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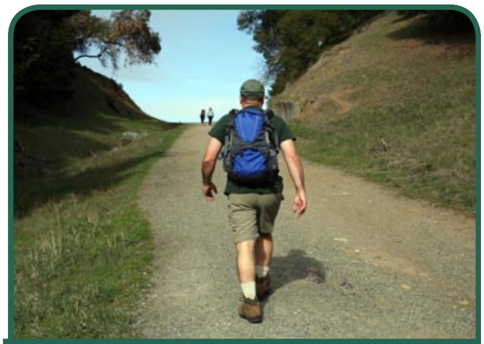
Provident Money

Your independent window on financial issues

Suffering from low interest rates?



Are low interest rates making your life an uphill struggle?

Recent economic data suggests that we are unlikely to see interest rates rising substantially for some time to come.

In fact, the good weather and Royal Wedding in April may have been counter-productive: while some aspects of consumer spending may have been given a boost, it is likely that when the final figures are available (which may not be for a month or two yet, because they are often revised up or down), the all-important manufacturing output is likely to have suffered from a virtual two-week holiday.

Another economic problem is that inflation is likely to rise during the latter part of this year, partly due to higher energy costs. The Bank of England's Monetary Policy Committee must inevitably be cautious about how quickly interest rates are increased to help bring rising prices under control, as premature action could further slow economic growth.

Should we be gloomy?

While inflation is bad for savers and those on fixed incomes, it is not necessarily so for investors. There are strategies that can help those investing lump sums or regular amounts to avoid the worst pitfalls of inflation. These can include investing in sectors that are likely to benefit from what is going on, such as energy companies, and those areas where growth may be expected, such as alternative energy businesses. Before considering such an approach, however, it is essential to discuss this with us, because some investments can carry higher risks than some individual investors may feel comfortable with.

In any event, a balanced approach is likely to be more beneficial than putting all your eggs in one basket.

Lower risk alternatives

One option is to consider investing in bonds. Some of these are government backed, others are issued by businesses. In essence, those issued by the UK and some other governments are likely to carry the lowest practical risk although, as we have seen from recent events, some governments that have failed to bring borrowing under control have recently seen their credit ratings reduced – and in some cases downgraded almost to the lowest level. This means that their bonds could – in theory at least – become worthless.

However, bonds issued by National Savings and Investments can be considered relatively secure and it is expected that NS&I will issue some RPI linked bonds within the next year, which could be of interest as part of a balanced investment strategy.

Overall, it is likely that the economy will recover faster than the worst predictions forecast, but more slowly than optimists may hope. We are, after all, in this together. Why not ask us to review your investments now?

INSIDE THIS ISSUE

Goodbye CTFs, hello Junior ISAs

The demise of Child Trust Funds (announced last year) has now led to an announcement that their replacement, Junior ISAs, will be introduced later this year.

Young people can build up significant funds

ISAs are currently available to 16- to 18-year-olds on a cash basis only, for up to £5,340 a year. This age group cannot invest in a Stocks & Shares ISA. Under the new Junior ISA, eligibility is from birth, and although the money will not be available until the age 18, up to the entire allowance of £3,000 a year can be invested in equities, if required.

Will this be worthwhile?

While the full details have yet to be published, the loss of the government's previous £500 per child contribution (in two tranches) is balanced by a total annual investment allowance per child that is two and a half times as high as that applying to CTFs.

This means that, even ignoring investment growth (and charges), 18 years' worth of contributions would amount to £54,000 and investment growth could add significantly to that. It is therefore possible that, even if university tuition fees rise even higher in future, there will be sufficient money available to pay most young people's way through higher education (especially as the cost of the fees is met retrospectively, when funded by a student loan).

For those young people who decide to go directly to work, the money received from their Junior ISA could well provide sufficient capital to start a small business, or put down a significant deposit on their first home.

Combining with pension investments

One aspect of inter-generational planning that should not be ignored is that it is also possible for parents and grandparents to invest £2,880 a year into a personal pension for each child, which is worth £3,600 when basic rate tax relief is added to the fund by the government. In this way, total investments worth as much as £6,600 a year can be put aside for each young person (who does not have a CTF) in a highly tax-efficient environment. There may be some merit in considering self invested personal pensions for young people, since the investment options are wider than those relating to insurance company schemes, although the charges in the early years may appear to be higher. However as the fund grows these are likely to represent a smaller proportion of its overall value and could be used to purchase a wide variety of assets, including commercial property, as part of a 'family SIPP' arrangement.

Of course, the pension fund will not be available until age 55 (under current rules) but having a substantial pension fund by the age of 18 could well take some pressure off the young adult, as they will doubtless have other priorities.

It is important always to seek independent financial advice before making any decision regarding your finances. The value of investments is not guaranteed; you may get back less than you put in.

Are you putting enough by?

According to recent research, while 44% of working women are responsible for family financial decisions and 46% describe themselves as the main earner within their family, more than a quarter of them have no savings accounts in place.

The absence of savings is not, however, a gender-specific issue; it can affect everyone and therefore applies to millions of families.

Almost half of working women are main earners

Saving for the future is not an option but a necessity, if we are to secure a reasonable standard of living later in life. There are many times during our family lives that we may require access to capital and probably the only ways to obtain it are inheritance (relatively unpredictable), borrowing (which, as the UK is discovering, may cause problems later) and saving.

Different forms of saving and investment

There are two questions that need to be addressed; first, ***when*** are you likely to require access to your money? (this is likely to be on many occasions, rather than just one). Secondly, ***how*** can you invest and save to gain the best chance of having money available at the right time?

Timescales

Nobody knows what the future holds, so it is important that any approach to investment and savings takes account of the need for some money to be accessible at short notice and with the minimum of fuss. This may be why up to half of ISA investments (£5,340 out of a possible £10,680 for 2011/12) can be in cash. Savings and deposit accounts are generally instantly accessible and have no 'charges' – although the interest rates offered allow the bank to make a profit and fixed-term or notice accounts may include penalties for early withdrawal.

For money that may not be required for five years or longer, immediate access is normally a lower priority, because some degree of advance planning is possible. Similarly, investing over the longer period can make such issues as dealing costs (when buying/selling shares or purchasing units in a unit trust, for example) become proportionately less important.

Investment strategies

When it comes to thinking about longer-term savings, there are risks associated with some investments, including that their value can be lost in part - or even entirely, in extreme cases. More common risks are that the value of investments will fail to perform in line with possible alternatives (relative underperformance) or fall in purchasing power due to inflation (absolute underperformance).

Investments may also fluctuate in value just when you want access to the capital. There are mechanisms for managing volatility, particularly in respect of pension planning, by the use of so-called lifestyle strategies. These move money gradually into less volatile assets (such as gilts) in the run up to retirement and are useful if you intend purchasing an annuity on a fixed date in the future.

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Planning for later state pensions

Investors may be pleased to learn that they no longer have to purchase an annuity with their pension fund by the time they reach 75, but news that they could have to wait a very long time for their state pension will be less welcome.

The state pension age, already set to rise to 66 by 2020, could soon be subject to a new 'automated' approach towards future age increases based on regular, independent reviews of longevity. So, as people continue to live longer, they will have to wait even further into old age before the state pension starts. So 66 could eventually become 70, 75 or even later.

A retrograde step?

Actually, the Old Age Pension, as it was then called, was introduced by Lloyd George in a 1909 Act to provide a (non-contributory) pension for those aged 70 or over. This was at a time when few people could expect to reach such an age, so the fact that our new system is still intended to start providing benefits well before people reach the end of their lives means it

People continue to live longer

remains superior.

The 1909 version paid a weekly pension of of between 10p and 25p a week (the pre-decimalisation equivalent) or 37.5p a week for married couples (roughly a quarter of today's basic state pension in real terms). Only workers earning less than £31.50 per year and of 'good character' could become entitled to the pension.

Personal provision was essential even then

The level of benefit was deliberately set low to encourage workers also to make their own provision for retirement.

The need for personal provision remains today, which is why the Government is also introducing the National Employment Savings Trust for all employees who do not have access to an occupational pension (although they can opt out).

Today, the basic state pension is worth about £102 per week for a single person or £163 per week for a married couple – clearly not sufficient to live on comfortably, so it is important to ensure that you have adequate private provision either via an employer's scheme or a personal pension. Those who fail to make adequate provision could find themselves with insufficient income when they come to retire.

Covering the delay

Those who previously had no intention of working beyond age 65 (or even 60 for women) now face the prospect of working much longer before they receive their basic state pension. A key advantage of private pensions is that they are available when you want to retire, after age 55, rather than when the Government says it can afford to start paying you an income.

By managing your own retirement plans effectively, the basic state pension can become the 'icing on the cake' with the main retirement benefits coming from your own (or an employer's) pension plan.

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News in brief
(data compiled by The Insurance Marketing Department Ltd. except where otherwise stated)

The second quarter of 2011 saw the FTSE100 inch ahead by 0.63%, largely held back by developments in Greece although apparent resolution of this issue helped towards the end of the quarter. This, however, masks the fact that the index is now almost 21% higher than a year ago.

The mid-cap FTSE250 performed more strongly over the quarter and gained 2.95% to finish the period more than 27% higher than at the end of June 2010. If the economy is to grow in 2011/12, much of the growth could come from this sector.

Sterling gained considerably against the dollar in April, but fell back during May and June to end the quarter just 0.15% higher. A relatively weaker pound is good for exporters, which is just as well, because it fell by -2.43% against the euro during the quarter, and may fall further if interest rates in Europe rise again.

Brent Crude 1-month futures fell by -2.3% over the quarter to the end of June, but might have gone higher had several governments not decided to release some reserves in order to combat OPEC's refusal to increase output to cover the loss of production caused by the Libyan civil war.

Unisex annuity rates

Thanks to a decision of the European Court of Justice (ECJ), the landscape for UK pensions will soon have another bureaucratic blot.

From 21st December 2012, it will be illegal for insurance companies to use gender as the basis for determining insurance premiums and annuity rates. This will hit the pension annuity market hard, because lower life expectancy means that insurance companies currently pay men higher annuities than women. After all, the insurance company will be paying men over a shorter period than women, so it is only fair that they should give more per annum. Unfortunately, the ECJ has decided that this is discriminatory against women.

What this means in practice

Actually, the current position is not discriminatory when average life expectancy is taken into account. If a man and a woman aged 65 each have a pension fund worth £250,000 today, the man might receive an annuity of about £16,475 a year and the woman about 5% less at £15,570 a year. Women can expect to live, on average, some three and a half to four years longer than a man of the same age. So if the man lives for 20 years and the woman, say, 23½ years then (disregarding tax and inflation) he will receive £329,500 over his remaining lifespan, while she will receive £365,895 – which is **£36,395 more** overall; hardly discriminatory against female annuitants.

By unifying the rates at (for example) £15,750 a year for each of them, the man might get (over 20 years) £315,000, while the woman might receive (over 23½ years) £370,125 – which is **£55,125 more** for the woman, over the term – more than a fifth of the original pension fund!

What are your options?

Women may, from late December 2012, see a modest improvement in annuity rates, provided insurance companies do not simply reduce rates to the 'female' level for everyone. In theory, purchasing an annuity before the change comes in could be a good idea for men. However, with interest rates so very low at the moment, any increase could actually help annuity rates, so moving into annuity purchase too early might not be the best strategy.

Fortunately, most people will have the option of using a drawdown pension for the income from their pension fund. This is still currently gender-specific, although from December 2012 the Government Actuary's Department (GAD) may also have to adopt unisex rates. The maximum anyone can draw directly from their pension fund is 100% of the GAD rates. Only those with a guaranteed lifetime income of at least £20,000 a year (including the state pension) can draw a higher amount each year.

The importance of advice

This will remain a complex area for some time and it is important to seek independent financial advice before making any decision regarding your finances. The value of investments is not guaranteed; you may get back less than you put in.

Decisions in Europe can affect us

It is important to take professional advice before making any decision relating to your personal finances. This publication represents our understanding of law and HM Revenue and Customs practice as at the date of publication. It does not provide individual tailored investment advice and is for guidance only. Some rules may vary in different parts of the UK, please ask for details. 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 investments can go down as well as up and you may not get back the full amount you invested. The past is not 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 back 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.