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Have a prosperous New Year

One way or another, 2007 proved to be an 'interesting' year, with equity markets fluctuating widely and interest rates rising across the world, contributing towards a slowdown in housing markets.

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The slowdown of house prices in the US was a major factor contributing to the credit crisis that led to the run on Northern Rock here and at least one resignation amongst leading worldwide bankers.

Perhaps too much emphasis had been placed on market share and too little attention paid to risk—or at least a proper understanding of it.

Should this act as a cautionary tale for investors in the UK?

Well, yes and no. Taking a one-year view of investments is rather like dipping your toe in the water in January and deciding that it will be too cold to swim in August. All investment decisions need to be taken in the longer term; markets will always be too volatile—and the costs too high—for a one, two or even three year view to be helpful.

Investors should always be looking at five years and beyond when considering investment decisions. For shorter term needs, deposits are usually better, because they offer ease of access, greater security and no volatility. Following recent events, for deposits of up to £35,000 there is now 100% compensation from the Financial Services Compensation scheme (this used to be 100% of £2,000 and 90% of the next £33,000, but was increased on 1st October 2007).

The New Year can be a good time to think about investments and family protection. After all the excitement of Christmas, January can often be a quiet month. It is therefore a good time to reflect on what you have achieved so far, as well as planning what you want to do in the future.

As part of your review, you may wish to consider the following questions:

1. Has the amount you are saving towards your retirement increased by at least as much as your income has grown? Each year there is less time for your money to grow—savings should increase as a proportion of income.
2. Are your investments invested in ways that give you the best chance to protect them against adverse movements within individual markets?
3. Is your mortgage costing you too much? With many mortgages coming to the end of fixed rate periods, you could find yourself paying more than necessary; planning ahead could save you money.
4. Do you have adequate protection for your income, should you fall ill and be unable to work? You need to consider covering not just your mortgage but also other costs of living, if you are not to find yourself eating into savings.
5. Would there be enough for your family to live on should you die? Life assurance is far less expensive than it once was, so you could be able to save money, or at least obtain more cover for about the same premiums.

Whatever you do, we hope you will have a peaceful and prosperous 2008.

THIS ISSUE

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Taxing Capital Gains

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In his first Pre Budget Report, Chancellor Alistair Darling announced a change in the way capital gains will be taxed in future.

Despite a serious level of opposition from business groups, which may bring about a modest U-turn on the taxation of business assets sold at retirement, it is likely that the proposals contained in the PBR will be brought into effect from April 2008.

In essence, there has been a simplification of the entire system. Currently the tax rate can range from 10% to 40% on anything between 100% and 25% of the gain, depending on the type of asset and how long it has been held. The new tax rate will be just 18% for everyone, irrespective of the type of asset or how long it has been held.

As previously, there will be a personal allowance of £9,200 (which could well increase in the Budget) before capital gains tax applies.

In simple terms, capital gains tax will rise on:

- Business assets held by basic rate taxpayers and for higher rate taxpayers holding assets for more than two years;
- Non-business assets held by basic rate taxpayers for more than five years.

Conversely, capital gains tax will fall on:

- Non-business assets held by basic rate taxpayers for fewer than three years and by higher rate tax payers for more than one year.

This means that for those who have held non-business assets for longer periods and almost everyone with business assets, it could be worthwhile realising assets some time before 5th April 2008 so that the current capital gains tax rates apply.

However, because of the annual personal exemption that applies—and in order to take account of other considerations—it is important to take individual advice before making any decisions.

As an interesting side-line, the change in capital gains tax is likely to make unit trusts and open ended investment companies (OEICs) relatively more attractive to investors than investment bonds. This is because of the way they will be taxed in future. The position for bonds will not change, but because tax on realisation of unit trusts and OEICs will be at 18% in future, this is likely to result in a lower overall tax charge for many investors.

However, tax is not the only consideration when looking at investments. Overall asset allocation and investment risk must also be taken into account. So while there could be some merit in considering moving out of bonds and into other forms of collective investment, this should only be undertaken in the light of professional advice.

Mortgages in the "post Northern Rock" world

It is probably unfair to talk about "pre-" and "post-" Northern Rock because the real problems started in the US sub-prime markets.

Sub-prime mortgages are those lent to people with poor credit histories or where the loan-to-value percentage is high; it simply means that the lender accepts greater financial risk than usual.

It seems likely that, on both sides of the Atlantic, market share (rather than purely financial considerations) has been the driving force in making lending decisions. This has led to an increase in loans to those who may find difficulty in repaying borrowings; not necessarily a problem for lenders *if* house prices continue to rise and employment remains high. Defaults should be few and capital recovery—by repossessing and selling the property—relatively easy.

Unfortunately this has not proved to be the case, so lenders are facing losses. This might not matter in the UK had the lenders (particularly in the US) not "securitised" their lending, that is bundled up the debts and sold them to other banks and investors all over the world.

This not only hit equity markets, but also caused a tightening in money markets that sent the rate at which banks lend money to each other—on which Northern Rock and others rely—soaring.

Whatever the reason, it is highly unlikely that the underlying problems are yet resolved and there are predictions that a further set of

defaults will hit the US early in 2008, when borrowers come to the end of low interest rates offered under "teaser" loans at the height of the property bubble in 2005 and 2006.

Combine this with the difficulty that UK banks and building societies are already experiencing in raising money on capital markets to finance further lending and it is not difficult to predict that lending could become tighter. Lower loan-to-value lending multiples and a tightening of salary multiple criteria could result.

How to defend yourself against higher rates

If lenders do have to raise interest rates they are likely to do so selectively, at least initially. Those affected will be people borrowing high proportions of the value of their home, as well as those who have a poor credit history. An obvious defence against this is to ensure that your mortgage repayments are always met on time or

News in brief

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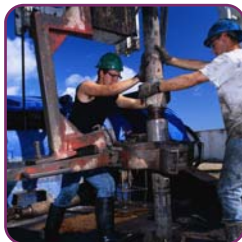
FTSE100 grew by 3.8% during 2007
Despite a volatile year and concerns over the impact on banks and other financial institutions of the 'credit crunch', the FTSE100 rose during 2007. The FTSE250 fared less well, falling by 4.65% over the same period.

House prices up 4.8% during 2007
According to the Nationwide Building Society, house prices fell by 0.5% during December, to end the year just 4.8% up. The average home was worth £182,080 compared with £173,746 this time last year.



Oil prices rose by 54.26% during 2007
At US$93.88 a barrel for Brent Crude 1-month futures, oil prices are more than half as much again as at the start of 2007. While this has impacted on consumer prices, any resulting fall in demand could help slow climate change.

Sterling weakens towards end of 2007
Despite a largely strong year against the dollar, the pound actually ended only 1.39% up. However, against the euro, sterling fell by 8.45% during the year. Should this trend continue, exporters will benefit, while import prices will rise.

that, if you do run into problems, you discuss this with the lender immediately, rather than letting matters run on. Lenders can be very helpful to those who get into temporary difficulties and are less likely to take drastic action if they are consulted early.

Another step that can help you in the longer term is to try to repay more capital early, in order to reduce the overall size of your mortgage.

It is important to know how your lender treats early repayments. Often, you will be credited immediately and future interest payments calculated only on the outstanding balance. Sometimes (especially with offset mortgages) your repayments may remain the same, which means that you are actually clearing more of the debt each month.

With some mortgages, however, the capital is held in limbo until the end of the year and only then is it credited to you. In the meantime, you have been paying interest on the entire mortgage and may not even receive interest on the money you have paid in. (If you do receive interest, this is subject to tax.)

Many modern mortgage arrangements facilitate the flexibility of early repayments on whatever basis you wish.

Will your pension cope?

Research by a leading firm of actuaries suggests that, for many people, the state will provide more towards their overall retirement income than their company scheme.

This is primarily due to a massive move away from 'final salary' schemes (where the member is promised a retirement income based on what he or she earned while working) and towards money purchase schemes (where benefits are based on contributions, net investment growth and annuity rates, or unsecured pension drawdown limits, at retirement).

The problem is that contributions are simply too small. Employers pay on average 6.8%, while employees typically put in 3.6%; this gives a total of just over 10% of salaries. Such a low amount is seen as highly unlikely to provide enough for most people to retire on.

An example might help to outline the scope of the problem. Consider a man of 40 who earns £50,000 a year and intends to retire at 65 with a defined contribution (money purchase pension). In our example, inflation is assumed to be 2.5%, while earnings grow at 3.5% a year. Investment growth (net of charges) is set at 6% a year. The basic state pension will grow in line with inflation until 2012 and then in line with average earnings (at least this is the plan).

Our "guinea pig" can expect to be earning £118,162 a year just before he retires and the state pension could provide £16,502 a year (less than 14% of earnings) for a married couple; less for a single man.

If employee and employer contribute 5% of his annual earnings into his pension between them each year, the private pension will be just under £10,250 a year, assuming he wishes the pension to rise with inflation and to give his widow a 50% pension. This is less than two thirds of the estimated state pension.

If joint pension contributions were increased to 10% of earnings, his retirement income from this source would double, but his total income would still be less than a third of what he was earning in the run-up to retirement. In fact, a contribution rate of more than 20% of earnings would be required every year, just to achieve a pension of 50% of pre-retirement earnings.

The purpose of all these figures is simply to demonstrate how vitally important it is to take personal control of your pension planning as early as possible. For someone of 30, the figures would be far less daunting. But the fact remains that, even for them, a relatively high proportion of income needs to be committed to pension planning.

Of course, not all this needs to be within formal pension arrangements, although there are tax benefits in doing so, since contributions attract tax relief at the highest marginal rate paid and a

quarter of the fund can be taken as tax free cash after age 50 (rising to 55 in April 2010). Some other investment options can offer tax benefits too, most popular of which are Individual Savings Accounts (ISAs) See below.

There are also more 'high-risk' investments offering tax benefits, including Venture Capital Trusts, Enterprise Investment Schemes and more complex vehicles utilising what is called 'sideways relief'. The latter involves offsetting 'losses' in selected investments against current and past tax liabilities. (These are highly complex and require specific and specialised advice.)

Returning to the mainstream of investments, it is important to be aware that, thanks to changes made in April 2006, everyone can now contribute to a personal pension in addition to – and quite separately from – their company pension scheme, even if it is one of the highly-prized defined benefit (final salary) types. This gives considerable flexibility to everyone and allows a completely different investment strategy to be followed (including using "self invested" pensions) if required.

Back page briefing:

Don't forget your ISAs

A change in the rules relating to Individual Savings Accounts (ISAs) will make them even more appealing to many people from April.

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But you don't have to wait until then to ensure that you are maximising your tax-efficient investment potential, because the new rules will apply to existing arrangements as well as new ones. They will also bring the old Personal Equity Plans (PEPs) into the same regulatory framework, making transferring investments much easier.

The essence of the new rules corrects what many insurance professionals have been concerned about for some time. The current separation of cash and equity investments means that money put into a Cash Mini-ISA or the cash element of a Maxi-ISA could never be converted into equities unless the investment was encashed and a new investment made into the equity element of a Maxi-ISA.

For many investors, holding too much cash as a proportion of their overall investments makes little sense; it tends to produce lower (if more reliable and less volatile) returns than equities. As a result, most people will wish to hold a modest proportion of their assets in cash, in order to benefit from higher potential investment returns overall.

The inability to "switch" assets built up as cash within the ISA regime into equities has therefore been a bar to rational asset management within this tax efficient vehicle.

From April 2008, it will be possible for cash held within an ISA to be switched into equity investments without the need to use up part of your annual contribution allowance—which is set to rise from £7,000 a year for each person to £7,200—for the purpose.

At the same time, the amount of money that can be invested in cash within an ISA is being increased from £3,000 to £3,600 (i.e. half the new overall ISA limit) and the difference between Mini- and Maxi-ISAs is being swept away.

The rules for ISAs will now be relatively straightforward.

- Each year, everyone over 18 can invest up to £7,200 in an ISA, up to half of which can be in cash (different rules apply for 16 & 17 year-olds).
- You can move money from the cash element of your ISA into equities without affecting your annual investment allowance (but not from equities to cash).
- Money grows free of UK capital and income taxes (other than the 10% withholding tax on UK dividends).
- Money can be taken out at any time as a lump sum or income without any tax being levied.

Don't miss out on this year ...

There is no need to wait for the new rules; make sure that you have used up your full £7,000 per person for 2007/8 before "close of play" on 5th April 2008, or you will lose the right to do so; forever.

You will be able to adjust the balance of your investments after 6th April, if you wish.

Another internet scam

A new breed of e-mail scams has been hitting in-boxes, recently. Instead of asking for re-registration on a website, some are now simply telling you that you have a message from the bank and have to log-on to read it. As ever, never do so without being absolutely sure!

This publication represents our understanding of law and Inland Revenue practice as at the date of publication. It does not provide individual tailored investment advice and is for guidance only. Rules may vary for Scotland and Northern Ireland. We cannot assume legal liability for any errors or omissions it might contain. Levels and bases of, and reliefs from taxation are those currently applying or proposed and are subject to change; their value depends on the individual circumstances of the investor.

The value of land and buildings is generally a matter of a valuer's opinion rather than fact. The value of investments can go down as well as up and you may not get back the full amount you invested. The past is not necessarily a guide to future performance and past performance may not necessarily be repeated. If you withdraw from an investment in the early years, you may not get the full amount you invested. Changes in the rates of exchange may have an adverse effect on the value or price of an investment in sterling terms if it is denominated in a foreign currency.

Your home may be repossessed if you do not keep up repayments on your mortgage. Loans are subject to status and written details are available on request. Always seek independent advice from a qualified financial adviser. Think carefully before securing other debts against your home. Fees for mortgage advice maybe charged and for details of these please contact us. The Financial Services Authority does not regulate all the activities undertaken by the company, including taxation advice and overseas mortgages.