in many cases, our advice will always be to take the cash.

Why? Well firstly, pension annuity income is fully taxable at your highest marginal rate whereas you could invest the cash sum more tax efficiently using things like ISAs for example. If you don't need to keep control of the capital sum and seek maximum income, you could instead invest the tax free lump sum into a Purchased Life Annuity (PLA). Here you give away a capital sum at outset and in return, you will get a guaranteed income for the rest of the life. Like a normal pension Annuity, the level of annuity income payable will depend on many factors such as your age, your health, whether you wish to provide a spouses pension or any inflation protection etc. BUT the key benefit of the PLA over the standard pension annuity is the differing tax status. This is because part of the PLA income is classed as return of capital and thus is not fully taxable. When compared to a pension annuity therefore, you could end up with more "after tax" income.

Here is an example….

Male age 60 in fair health looking for a joint life level annuity with a 50% spouse's pension.

Under the pension annuity option and with a £20,000 equivalent tax free lump sum available that he decides NOT to take, he would generate an annuity yield of 6.35% gross or an annual pension of £1,270 gross pa. This would net him £1,016 pa after 20% basic rate tax is deducted. (The tax hit could be even greater if you are a higher rate tax payer.)

In contrast, had he taken the £20,000 tax free lump sum and invested it into a PLA on comparable terms, he would only secure an annuity yield of 5.84% or £1,168 gross annual pension BUT as a large part of the income paid is classed as return of capital and thus is non-taxable, he nets £1,080 pa on the same sum invested – an increase of £64 pa in this example.

You will see in this case that if you are in poorer health, you can secure a higher annuity when compared to normal market rates and this is because in both cases, your life expectancy is potentially reduced and thus the annuity provider expects to pay out for a shorter period, due to your impaired health. For those with long term care needs, you could even invest into an "Immediate Needs" annuity. This is a PLA where your annuity income is enhanced to reflect your poorer state of health. BUT should you decide to pay the annuity income direct to the care home provider, there will no tax deduction at all leading to even further savings.

In summary, with interest rates on cash deposits at an all time low and if you are seeking more income in retirement, a PLA could be a great way of securing a higher level of guaranteed income for life in return for a capital sum.

To see online comments about this blog and Jason's responses, please visit http://blog.critchleys-fp.co.uk/

If you have any queries on this or any other aspect of financial planning, contact Jason McGuigan on 01865 2611170 or email jmcguigan@critchleys-fp.co.uk

Planning for a 50% Tax rate

In approximately 3 month's time, changes to the UK tax rates announced in the 2009 Budget, and the Pre-Budget report will have become a reality. The changes already announced mean the following:

- **60% top rate of income tax will apply to people earning between £100,000 and approximately £113,000. Income above £113,000 but below £150,000 will remain taxable at 40%.**
- **Claw back of tax relief on pension contributions – from 6 April 2009, incomes of £130,000 could easily be affected by this change.**
- **50% tax rate on all income over £150,000.**

We understand the pressures that higher taxation imposes on our clients still struggling to beat the recession, now facing even greater burdens imposed by Government. That is why our tax and financial planning teams have put together a number of strategies to help reduce tax burdens during what will inevitably be a period of severe taxation that is likely to continue for at least 4 years.

If you would like to take advantage of this please telephone Tim Keeley, Personal Tax and Trust Planning Partner on 01865 261133 or email tkeeley@critchleys.co.uk

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Events 2010

25 February 2010

Help your clients protect their estates against inheritance tax

6.00pm – 9.00pm

Manches, 9400 Garsington Road, Oxford Business Park, Oxford

An event specifically designed for accountants and lawyers. We have joined up with law firm Manches to deliver an insightful inheritance tax seminar to talk you through a number of strategies that you can advise your clients to adopt to help them limit their inheritance tax liability.

6 May 2010

Your family or the Government? Who deserves your money more? Protecting your estate against inheritance tax

6.00pm – 9.00pm

Henmans, 5000 Oxford Business Park South, Oxford

Hosted in association with lawyers Henmans private client team, this seminar will cover the following:

- An introduction to inheritance tax
- Inheritance tax mitigation using financial products

To register for further information contact info@critchleys-fp.co.uk

Your feedback

We would welcome your feedback on this issue and your letters/comments for future publications. Please contact info@critchleys-fp.co.uk

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Team news

Ian Brookes & Katy Bruce's little bundle of joy has arrived! Meet Alexander George Brookes who was born on Wednesday 11 November, weighing in at 9lbs 10oz!

Meet the team

TOP LEFT TO RIGHT

Camilla Harris, Co-ordinator • **Jason McGuigan**, Partner • **Rachel Weaver**, Group Personal Pension Administrator • **Chris Miles**, New Business Administrator

BOTTOM LEFT TO RIGHT

Teresa McHugh, Finance Officer • **Ian Brookes**, Independent Financial Planner
Gail Young, Client Support Manager

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