Provident Solutions

Independent Financial Advisers
& Mortgage Brokers

Call us on
0116 2592371
or email:
info@providentsolutions.co.uk
www.providentsolutions.co.uk

Provident Money

Your independent window on financial issues **January 2004**

Time to review your finances?

New Year is a time during which many of us tend to think about planning ahead, as the welcome quiet after the enjoyable storm of Christmas allows a period for reflection.

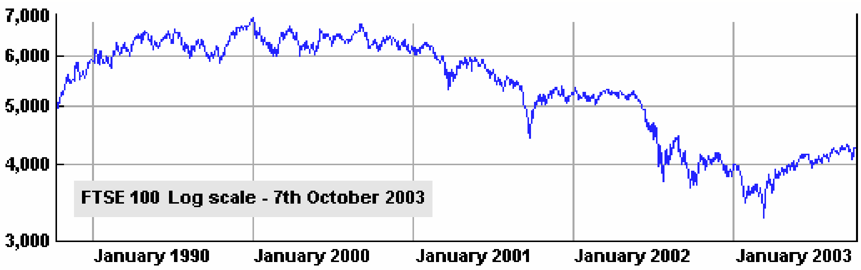
Thinking about holidays can be a good way of warming ourselves up in the winter months, but it is far more important to our long-term wellbeing that we also take a long hard look at our finances in order to ensure that we have the right arrangements in place. This falls broadly into four areas:

- Providing for short-term needs such as that holiday, entertainment, incidental expenses and so on;
- Providing for medium-term needs, such as replacing the family car, paying for education costs, perhaps for school fees, or to help with living expenses and tuition fees at university, later on;
- Providing for the longer term, planning for retirement and possible care needs, later in life; and
- Protecting ourselves and our families against the financial implications of death or long term illness.

And on top of these core financial issues is the need to consider the impact that various charges such as capital gains tax and inheritance tax could have on you and your family. All in all, there is a lot to think about and the need for professional financial advice has never been greater.

In this issue of *Provident Money*, we will be looking at some of these issues in greater detail, but we will also bring you up to date on any new developments in the financial markets, including pensions which are currently very much under government review.

Family finances need thinking about now



This review recognises that individual pension provision in the UK is inadequate and that the State will not be able to afford paying an adequate level of pension, further into the 21st century. With the proportion of those in work—and thus paying National Insurance contributions—falling as a proportion of those drawing retirement benefits, encouraging more individual provision is essential.

We hope you will enjoy reading this newsletter and will be pleased to answer any questions you may have in respect of the issues raised.

If you would like a personal meeting, in order to address these or any other topics, please let us know.

In this issue:

☑ Christmas and the New Year are a good time to reflect on how our finances shape up for the future.

☑ The new pension credit was introduced last October. We look at how it works and the impact it might have on personal finances.

☑ With profit funds are hardly “flavour of the month”, but we look at how they stack up against some alternatives, with surprising results.

☑ Mortgage “overhangs” can give you a financial hangover; don’t get caught.

☑ Protecting your family; some of the key points considered.

The new Pension Credit

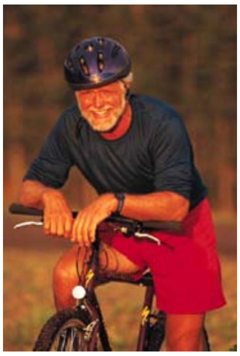
The new Pension Credit, launched in October 2003, aims to help those with low retirement incomes to achieve a better standard of living. It guarantees single people over 60, a minimum income of £102.10 a week (£155.80 per week for couples). At 65, when the basic State pension starts, these figures rise to £139.10 per week and £203.80, respectively.

In calculating the level of credit to be given, the Department for Work and Pensions only counts pensions, earnings from a job and some state benefits. It ignores interest from savings, although it does reduce entitlement to the payments by £1 per week for each £500 invested. This is somewhat draconian, since it implies a gross return of more than 10% a year on earnings, which is highly unrealistic.

So a male personal pension holder retiring at 60 with a fund of £24,000 could afford to take his full tax free cash of £6,000 and be left with a fund of £18,750 with which to purchase an annuity. Assuming no other income and, of course, not being entitled to the State Pension, the index linked annuity he could expect to receive (perhaps £15.16 a week at best), would leave a shortfall under the minimum income guarantee of some £86.94 (less any unemployment benefits he might be entitled to).

For a married couple whose annuity would, naturally, be lower (while the minimum income guarantee is higher) the shortfall to be made up could be as much as £155.80.

Had the pension fund been £40,000 then taking the maximum tax free cash would have given them a lump sum of £10,000 and a residual annuity some two thirds higher, effectively reducing the impact of the minimum income guarantee. What's more, the £10,000 invested would reduce the payments received by a further £8 per week, being £1 per week for each £5000 in excess of £6,000. Spending the cash on a new car clearly has some appeal!



However active pensioners are, Pension Credit rules can confuse

For those women entitled to a basic State Pension in their own right from 60 the figures are clearly reduced by the state pension on a pound-for-pound basis. At 65, when the basic State pension cuts in, the amount claimable (naturally) falls.

This might not appear directly relevant to many readers—particularly those with significant pension funds and other investments. After all, accumulated savings totalling little more than £100,000 would extinguish the benefit completely, for a 65-year-old couple.

However, there are certainly implications for those who may have started planning a little later than they intended, or who have suffered from recent investment downturns.

What is more, many investors may have elderly parents who are capital rich, income poor, as the result of having lived in their home for a long time, the upkeep of which is becoming expensive. For these people, an additional income could be invaluable and the new Pension Credit could make the difference between having to rely on their children to help make ends meet and being comfortably independent.

Key points:

- Pension Credit has to be claimed and can be valuable to those with low incomes;
- Earnings, pensions and benefits reduce the amount that can be claimed;
- Savings are assumed to generate a high level of income and reduce the pension credit £1 per week for each £500, or part thereof, in savings.

Are with profit funds worthwhile?

Nobody would wish to deny that with profit returns have been falling for some years and that maturity values are now much smaller than they were, just a few years ago.

But what may not be so obvious is that, over the last fifteen years, even the poorest performing with profit pension fund performed only a little worse than the top Unit linked fund. Indeed, Money Management's excellent survey—published in October— which is based on £200 a month premiums over the period, shows that the top performing with profit fund beat the best performing unit linked fund by some **94%**.

Janet Walford, Editor Money Management

There are, of course, assumptions within the survey, relating to the fund selected for unit linked performance. Clearly, an equity fund will perform differently from a managed fund—until recently we might have said "better"—but the rule-books are being re-written by experience!

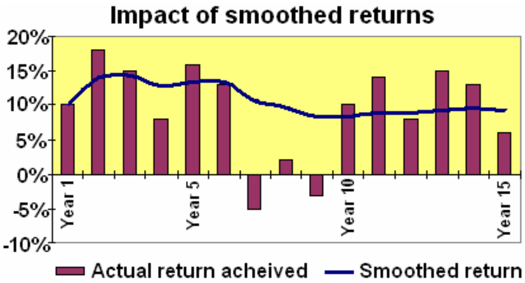
But that is the entire point about a with profit fund. It is intended to offer two benefits that a unit linked fund cannot do—and in return there is usually a trade off, against the maximum upside potential, just as recent performance indicates the limited comparative downside risk. The with profit funds offer diversity and smoothing.

Unlike unit linked funds, with profit funds are usually invested in a spread of equities, gilts, property and deposits (cash).

American research in 2000 suggested that asset allocation contributes more than 90% towards the relative success of an investment portfolio, compared with stock selection and other criteria. This knowledge means that an investment strategy can be developed that reflects specific aspirations and objectives and this can be of considerable benefit in matching likely requirements to resources.

Naturally, no collective investment can reflect the aspirations of all its members and with profit funds are no different. But a broad asset mix ensures that investors can benefit from those assets which do well, while also having some protection against the extremes of poor performance. So, although the best performance of a fast rising market will apply to only a proportion of the fund, so the worst performance of a rapidly falling market will only hit a proportion of the fund.

"Smoothing" is the term used by life assurance companies to describe the process whereby movements in underling asset values are not directly reflected in the value of policies invested in the fund. Instead, a view is taken on the long term performance of the fund and bonuses added to each policy, payable at some time in the future, based on an equitable share in the long term growth of the fund and allowing adequate reserves to be maintained to cover the effects of future short term volatility. The life company will look at the actual returns on its investment strategy and then ensure that different 'generations' of policyholders benefit in such a way that the contribution they have made to the fund is fairly reflected in the returns they receive.



By looking at investment returns over time, with profit funds can balance good years against poorer ones

In the case of unit linked funds, not only is the asset mix generally far less diversified, but there is also no facility for smoothing returns, as unit prices directly reflect the value of underlying assets.

The key problem relating to with profit funds, is their lack of transparency. It is impossible for anyone outside the company easily to understand how charges are taken from the fund and what proportion of investment growth is actually shown in the books. Fortunately, it is the responsibility of the Appointed Actuary to meet policyholders' reasonable expectations and the profession prides itself on maintaining this trust. Nevertheless, a number of companies, as well as the government, are currently considering alternatives that will allow investors to benefit from the advantages of this approach, while minimising the potential downsides.

Key points:

- With profit funds offer a wide spread of asset classes;
- They provide a smoothed return, compared with single asset class investments;
- They can also reduce volatility of performance overall, but adjusting the distribution of profits gradually.

Mortgage "overhangs"

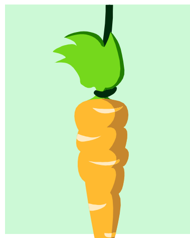
Choosing the wrong mortgage is something that can have a long-lasting effect on your family finances. After all, buying your home is a high priority for most people, but can also be highly confusing, what with fixed rate, capped rate, tracker and offset mortgages, it can be a minefield trying to pick the right deal to suit your needs.

Looking for the lowest monthly cost is not necessarily the answer, because it can often be difficult to unwind an arrangement that suddenly starts to look unattractive, when better deals become available.

For example, so called "cash back" deals—where often quite substantial sums of money are paid to the borrower when the mortgage is actually granted—will often impose stiff penalties if the mortgage is repaid before the end of a stated period; which can be quite a few years.

In the case of some special offers—particularly those where a lower than normal interest rate is offered—there are not only penalties for redemption before the end of the period during which the low interest rate applies, but the penalty can sometimes last longer than the low interest rate.

As a result, borrowers can effectively be locked in to an above average rate, for several years.



Not all carrots taste as sweet as they ought

This situation is usually referred to as an "overhang", that is the penalty lasts longer than the benefit. It is not that these "overhangs" are necessarily unfair—after all, lenders have to make a profit and it is hardly fair that incentives should be paid for by everyone else—but borrowers must know, in advance, precisely what commitment they are taking on.

Clearly, if you select a mortgage that offers a discount for two years you would not wish suddenly to discover that, at the end of the initial period, the rate rises far above the market norm, if switching to another lender, involves penalty payments equal to many month's interest.

As ever, taking professional advice is the best way to ensure that you are not caught out by unexpected conditions.

Key points:

- Some offers are worth looking at very closely to ensure that any penalties do not last longer that the benefit;
- Some penalties can cost more than the saving in switching to an alternative 'cheaper' deal

Protect your family

Protecting our families is, perhaps, one of our most basic instincts. So naturally, we wish to ensure that in the event of our death or long term incapacity, we are still able to provide for them. There are a range of different ways of achieving this and the most appropriate will vary from person to person.

In general, each earner should ensure that in the event of their death, there is either an income from life assurance to replace theirs, in the event of death, or a lump sum that can be invested to produce such an income.

Illness can affect our finances as well as health

Carers—parents and those looking after elderly relatives—should also ensure that they have enough life assurance to cover the cost that the family would have to pay a third party to provide the same level of care.

This form of cover can either be for a level sum, or a reducing level, as future need is expected to reduce—perhaps in line with a reducing mortgage balance, or as the family becomes increasingly self sufficient.

Some life policies are arranged to pay out only on death before a fixed date, others will pay a lump sum whenever death occurs, even if that is long after retirement. A third type will pay out on death before a fixed date, or on survival until then—these are endowment plans.

But it is not just death that can threaten a family's financial health. Long term incapacity—or even the onset of a critical illness which does not initially prevent working—can have a devastating financial impact on any family.

There are a number of different ways of providing against the financial impact of severe illness, the most popular of which are critical illness cover and permanent health insurance.

Critical illness insurance is often, but not always, arranged alongside a life assurance. It normally pays out if one of a list of severe illnesses are diagnosed rather than, as with life assurance, waiting until death occurs. This can be invaluable in helping to meet the additional costs can so often accompany the onset of severe illness.

Permanent Health insurance is rather different. Arranged for a fixed period, normally up to age 55, 60 or 65, it is intended to provide an income payable monthly, from a set time after the onset of any illness or injury that prevents working—often 4, 13 or even 52 weeks—and carries on until the individual recovers, reaches the end of the policy term, or dies.

Probably the most recent form of family protection to be introduced is insurance against the need for Long Term Care. This form of insurance can be arranged when care starts, at retirement or even while working, if required. Clearly, the earlier cover starts, the lower the cost.

Insurance normally operates as soon as the individual is no longer able to perform four out of a list of six activities of daily living, such as washing, dressing, feeding themselves, using the toilet and so on.

There is an ongoing debate about the fairness of insisting that the elderly contribute towards the cost of personal care—as opposed to nursing care—and it is hoped that this will ultimately result in reducing the cost of care, which can cost as much as £25,000 a year, or more, in certain parts of the country.

Key points:

- The need for long term care can affect anyone;
- The costs can be substantial;
- Advanced planning can mitigate the adverse financial effects on the family.

Back page briefing

Significant savings can be made by those who have insurance company bonds that are reaching specific dates where Market Value Adjusters—-which allow insurance companies to reduce policy payouts to reflect market conditions, rather than paying the face value of the policy plus any bonuses—-do not apply. These breaks can occur on the fifth, tenth or other policy anniversaries, but few insurance companies will remind you when one is approaching, so it is a good idea to look out your documents and see if such an anniversary is approaching; cashing in at the right time and switching to an alternative investment might be worth considering.

You can effectively 'lock in growth to date, without necessarily suffering the full impact of the last three years, while making a fresh start for the future, based on today's relatively low market values.

If you run a small business, you might be able to earn a 'pay-back' from the taxman, by switching to electronic payroll filing. This can add up to £825 over the next five tax years, starting with £250 in 2004/5. A bit late for this Christmas, perhaps, but many small business (who do not currently *have* to register for this for some time) will find the system easy to use and should save time, as well.

Number of employees	1st compulsory returns due
250 plus	2004/5
50 to 249	2005/6
Up to 49	2009/10

Incentives available for e-filing 'earlier' than required are:

- £250 for years 2004/5 and 2005/06;
- £150 for year 2006/7;
- £100 for year 2007/8; and
- £75 for year 2008/9.

For more details visit the Inland Revenue Website at www.inlandrevenue.gov.uk