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Your independent window on financial issues

New Year 2005

Time to return to the party?

Those investing in equities have had a difficult few years; "shocks and scares, rather than stocks and shares", as one commentator put it. But, while nobody realistically thinks that we are in for a return to the sustained period of growth experienced in the 1980s and late 1990s, there could still be scope for long term growth.

The main point, however, is that investors—whether putting their money into equities, property, or other forms of asset—must be prepared for a degree of volatility. As the chart alongside shows, prices have grown over the last two years, although the FTSE100 is still well below its high of 6930.2 at the end of December 1999. Many would argue that the market was then overpriced and a return to such high levels is unsustainable; and this may well be true for the next few years.

However, a more gradual rate of growth—supported by solid economic foundations—could offer equity investors a far more profitable long term.

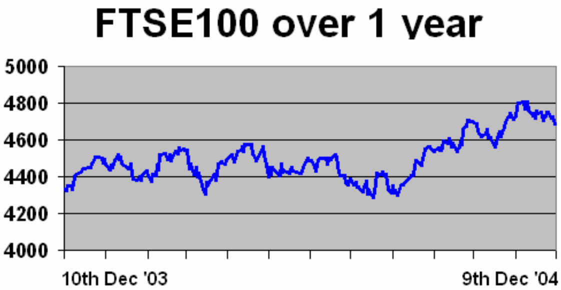
More importantly, as the recent Pension Commission report clearly indicates, there is a massive gap in pension provision within the UK, which needs to be made good; and the government simply cannot afford to make up the shortfall. Already the value of the basic State Pension is linked to inflation, rather than average earnings, thus reducing its effective value compared with wages. It is likely that, as the proportion of those in work compared with those claiming benefits continues to fall, the value of State benefits will reduce even further.

Of course, planning for retirement is not just about pensions, it can involve a wide range of different ways of saving for the future, some of which may not be available—at least to the extent they currently are—for long.

Chancellor protects ISAs for 5 more years

At one end of the spectrum are the high risk Venture Capital Trusts (VCTs) and Enterprise Investment Schemes (EISs), both of which were granted temporary enhancements in the last budget. But for the majority of investors, the tax efficiency of Individual Savings Accounts (ISAs) which have been around since 1999 offers far greater flexibility, in practice.

ISAs can currently accept investments of up to £7,000 per person each year, invested all in Equities or, in its Maxi-ISA guise, up to £1,000 can be invested in life assurance and up to £3,000 in cash. This means that a husband and wife can invest as much as £14,000 a year



Share prices are well within their 1-year range as markets grow

in an account that attracts no tax (although it is no longer possible to recover the 10p tax deducted from every pound of UK dividend income) and the cash or an income can be drawn tax free, when required.

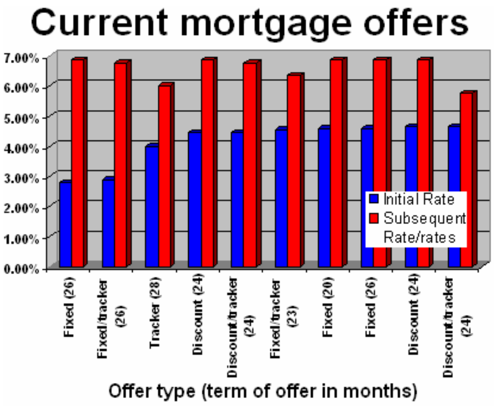
The Government had indicated that the maximum annual contribution was to be reduced to £5,000 per person, including up to just £1,000 in cash, from April 2006. Fortunately, the Chancellor announced in his Pre Budget Report in December, that he would consult on extending the current rules to 2009, so there is every chance that couples will be able to continue investing £14,000 between them, in such a tax efficient way.

So looking at maximising the amount invested in ISAs now and next year could well be worthwhile. But it is also important to ensure that your investments match your short-term as well as medium- to longer-term needs. This means ensuring that there is a balance of asset classes, some of which are available to meet day-to-day needs and emergencies, while those intended to provide lump sums and income in the future are geared towards assets that are likely to provide longer term growth potential.

Is your fixed rate mortgage running out?

About now, thousands of families throughout the UK are finding that they have come to the end of their fixed rate mortgage period, with the prospect of facing a return to standard variable rates.

For many borrowers, there may be little choice, either pay up, or face hefty exit charges that run beyond the expiry of the fixed rate period. Of course, not all discount or fixed rate mortgages carry penalties that 'overhang' the end of the special terms, but many do.



As the table shows, standard variably interest rates can be quite a lot higher than the special offer, so how long an overhang lasts can be vital.

It is also clear that there are a large number of mortgages on the market today, all of which offer different benefits and researching these can take time. So talking with your financial adviser can be important; it can not only save you money to do so, but your adviser can also check that your other financial arrangements are fully up-to-date.

One of the more modern approaches to mortgages is the 'offset' or 'one account' mortgage. These arrangements allow you to reduce the amount of interest you pay each month by offsetting the value of your savings and current account held with the same bank or building society. In practice, this means that if you have a mortgage of £100,000, savings of £5,000 and an average current account balance of £1,000, your monthly mortgage interest will be based on £94,000, rather than the full mortgage. If you repay your mortgage at the same rate as if you were paying interest on the full amount, you will reduce your mortgage more quickly, thus saving interest over the longer term.

Your dream home could turn into a nightmare without the right mortgage advice

Of course, you have to give up any interest on your savings, but these are subject to tax, in any event, and the rates you receive on savings are usually lower than are charged under a standard variable rate mortgage. So on balance you are probably better off giving up the interest on savings.

What's more, because offset mortgage interest is calculated on a daily basis, having your salary paid into your account and then spending money as late in the month as possible helps keep your interest payments down.

And some offset mortgages even allow you to include your credit card and personal loan balances, offsetting the most expensive borrowing first.

Key points:

- Replacing your mortgage at the end of a fixed rate period could be worthwhile, but advice is essential.
- Some special deals have penalties that last longer than the offer period.
- Offset mortgages may suit some borrowers.

Planning for retirement

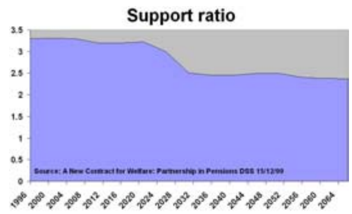
As indicated on the front page, there is a serious pension crisis looming for most of us, with the Pensions Commission reporting that total pension provision is a staggering £57 billion light *every year*.

With a working population of, perhaps, 28 million this suggests that each one of us needs to save an extra £2,000 each year, to make up the shortfall. There are a number of reasons for the problem.

Firstly, the government encouraged employers to reduce or cease contribution levels into (then) well-funded schemes during the 1990s. This might have been safe, had investment returns continued at their high levels, but few could have seriously believed they would do so. And, to make matters much worse, Gordon Brown later imposed a £5 billion-a-year tax charge on pension funds in one of his early budgets—just as investment returns started to fall.

But external factors such as well-publicised problems with a small number of employer sponsored schemes and poor performance of stock markets over the last three or four years have also contributed towards a reduction in the level of personal pension provision.

The key problem for the economy at large—which is, after all, what supports the State pension system—is that there is projected to be a far smaller rise in the number of people in work during the next thirty years, than the growth of the number of those eligible to claim state pensions. This is the so-called "support ratio" and it indicates just how difficult it will be for the state to sustain the level of basic provision, into the future. There are various calls for the State pension age to be increased and, indeed, this is already occurring in respect of women who, by March 2020 will all be retiring no earlier than 65—in the name of sex equality.



Better off investors will be able to weather the storm by relying on their own providence, but will not entirely be able to distance themselves from the effects. After all, for a couple with a retirement income of £30,000 a year, from whatever source, the State Pension represents an extra 22%; a not inconsiderable percentage.

Even middle income families can find that the State pension contributes towards their comfort in retirement

If its value is further reduced, even those who have provided for themselves could well find their standard of living falling.

This makes personal provision more important, but an added complication for some people is the existence of the new Pension Credit.

Being a 'means tested' benefit this can appear actually to act as a disincentive to making any pension contributions, since the proceeds of a pension fund can actually reduce entitlement to the Pension Credit. This is because every extra pound of income is taken off the amount that can be received from the Pension Credit. What's more other savings in excess of £6,000 can also act against you, reducing the potential additional income by £1 per week for every £500 invested.

The Pension Credit is means tested, so savings and pension income reduce its value

However, this is not an argument that should affect the serious investor, since those with any significant level of savings are not entitled to the Pension Credit.

Similarly, calls for compulsion on both employers and individuals to make pension contributions will have little effect on the financially aware since they will already be making personal provision. In any event, the downside of compulsion is that it could, for many small businesses, become a "cost too far" and one that renders them unable to continue to operate profitably. Worse still, there is evidence that in Australia, where pensions are compulsory, the savings ratio generally has fallen, although some commentators say are other factors have contributed towards this.

The pension world is currently going through a massive change, partly as the result of so-called pension simplification and partly as the long awaited Pension Bill, which brings with it the prospect of protection for those members of company pension schemes where the employer goes out of business while the pension has inadequate funds to cover liabilities.

In general, these changes will produce improvements for most people, either through raising the amount they can contribute, or by offering greater flexibility at retirement – in many cases both. What none of the changes will do is actively to encourage people to increase their level of pension contribution.

Nevertheless, it is essential that we all look at how much we are putting aside for our retirement now. We can realistically expect that the effective value of the state pension – already tied to the RPI, rather than National Average earnings – will contribute less towards our retirement incomes than was once the case. As we have already experienced, inflation rises at a slower rate than incomes.

Key points:

- We are not saving enough for our retirement.
- The value of State benefits is falling & may not recover.
- Savings levels need to increase to counter the effects of past events and poor investment returns.
- Even those with personal savings could suffer if means testing is applied to State pensions.

Regulation broadens to cover insurance

Somewhat belatedly, the Financial Services Authority—the body that regulates all financial advisers—has been given the task of regulating mortgages and insurance, as well.

This means that from November 1st 2004, for mortgages, and 15th January 2005, for life assurance, health insurance and home cover (amongst other classes) consumers will be able to benefit from the same sort of protection that investors have had for more than fifteen years.

Insurance and mortgage brokers now follow a strict regime of what they can and cannot do; and training and competence requirements for general insurance will become as important as they already are for investments and mortgages.

We welcome this move, which can only enhance consumer protection.

Protecting your family

Recent research from Egg, the internet bank, suggests that a high proportion of mortgages are unsupported by adequate life assurance to clear them, in the event of the death of the borrower. But the need for protection is far wider than this.

There could be several reasons for the reported shortfall; the most probable of which is that when people increase their mortgage, either to move home, or to release equity to spend on other things such as home improvements, or a new car, they forget to ensure that they have enough life cover. In some cases, people might have switched from an endowment mortgage to a repayment basis and cancelled their policy, forgetting that this provided valuable life assurance.

Whatever the cause, Egg estimated that the average mortgage holder is almost £40,000 light on life assurance cover.

Losing a breadwinner or parent can have a devastating financial effect

Yet at the same time as this shortfall has developed, the last decade has seen a lowering of life assurance premiums, as fear of AIDS has receded and life expectancy has grown longer. This means that the cost of protecting a mortgage – and, indeed, other liabilities – has fallen. For a non-smoking man of 35, the monthly cost of providing £100,000 life assurance to age 60 can now be as little as £10.50 with a leading life insurer. And even a smoker would be paying less than £17.50 a month. For women, who represent an increasing proportion of borrowers, today, the cost of life assurance is lower, since women tend to live longer than men. A non-smoker of the same age could expect to pay as little as £8.87 a month and a smoker, just £14.60 each month.

Of course, costs do rise with age, so it could be that cover arranged some time ago is cheaper than a policy taken out today, as lower ‘mortality’ is compensated by greater age. But at the very least, the cost of ‘topping-up’ any gaps on cover could be relatively inexpensive.

It is also worth, however, considering whether there are other areas where life assurance is insufficient. For example, other borrowings, such as personal loans and credit cards should also be covered by life assurance, unless this is integral to the loan or credit arrangement.

But one of the areas that many families could so easily forget is just how much of an economic contribution a mother makes to the family’s welfare. According to life assurer Legal & General, in its “Value of a Mum” survey, replacing the services provided by the typical mother would cost more than £20,000 a year. So even a “non-working” mum – a phrase that should bring tears of laughter to the eyes of those involved – needs to be insured for a substantial sum, at least as long as the children are at home and needing attention. Interestingly, the same survey indicates that two out of three men underestimate the costs of replacing a mother by almost a half.

And it should not, of course, be forgotten that women also comprise the largest group of carers for elderly relatives.

Nursing homes can prove expensive

The cost of replacing the service that they provide in this context could also be high. As a result, the need for adequate life assurance does not necessarily end when the children are no longer quite so dependent. Those women with elderly relatives who might eventually require care might also need to maintain adequate cover to provide for the cost of replacement care. The British Nursing Association suggests that the cost of three hours a day care for a year could be as high as £10,400.

Key points:

- Many mortgages are backed by insufficient life cover.
- Income protection is almost as important as life assurance.
- Insurance on carers is also very important.

Back page briefing

Fiscal drag is not, fortunately, the Chancellor of the Exchequer dressing up as a woman for the Treasury Christmas Party; it is the tendency for house prices to rise faster than the inheritance tax threshold.

While house prices appear to have started to fall—or at least level off for some time to come—it is clear that the price of the average UK house has risen faster than the miserly increase in the level at which inheritance tax (IHT) bites, for many years. If this continues, there will soon come a point when even the average house (worth almost £163,000 last November according to HBoS) will generate an IHT charge on death by exceeding the IHT threshold (currently £263,000).

There are several reasons why commentators believe house prices will steady.

First, the ratio of house prices to average earnings is at an all time high. According to Nationwide, the average home is now almost six times average earnings. In the mid-1990s, the ratio was less than three to one, so mortgage costs are currently a higher proportion of incomes.

Secondly, interest rates have risen during the last year, so that repayments are significantly higher. This can be a contributor towards wage inflation, which is why the Bank of England is so careful in the way it raises interest rates.

Thirdly, influences such as high world oil prices can lead to economic decline, if unchecked. With production near to its limit and rising demand in China, there is little prospect of them falling significantly for some time to come.

However, sentiment is important in the housing market and if homeowners continue to feel well off, then there is no reason to think that prices will do more than slow their rate of increase.

Whatever the case over the short to medium term, there is no reason to doubt that house prices will continue their longer-term climb. Equally, there is no reason to suspect that the IHT threshold will be increased at anything above its currently miserly rate – after all, why should the Treasury forego such a rapidly growing source of income?

If house prices rise at just 2.5% every quarter and the IHT threshold increases at 2.5% a year, then the average home will breach the IHT threshold during the 2011/2012 tax year; just seven years away. And we have so far only considered house prices. Most people have accumulated other investments and assets by the time they die, so many families may well discover that

their loved ones have become “higher rate” tax payers after they have died; even if they were not so, while working.

There are things that can be done about limiting the impact of IHT, including changing the way the family home is owned; allowing part of its value to be given away when the first marriage partner dies, thus taking maximum benefit from the IHT threshold, which applies to each person individually.

Efficient use can also be made of lifetime gifts, some of which are totally free of IHT and others are Potentially Exempt Transfers (that is, they become free of IHT only if the donor survives for seven years).

It is also possible to use life assurance and some investments to create separate pots of money which are not counted alongside the main estate on death and can therefore be passed to beneficiaries free of IHT.