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Provident Money

Your independent *window on financial issues*

Spring 2006

In this issue:

"A budget for Britain's future"

In his historic tenth budget, Gordon Brown offered his usual mixture of great-sounding spending plans and self-congratulation on his achievements to date.

And to be fair, he has delivered a sustained period of economic stability since taking office, partly by handing over control of some aspects of the economy to 'independent' bodies, such as interest rate management to the Bank of England. However, ambitious spending plans for the next few years are likely to result in even greater demand for income by the government. This will partly be covered by a new series of 50-year government bonds. The Chancellor's own golden rule that current account borrowing should balance over the economic cycle is already under pressure, as a result of which the goalposts have had to be moved several times.

The main parts of the budget affecting investors were fairly low key. The expected boost in help for those with families comes at the expense of those with no children, or whose children have grown up. We will increasingly have to rely on the next generation to continue paying taxes to cover our own retirement needs, as well as to pay for the government's increasingly ambitious plans over a wide range of areas.

The current rate of tax relief on Venture Capital Trusts and Enterprise Investment Schemes was due to revert from 40% to 20% in April, however the Chancellor has decided to reduce the cut so that 30% tax relief will now be available.

There is little in the budget for small to medium sized companies

Small companies lose their 'zero rate' corporation tax band, which will severely hurt those trying to build up working capital. This was rather glossed-over in the speech, with reference being made to the reduction in the lower tax rate from 23p to 10p some years ago, conveniently forgetting that small companies had been able to earn £10,000 without paying tax during the intervening period.

There was no good news for families wanting to buy new homes, as Stamp Duty was left virtually untouched; the nil rate band being increased by just £5,000. The problem is that this tax applies from the 'ground up', as soon as the next band is crossed, rather than being paid on each 'slice' of the price. So a property worth £125,000, will attract no stamp duty, whereas pay one pound more and the duty will be £1,250.

Inheritance tax is also becoming progressively more intrusive for many families as the much hyped £325,000 threshold does not actually come into effect until the 2009/2010 tax year. With increases averaging just over 4.2% a year between now and then, few people would predict that house prices will not rise at a faster pace and wipe out any benefit to families hoping to pass on their property without having to pay this 'tax on personal investment'.

Perhaps people should look at their IHT planning as a matter of priority?

How balanced are *your* assets?

Balancing your overall asset allocation to match the timescale in which you may require access to parts of your capital is important.

It can sometimes be worth taking a few moments to consider what your total assets are—especially if you are thinking about potential inheritance tax planning. But in this instance we are specifically addressing risk related to your investments while you are alive, rather than about passing money on.

Many families have more investments than they may think. For example, if you have a pension fund that is expected to produce an income of £20,000 a year at age 65, then the actual size of your fund could easily be as much as £400,000*. Add to this the value of your home (say £250,000 in this example) and some unit trusts, Individual Savings Accounts, insurance policies, building society accounts and so on and it is quite possible that your total assets could be in the region of £700,000 or more.

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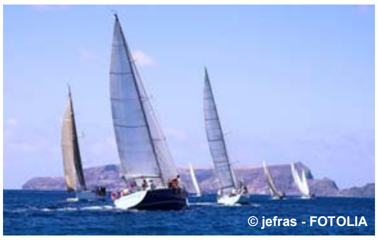
Successful investment is all about balance

On these assumptions, residential property could already represent more than a third of your total investments, while equities could easily make up a substantial proportion of the balance, especially if your pension fund is largely invested in shares of one sort or another. In practice, some pension funds will actually include property (often commercial) and government bonds (known as gilts) as well as cash.



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Investments are not all blown in (roughly) the same direction at the same time

What this means is that without a little digging you might not really know how widely spread your investments are.

This is important because different asset classes do not move in the same way at the same time. For example, shares might be rising strongly at a time when residential property is either falling, or static at the very best. Similarly, commercial property might be falling in value even though house prices are rising rapidly. This means that a good spread of asset classes could potentially give a better chance of smooth performance over the longer term than putting all your eggs in one basket.

However, not all assets are readily accessible. For example a pension fund is usually only able to provide a quarter of its value as a lump sum, the rest must be used to secure some form of income (although from April, that income could be zero) so only part of it is ever available to the investor. But the performance of the remaining 75% is of great importance in terms of determining what sort of income is available (except for those who are members of defined benefit or 'final salary' schemes) and remember, in many cases, you currently have little or no control over when you retire, so volatile fund values at the wrong time could be disastrous.

Similarly. With the exception of downsizing when the children have left home, or (later on) using part of the value of your home to generate an income, its value is not strictly relevant in terms of investment values. If you live there, it is difficult to realise the value.

This is another important issue; some assets are more difficult to turn into cash than others. For example, many property funds (particularly commercial property ones) will contain a stipulation that it can take up to 12 months to access your money. This is because the managers will not want to disinvest substantial amounts of property at one time, as this can depress the market. And finding a buyer is not always easy, as many homeowners will know.

The value of most investments is not guaranteed and you may get back less that you put in.

** Using the 20:1 ratio adopted by the government in order to express fund values for defined benefit occupational pension schemes in terms of the new annual contribution and lifetime fund limits.*

Key points:

- Asset allocation is very important in order to help manage volatility and minimise the unpredictability of returns.
- You should consider all your investments together, taking account of when access to money might be required and how accessible certain forms of investment are.
- Remember, pension assets may have to be accessed on a fixed date, so you do not want values to fall at the 'wrong' time.

Your options at retirement

By the time you read this, April 6th will either be very close, or visible in the rear view mirror of life. But with all the 'excitement' of pension simplification, it can too easily be forgotten that many of us *already* enjoy considerable flexibility in how they take their pension.

The company which helped your pension fund grow best may not be the most appropriate one to pay your retirement income to you. It is therefore worth looking at the market when you come to retire, because you may have the right to go to another company for your pension benefits, rather than staying with the same one. This is called an open market option and it allows you to scour the market to find the best deal to suit your circumstances.

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Decisions need to be made at retirement

Such an exercise can be really worthwhile. We looked at ten annuity offices in January 2006; the highest income offered was **17% greater** than that available from the tenth company. Based on a fund of £100,000 a 60-year-old single man could expect a level income of £6,272 from one office but only £5,359 from another. Over a life expectancy of 25 years, that is a difference of more than £22,500—almost a fifth of the starting value of the fund. And this list is the **top** ten—there are many other providers. So shopping around makes very good sense.

It is important to see whether your existing arrangement carries a Guaranteed Annuity Rate (GAR). When these were included in pension plans (largely in the 1980s) they may have appeared relatively unappealing because the guaranteed rate at age 65 was usually below what was then available on the 'open' market. But in those days, annuity rates were much higher than today, because people lived for a shorter time after retirement and interest rates were generally higher. Today a GAR could offer rather more than the 'best rates' available in the open market. Giving up such a benefit may not be a good idea, unless there are other considerations, such as the possible need to provide for a surviving spouse, or the requirement for an indexed income, which the GAR may not have accommodated.

Guaranteed annuity rates can be valuable

Of course, this is not the only decision you will have to make, when you come to retire. But thinking about it earlier might influence how other investments are to be arranged, so now is a good time to do so.

Annuities (basically a promise to pay an income for life) come in several forms but for practical purposes are:

- For the joint lives of husband and wife (or civil partners) and then for the survivor;
- On a level basis, or increasing by a set amount or in line with the Retail Prices Index;
- With a guaranteed payment period or not.

(For Protected Rights built up as the result of 'contracting out' of the State Earnings Related Pension or more latterly the State Second Pension there are some restrictions on the choices you can make.)

It is also worth noting that those with impaired health can often secure better rates, on the basis that they can expect to live for a shorter time. Even before the changes being introduced in April, investors can opt to take their tax free cash and draw an income directly from the fund, subject to a maximum and minimum level. They must, however, buy an annuity before their 75th birthday.

Income must recognise personal circumstances

All this changes on 6th April 2006. From that date, it will be possible to access your tax free cash and then either draw an income of up to 120% of the annuity rate for your age **or** leave the fund alone. You do not even have to buy an annuity by age 75, but the maximum you can take after then is reduced to 70% of the appropriate annuity rate.

This means that any unused pension fund on death can be used to provide benefits for a dependant or even given to charity, subject to certain rules. It may even be possible to transfer any remaining money to the pension fund of a family member, although there is likely to be a tax charge in this case. But at least the insurance company does not get to keep the money, as is the case now.

Key points:

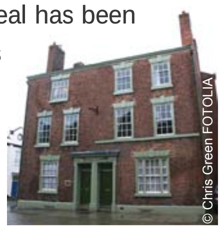
- Seeking the most apporpriate annuity rate at retirement is well worth the effort.
- Thinking about family circumstances couild avoid leaving a dependent without an income.
- Guaranteed Annuity Rates should not be ignored.

HIPs are coming

If you are considering moving home, you should be aware that Home Information Packs (HIPs) are looming on the horizon.

As most people would agree, the current home buying process has its problems. Some homebuyers (outside Scotland, where the rules are different) may on some occasion have been 'gazumped' (where the vendor accepts a higher price from someone else after the deal has been agreed) or had other last minute difficulties with the process.

This is frustrating since the purchaser has already committed substantial time and money in the purchase; if it falls through, the money is lost.



Buying a home is seldom easy

To counter this, the Deputy Prime Minister decided that vendors should be responsible for the cost of surveying the property, through the new Home Information Pack. In this way, if they accept a higher offer elsewhere the unsuccessful buyer will not have laid out so much money. On the other hand, if the purchaser suddenly decides to withdraw, the vendor is left with a large bill unless he or she can find another purchaser before the HIP becomes out of date; as it inevitably will, sooner or later. However, this does not appear to have occurred to Mr Prescott, who created HIPs as part of the Housing Act 2004.

The precise content of the HIP has yet to be decided but it is likely to include a Home Condition Report (HCR), which will be similar in content to a current structural survey (which not everyone bothers with at the moment), plus proof of ownership, local authority searches, sale particulars and copies of any guarantees and warranties applying to the property.

There is some dispute about the cost of creating a HIP—which is unlikely to be resolved before the full content is known—but the government disputes estimates that this could be as much as £1,000 on average, citing £650 as a more likely level.

This will not just apply to those selling freehold properties; leasehold property will also be affected with additional information likely to be required. This may include a copy of the lease, details of service charges and the most recent ground rent notice, details of building insurance, the memorandum of articles of the residents' management company and other items.

We can expect a national 'dry run' during this year, with an expected roll-out in June 2007. Hopefully there will be sufficient Home Inspectors to satisfy demand, or the whole housing market could grind to a halt, with HIPs attracting a premium for those wishing to move quickly. Unfortunately, while the government says 7,500 Home Inspectors are required, the Royal Institute of Chartered Surveyors has indicated that only about 1,800 are currently in training or have qualified. Whether the scheme is practical in volume is yet to be seen.

Home Information Packs will soon be the responsibility of the vendor

Key points:

- Home Information Packs will become mandatory after a test.
- The cost—which could average as much as £650 to £1,000—will fall to the vendor, in addition to Estate Agency and legal fees.
- There are not yet sufficient Home Inspectors to satisfy likely demand.

Assessing cover

According to the office for National Statistics Website (7/3/06), 367 men in every 100,000 and 239 women in every 100,000 will die each year, between the ages of 45 and 54. Between 55 and 65, the numbers rise to 900 men and 570 women.

In some families, it is the man who is the principal earner and it is common for them to carry enough life assurance to cover repayment of a mortgage plus, in some cases, life assurance under a pension arrangement. However, the loss of a breadwinner means not just that debts have to be paid off, but also living expenses met; in some cases for a very long time.

At one time, it was thought that life assurance of ten times income would be adequate to provide for a family, but with personal debt (excluding mortgages) being so high in the UK, this 'rule of thumb' may no longer be adequate.

We can help you establish the right level of cover for your family, but the following might give you an indication of how to assess your ball-park requirements.

Add:

- ☑ Mortgage and other outstanding debts;
- ☑ Known future costs (such as school and university expenses for children);
- ☑ Future expected income between now and retirement age (don't forget to allow for inflation and other increases);
- ☑ The amount an employer will no longer be able to put aside towards your pension;

Deduct:

- ☒ Existing life cover including death-in-service under pension arrangements;
- ☒ Widow's pension that is available under any pension scheme;
- ☒ Other sources of income that will continue after your death.

The result will give you an indication of how much overall cover you require. This can be made up of life insurance that provides a lump sum &/or an income.

Similar considerations will relate to the need to provide an income for yourself in the event of long term illness. This can be provided by 'critical illness' or 'permanent health/income protection' insurance.

Back page briefing—another telephone scam

We have come across another scam you should be aware of.

Credit card holders may receive calls from the issuing authority (such as Visa or MasterCard) and sounding quite authentic. They claim to be monitoring a company passing dubious transactions and wish to verify that a specific transaction notified to them is valid. They will give you details of a transaction that has been charged to your card and ask if it is valid. Of course it is not.

Cleverly, they will **not** ask for your credit card number (they already know that) but **will** ask for the last three digits of the security code on the back of the card. This is all they are after.

They will give you plenty of (false) information, promise to credit your card immediately and tell you they are opening an fraud investigation. They will even give you a reference number for future use.

What will actually happen is that they will then use the security code to put through a transaction equal to the one they told you about and your account is debited (rather than credited with a correcting item).

What the scammers want is the 3-digit security code on the back of the card. Don't give it to them. Instead, tell them you'll call VISA or MasterCard directly for verification of their conversation.

If you do give them the code, by the time you get your statement you'll see charges for purchases you didn't make, and by then it's almost too late—and more difficult to actually file a fraud report.

Scammers are becoming ever more inventive

VISA advises that they will **never** ask for anything on the card as they already know the information; after all, they issued it in the first place.