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Provident Money

Your **independent** ***window on financial issues*** **Autumn 2006**

In this issue:

- **Pensions—So much has changed, here is a brief overview.**
- **Pound cost averaging—are lump sum investments better than regular ones?**
- **Private Medical Insurance—a growing necessity or a luxury?**
- **Consolidating your assets could make for an easier life—we look at the new "Wrap platforms".**
- **Inheritance Tax—recent changes could mean that many plans put in place over the last seven years no longer fully achieve their objectives. We look at the current position and highlight some of the main issues.**
- **Back page briefing—Is the housing market set to collapse? Not according to recent research from the OECD. In fact we are one of the strongest countries in the group of 17.**

Don't be confused by pensions

As you will be aware, everything changed in the pensions world on 6th April 2006, as new rules were introduced to bring together the many regimes that have grown up over the past 50 years or so, for private pensions.

But the state pension is still something of a mess and the recent White Paper, issued by the government following a report by Lord Turner's Pensions Commission, makes it clear that the country simply cannot afford to continue providing pensions at their current level for long.

The problem is that the basic state pension (currently £84.25 a week for a single person and £134.75 for a married couple) has for more than a decade been linked to inflation, rather than average earnings, which tend to rise faster.

One good aspect of the White Paper is that it proposes restoring the link to average earnings. The downside is that this will not occur until 2012—and then only if it can be afforded. In the meantime, state pensions will continue to fall in value, compared with earnings.

To make matters worse, anyone under 47 will have to wait longer to receive their state pension (the retirement age for women between 51 and 55 is already rising towards 65, in stages).

It is perhaps fortunate that these proposals come at a time when it is possible for most people to significantly to increase the amount they save towards their retirement. The ability to put up to your entire income into a pension scheme (subject to an overall limit for tax relief purposes of £215,000 for 2006/7 and rising thereafter). This will allow people to increase their level of savings to cover the fall in relative value in the state pension between now and 2012, as well as to reflect the fact that the basic state pension—even when indexed—really does not provide sufficient to live on, in later life.

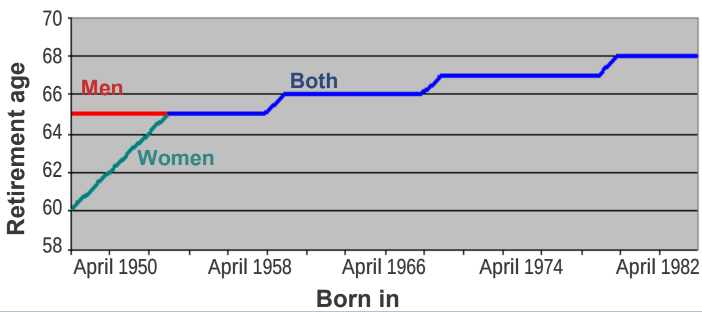
Younger people must plan pensions

Most importantly, there is greatly increased flexibility over how benefits are taken; it is now possible to have your tax free cash at any time after age 50 (rising to 55 in April 2010) without drawing an income. Alternatively, you can decide to draw your tax free cash and then a "maximum" income of up to 120% of the annuity rate at the time directly from your pension fund for several years, before reducing that income, as other sources, such as the state pension, become available to you.

This approach allows you to compensate for the changes while holding some of your pension fund back for later on, as required. And you can, of course, buy an annuity later on if you wish to.

Why not ask us for details of how you are likely to be affected by the recent—and proposed—changes?

Proposed increases to state retirement age

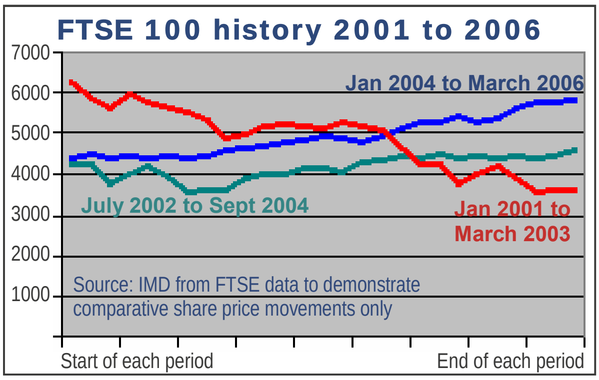


Which are best, regular or lump sum investments?

It has often been said that regular savings are better than single investments, in order to benefit from what is known as pound cost averaging. But is this necessarily true? We have looked at this issue in detail.

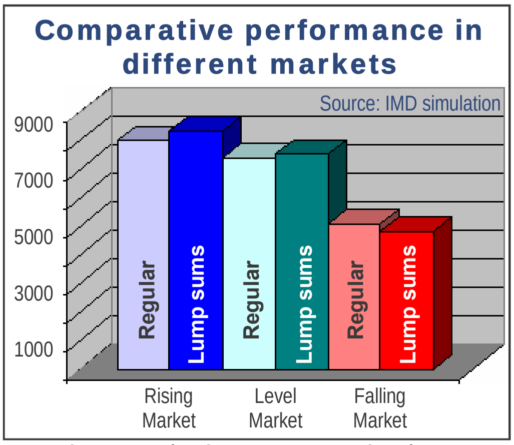
Pound cost averaging is the expression used to explain the fact that if you invest the same amount of money on different dates at varying prices, you get more 'units' or 'shares' for your money when prices are lower, than when they are higher. This is something of a "truism".

Conventional wisdom has it that price fluctuations will usually mean that you benefit from buying units over a period of time rather than all on one day—so called pound cost averaging. We decided to test this by looking at the FTSE 100 over three periods of 27 months selected from the last six years. (These unusual periods were selected primarily because they are not used for investment performance comparisons.)



In each case, we assumed that £250 was invested each month or that £3,000 was invested at the start and after 12 months, while £750 was invested after 24 months. In this way a total of £6,750 was invested over the entire period. We took the value of the FTSE 100 over the period to represent constantly changing prices and ignored the effects of charges and tax; this is after all simply for comparison.

The three periods selected were one of a rising market, one of a static market and the third of a falling market.



In the case of the rising market, it would be natural to expect that investing a lump sum at the start of each period would do much better than regular investments, simply because all the units were purchased at the lowest cost. However, because prices seldom rise uniformly, there were times when the monthly investments actually purchased more units than at the outset. The net result of this was that while the lump sum investments actually outperformed the regular contributions, the difference was modest at just over 4% more than the regular contribution result for the same total outlay.

In the case of a broadly level market, the difference was even smaller at just under 2% more for the lump sum. This appears to fly in the face of conventional wisdom that regular contributions are better than lump sum investments because of pound cost averaging.

However, when we come to look at the impact of a falling market, the position is reversed. In our simulation, both methods of investment actually showed a loss, but that relating to the regular investments was smaller than that relating to the lump sums by more than 5%. In this case, the regular contributions were better. More importantly, because more 'units' were held at the end of the period, the result of any subsequent upswing in the market would be even more beneficial.

What you win on the roundabouts you lose on the swings

The conclusion of this simulation—which might not be replicated in other conditions—is that there is not generally a discernible difference in fluctuating markets between regular and occasional lump sum investments. Clearly, these examples are by no means likely to be replicated precisely and you should note that the potential for loss is by no means smaller than the potential for gain.

What is important is that investments are made, and in a pattern that suits you. But you must always remember that the value of investments is not guaranteed and you could receive back less than you invest.

Key points:

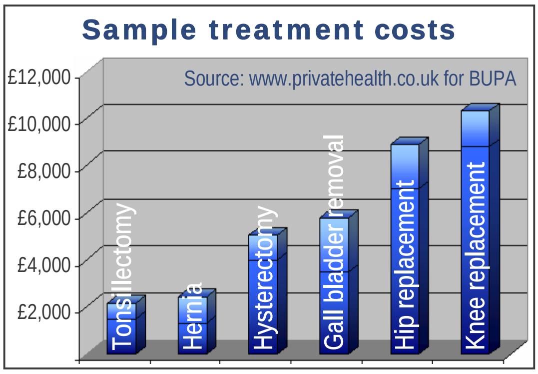
- Markets can go down as well as up so you must be prepared for reversals.
- Ultimately, there is less difference in performance between regular and single investments than you might think.
- What is important is that you do invest for the future.

Are you happy with the NHS?

Most people with any experience of hospitals will probably agree that individual doctors and nurses give a first class service. The problem is that, as a whole, the NHS simply does not seem to be getting its act together.

However much of our money the government pours into the system, it never seems to be enough to provide all the treatment people need. It is not just the waiting lists—although these can be frustrating enough. But there also appears to be a ‘postcode lottery’ for certain types of treatment, which appears to make where you live of higher importance than how urgent your need is.

For many families, a preferred option is to go for private healthcare, but the costs can be significant and are rising.



As the chart show, the cost of a simple tonsillectomy can range from £1,500 to £2,150, while a knee replacement can cost as much as £10,300.

Any family can find that they have a need for medical treatment at some time or other. If the NHS cannot respond promptly enough, for whatever reason, finding the amounts indicated above is unlikely to be practical for most—or even if it is, would they wish to commit so much?

Fortunately, there is a strong Private Medical Insurance market in existence that can help families find the right treatment when they want it—and from the consultant they choose. There are plans to suit all pockets from cash plans that provide some money to cover the additional costs associated with a hospital stay, through to plans that cover virtually everything—at a price.

Medical care is not cheap, so insurance can help spread the cost

The problem can be that there are so many different schemes on the market that selecting the right one to suit your needs can be difficult. Independent Financial Advisers are ideally placed to help clients through the maze of options, helping them to find the right scheme to suit them.

Of course, the cost of private medical insurance is directly related to the number and size of claims. So as you get older—and everything becomes more expensive—the cost of medical insurance rises. There are, however, ways of keeping the cost down, including accepting the first part of every claim (you can achieve substantial discounts if you are prepared to pay the first £1,000, £2,500 or £5,000 yourself, every year) or taking a plan that only pays for treatment if there is an NHS waiting list of at least 6 weeks.

Of course, some private medical insurance is arranged by employers—who may pay for employees and offer a low-cost top-up to include other family members. However, there is usually a tax charge as a benefit in kind which can carry on beyond retirement.

Key points:

- Millions of pounds invested in the NHS has not yet solved the care crisis.
- Private medical treatment is a good idea, but can be very expensive even for fairly ‘routine’ operations.
- Health insurance can provide the finance for treatment.
- There are a wide range of plans to suit most people.

Consolidate your investments for an easier life

Over the years most people tend to build up a “collection” of unit trusts, Individual Savings Accounts (ISAs) and their predecessors Personal Equity Plans (PEPs). Typically, these will be spread across a number of different providers, partly because your investment priorities may have changed from time to time and also because this was the best way to secure a spread of investments.

The problem associated with this is that you can end up with a multitude of statements—received at different times of the year—from a range of investment managers. Not only does this makes it difficult to understand how much your total investments are worth at any one time, but it can also result in filing cabinets full of paper! And if you receive income from you investments, you are also likely to receive a number of different tax vouchers, one for each unit trust holding; resulting in both complicated and error prone tax returns. (There are, of course, no tax certificates for ISAs and PEPs).


Traditional Investments can produce piles of paper

Recently “Wrap platforms” as they are known have arrived on the scene and done much to alleviate the problem. In the same way that supermarkets allow you to buy all of your shopping in one place these Wrap platforms (such as Selestia, Lifetime and Skandia) offer a wide choice of funds (from a range of fund managers) all under one roof. All the communications and records are dealt with on-line centrally and your Independent Financial Adviser can continue to provide all the advice you require.


Information on all your investments can be just a click away

Wrap platforms enable you to invest in many forms of collective investments, as well as equities, bonds and pensions all under one ‘umbrella’ arrangement. They also allow you to consolidate your existing ISAs, PEPs, unit trusts and Personal Pension holdings all together in one place.

For ISAs, PEPs and unit trusts it is often possible simply to re-register them in order to move them on to the platform. The holdings remain invested in the market at all times and the ISA and PEP holdings still retain their tax benefits. Best of all, most re-registrations are free of charge.

The principal benefit of the consolidation process is that you subsequently, only receive one six-monthly valuation statement, which allows you easily to see the value of your investments. More importantly, for some people, there is only one consolidated tax voucher!

Once you have moved your holdings on to the platform you are able to benefit from access to a substantial number of additional funds so that when you and your Independent Financial Adviser wish to review your portfolio you can benefit from cost efficient switching.

Key points:

- Consolidating investments can help you manage them better.
- You need to retain access to difference fund managers.
- Wrap platforms can make this an easier process.

Inheritance tax changes

The threshold at which the 40% inheritance tax applies was raised in the last budget by just 3.6% to £285,000. This means that homes in many parts of the country—when put together with a modest level of investments—will now attract this tax.

This situation has been creeping up on us for some time as the starting point for inheritance tax (IHT) has been rising at a far slower pace than the rise in average house prices recently. For example, while house prices over the past 5 years averaged 3.4% a quarter, the IHT threshold has risen by an average of 3.33% a year from £250,000 in 2002/3, so the gap is rapidly closing between house prices and the level at which IHT starts to bite.

What is new is that the Chancellor has suddenly and without any warning imposed IHT for the first time on certain types of family trust that have historically been used in order to minimise the impact of IHT and help pass more of a family's money down the generations.

The two types of trust that are primarily affected are "accumulation and maintenance" trusts and "interest in possession" trusts. These arrangements are established with the intention of passing money down the generations. In the former case, the primary intention is to ensure that children or grandchildren receive the benefit of income generated by the trust, but cannot actually control it until they reach the age (usually) of 25. In the latter case, the aim is to allow a spouse to enjoy an asset – either the family home, or the interest from capital – during her lifetime while leaving the capital intact for the next generation.

Thousands of ordinary families could be caught

The arrangement assumes that the donor places money into the trust (what is called a Potentially Exempt Transfer, or PET) and then survives for seven years, so that there is no IHT on the money held within the trust.

The change Gordon Brown has made is to state that money being placed into a trust during the donor's lifetime is no longer a PET, but is liable to tax at a rate of 20% in excess of the lifetime limit. What is more there will be an additional tax of 6% every ten years and a further 6% charge when the trust is wound up.

This is an area at which we will be looking in some detail, over the next few months. If you feel you are affected, please contact us.

Back page briefing—housing market on the precipice?

Homeowners have gone through a difficult few years, with house prices rising only slowly for sustained periods. Is a collapse on the way?

It would be a brave—some might say foolhardy—person who predicted that house prices will not fall; after all, we all saw what happened to markets in the 1990s. Yet this is effectively what the Organisation for Economic Co-operation and Development (OECD) has just said. Well, almost.

In a detailed summary of housing markets in the 17 OECD, the UK shows up as amongst the lowest countries likely to see a peak in the market (or, in other words, a fall in house prices) even if there is a 1% or 2% rise. By contrast, Denmark has a 95% probability that house prices will start to fall if interest rates (currently at 3.4%, compared with our 4.5%) rise by just one percentage point.

Indeed, there are only seven countries less likely to see a fall in house prices, including Japan, Germany and Switzerland.

The likely reason for our strength is that the Bank of England's Monetary Policy Committee has exercised tight control over interest rates and this has prevented us from seeing runaway house price inflation, of late.

This does not necessarily mean that we should all rush out and increase our mortgages, because most commentators are preparing themselves for a hike in interest

Negative equity is unlikely to rear its head again for some time to come

tares in the UK in any event. This will obviously increase housing costs, with a knock on effect on inflation, which can lead to higher wage demands and the whole spiral could start again. However, this news should give us all some degree of comfort. Except those wishing to get onto the bottom rung of the housing ladder, of course.