SimplyMoney

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Your independent *window on financial issues*

A budget to help people through the global recession …

The Chancellor was always going to face a tough challenge putting together a coherent budget in the current economic climate.

He has had to make some optimistic assumptions about the rate of recovery in order to generate the level of income the government needs. In any event, it looks like we will soon have the biggest borrowing figures in the country's history.

The recession is forecast by the Treasury to start easing by the end of this year, with a total fall in Gross Domestic Product (GDP) of 3.5%, and economic growth to return during 2010 at an estimated 1.25% GDP growth. Thereafter, it expects growth of 3.5% a year, working towards the long term 'trend' of 2.75%.

If these figures are not achieved, the government's borrowing plans will prove inadequate to cover its expenditure, even taking into account this year's minimal (0.7%) growth forecast for government spending.

Investments

While initial market reaction to an estimated £220 billion in borrowing was adverse, the long term impact will be more difficult to determine.

One positive is that, after years of lobbying, the Individual Savings Account (ISA) limit has finally been increased from £7,200 (including last year's modest rise) to £10,200—half of which can be in cash. Unfortunately, only those over 50 benefit in the current tax year, but younger people can benefit from April 2010.

The change may not sound much, but in percentage terms it is more than 40% extra. A couple nearing retirement can now aim to salt away over £20,000 a year into this 'tax exempt' regime.

Unfortunately, the Chancellor failed to reinstate the tax reclaim for tax deducted at source in respect of dividends from UK companies. Doing this for ISAs and pensions would have been of massive benefit to millions of savers.

Tax and benefits

Minor tweaking of tax on alcohol, tobacco and petrol/diesel was to be expected. It was also unsurprising that the winter fuel allowance has been continued for another year. Improvements to child benefits will help many families and the state pension will rise by 2.5% next year, even if the RPI is at (or below) zero in September. Pensioners on Pension Credit will also see an easing in the amount of capital that can be disregarded in calculating entitlement, from £6,000 to £10,000.

Potentially worse off will be those earning above £150,000 a year who will, from April 2010, see their top rate of income tax rise to 50%, while personal allowances will disappear for those earning more than £100,000 a year.

Those earning more than £150,000 a year will also have their tax relief on pension contributions reduced, down to 20% at £180,000 a year from 2011. Rules are now in place to prevent many higher earners making additional contributions in advance of the change (please ask for details).

Let's hope this all works for the British economy.

THIS ISSUE

Budget review

Absolute returns …

Shrinking mortgage market

Retirement planning

Boosting income now

Absolute returns

At a time when investment markets have been falling, the words 'absolute' and 'return' could well seem attractive. But this area requires careful consideration ... and professional advice.

With investment markets displaying many of the characteristics of a roller coaster ride, investors could be forgiven for seeking 'safer' alternatives to investment markets. But these are not always what they seem and the so-called absolute return funds may not offer all that might be expected.

Absolute return funds aim to give a positive return to investors even on a falling market, doing so through a variety of strategies including the use of bonds, property, cash and so-called 'hedge' funds. They also frequently use what are called derivatives—investment instruments that are 'derived' from other markets, such as equities by allowing investors to 'bet' on future market movements. The principle is that you can make money on a falling market provided that you can borrow shares and sell them at the current price, buying them back when prices have fallen (then returning them to the original owner), so that you make a profit on the difference.

There are considerable risks inherent within this strategy, not least that you get your bets wrong and have to buy back the shares at a higher price in order to fulfil your contractual obligations.

The actual strategy adopted varies from fund to fund, but the aim is always to give a positive return, whatever happens to markets. In practice this is not always achieved and, in a rising market, these funds almost always underperform more conventional funds. And it is here that the crux lies.

Compared with what, if not the market?

Most investment managers compare their performance with the sector in which each fund is invested. So if the managers can achieve a 'top quarter' performance for their fund within the appropriate equity market, they feel they are doing well.

The problem is that, in a falling market, this might simply mean losing less money than most competitors. But individual investors are more interested in seeing their money grow in monetary terms, rather than just comparatively; this is where the apparent appeal of absolute return funds lies.

However, there is little evidence to date that those funds using derivatives actually do much better than more conventional investments. For example, in the last quarter of 2008, the average hedge fund lost 10.23% of its value (source: www.Morningstar.co.uk) while the FTSE100 lost just 9.55% (although the Dow Jones lost a hefty 19.12% over the same period).

What goes down usually comes back up again

For some investors, absolute return funds may have a place in their portfolio. However, most investors may feel that the long term performance of investments are such that recent losses are likely to be reversed within conventional funds, so that making a switch now might be the wrong decision.

There are no guarantees in investment markets, but recent developments simply reinforce the adage that equity investments should always be seen over the longer term, ideally at least five years.

Key points

- Some funds aim for positive returns in *any* market
- There is no such thing as a 'risk free' investment
- Advice is essential to understanding the risks

Importance of advice

According to one source, there were recently just 4,357 mortgage products available, compared with almost 41,000 a year earlier. So who needs professional advice now?

The answer to this comes in the next statistic from Trigold, the system used by many professionals. Apparently mortgage professionals searched for more than 483,500 mortgages last December, a third more than a year previously (source: Incisive Media 14/01/09).

The fact is that with a shrunken mortgage market, it is more difficult to find the right deal, rather than easier. This may seem rather counter-intuitive, since one generally considers that greater choice leads to confusion, so more limited options should make things easier.

All too easy to make a mistake

In theory, making the wrong mortgage decision will mean that you pay more for your borrowing than you need to – and therefore lose money. This is, of course, true but it is not the only thing that can go wrong; and a 'do-it-yourself' approach to arranging your mortgage could have serious consequences. This is because if, in the course of looking for a loan to buy a new home (or simply rearranging your existing borrowing at the end of a special deal period), you apply to too many lenders, you will find your credit rating blighted for some time.

Yet this is precisely what borrowers may try to do, if confused by competing advertised deals. It is here that the services of a professional mortgage broker are so important.

Knowing who to ask

The skills involved in arranging mortgages are not simply a matter of knowing how to present your circumstances in the best possible light,

News in brief

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The FTSE100 fell by 11.5% during the first three months of 2009. The mid-cap FTSE250 was very slightly up over the period. Since then the FTSE100 had fallen further, but at the time of writing has recovered to about the same level; meanwhile the FTSE250 has gained ground.

According to Nationwide, house prices fell by 2.3% during the first quarter of 2009, making an annual rate of fall of just less than 14.6%. However, this is actually the smallest 'moving three months' fall for a year and may indicate a slowdown in the decline, which is good for homeowners.

Oil prices have unfortunately started to rise again, increasing by almost 8% during the first quarter of 2009. At the time of writing, they are still slightly below US$50 per barrel for Brent Crude 1-month futures. This is about half the price of just a year earlier, so consumers are still better off.

Sterling has had a pretty weak twelve months against the dollar and euro, falling by 27.6% and 14% respectively. However it had a better first quarter of 2009 with only a 1.25% fall against the dollar (and actually rising 4.6% against the euro). Weaker sterling helps exports and inward tourism.

so that lenders are more willing to offer you the loan you want on favourable terms.

This is important; but it is also a core part of a professional mortgage adviser's skills to know which lenders are best for what sort of requirements, at any one time. Of course, this will change on a regular basis, as lenders seek to attract a balance of borrowers in order to give them a spread of 'risk'. So what was true last month may not be the case now. If, without the appropriate market knowledge, you apply to several lenders at the same time, the second one will see that a search has just been done by another lender and wonder why. If there is any doubt in their mind—perhaps they imagine that you are desperate for a new loan, or are trying to get two mortgages on the same property—they will be more likely to reject your application. At the very least, your credit score will suffer.

A professional mortgage adviser will know which lender is most likely to be willing to lend to you and will only approach one company. Should that application fail, he or she will have sufficient knowledge and market contacts to re-present your case - possibly to an alternate lender - in the best possible light.

Key points

- **The mortgage market is smaller than a year ago**
- **This makes it more difficult to find the right deal**
- **DIY can lead to costly mistakes; advice is essential**

A century of pensions

Thanks to Lloyd George and his 1908 Old Age Pensions Act, state pensions are 100 years old. In 1909 the pension was five shillings (25p) a week, which was roughly 16% of average wages at the time; 25p then is worth about £19.30 today.

Today the basic state pension for an individual is £95.25 a week, which is less than 20% of a typical income of £25,000 a year, while the pension for a couple is higher at about 30%. While this represents some progress, it is clear that a 70% (or even 80%) fall in income when you reach 65 is likely to constrain retirement activities considerably.

Of course, you already know the importance of making personal provision for what is frequently described as the longest holiday of your life; but failure to plan adequately could make that holiday closer to the experience of an unfinished 1960s Spanish hotel, than an enjoyable time of life.

How much is enough?

Recent research by Friends Provident suggests that people expect to need as much as £832 a month to live on (after housing costs) which is much more than double the amount a single pensioner currently receives from the state.

In practice, an income of even £10,000 a year (especially when it is subject to tax) is unlikely to be adequate to provide a comfortable level of retirement living. With people being far more active than was the case a generation ago, they are likely to need more, rather than less, to live on later in life.

Of course, people are also living much longer than a century ago. In 1909, average life expectancy was 52, so few people ever reached the minimum pension age of 70. Today, life expectancy for a pensioner is around age 77 and for younger people is likely to be much higher.

This means that your retirement pot has to last longer. What is more, interest rates are very low at the moment, so those purchasing an annuity are hit by a double whammy which considerably reduces the income they can expect for a given pension fund.

For some, this could mean deferring their retirement, or using the tax free cash available under their pension scheme for a few years, before making a decision about purchasing an annuity or drawing an income directly from the fund. (This is only available from age 50 to 74, with the minimum age set to rise to 55 in April 2010.)

There are options

For most people a conventional pension plan or self invested pension is the obvious choice for retirement planning, because there is tax relief on contributions at up to 40% (subject to some restrictions) as well as no UK tax on fund growth (other than the 10% tax on dividends

from UK companies) and a quarter of the fund can be taken as tax free cash. However, Individual Savings Accounts also offer tax efficient growth and while there is no tax relief on money put in, there is equally no tax on money taken out, whether as a lump sum or an income.

Some people suggest moving money from an ISA into a pension scheme as this can generate an immediate tax saving, but this is a matter for individual advice, due to the tax implications. In addition, other forms of tax efficient investments are available but these generally involve substantially higher risk and should only be used with professional advice as part of an overall investment portfolio.

Key points

- **People live much longer today than in 1909**
- **The cost of living is rising fast for pensioners**
- **Personal retirement planning is absolutely vital**

Back page briefing:

Boost your income now

With investment markets depressed and interest rates at historically low levels, now may not seem like the time to be considering converting your pension pot into an income.

Some people may have little choice other than to access their pension fund because they are made redundant in their mid- to late 50s and have little prospect of getting another job. For others, it may be that 'early' retirement has always been a target and they are now within striking distance of achieving their goal.

Annuity rates are not particularly attractive at the moment. However, the option of using an accumulated retirement pot to generate an unsecured pension could well be of interest. One reason for this is that you can (provided you are over 50 now, or 55 from April 2010) take your 25% pension commencement lump sum (currently tax free) without purchasing an annuity—or even drawing an income from the balance of the fund.

This means that you can 'have your cake and eat it', receiving a lump sum but avoiding switching everything from equities into gilts (which are what back annuities) at a time when the FTSE100, in which many pension funds are invested, is over 35% below its long-term trend.

'Drawdown' in action

For example, with a pension fund worth £400,000, a 55 year old man might today expect to have a retirement income of as much as £38,000 a year, ignoring any tax free cash or widow's benefits (source: www.sharingpensions.co.uk). This is, of course, taxable so the net figure could be in the region of £29,500 (based on the assumption that there are no other levels of income, so that basic rate tax only applies).

By taking a tax free lump sum of £30,000, the net income would be roughly the same and the pension fund would still be worth £370,000. Should markets recover, this would enable the investor to decide what to do next year, which could include, repeating the exercise, altering the amount taken or buying an annuity. (Of course the growth is unlikely be sufficient to 'make up' for the amount taken as a lump sum, so the eventual annuity would potentially be smaller.)

Death benefits

Once benefits are being taken, the way funds are treated on death changes. In this case, £120,000 worth of the fund will have been crystallised (that is, 4 times the amount taken as tax free cash). So, in the event of death, the *un*crystallised part of the fund (£280,000, or £400,000 less £120,000) will be available for use to purchase a dependant's annuity or returned to the estate. However, although the remaining £90,000 left in the fund (i.e. £120,000 less the £30,000 taken as cash, no income having been taken) could be used to provide a dependant's income in the same way; should the money be returned to the estate as a lump sum there would be a 35% tax charge.

Age 75

At age 75, everything changes; it is no longer possible to take further tax free cash, and a minimum income must be drawn from the pension fund. In fact the additional tax on death may make this unattractive to those who do not have strong religious objections to annuitisation.

This approach many not be suitable for everyone and, as ever, you should take individual professional advice before making any decision relating to your personal finances. The value of investments is not guaranteed; you may get back less than you put in.

Key points

- **Interest rates are low at the moment**
- **Using pension funds may be an option for some**
- **Death benefits are different once benefits are taken**

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