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Finding income in a tricky savings climate

Real interest rates may not rise much above 1% – even in the longer term according to the Bank of England. If the Bank is right about this, where can investors find income now?

The Bank of England asked two key questions last December – first: how far have ‘real’ interest rates (that’s after allowing for erosion by inflation) fallen globally? Second: how likely are they to stay at their current low levels? The Bank argued that the fall in real interest rates over the last 30 years was driven by a mix of changes including population aging and increased levels of saving, especially in emerging markets. They thought these trends would persist for some time and didn’t see interest rates rising much.

If this is the case, what are the implications for people who need income from their investments – especially those in retirement? Both cash and fixed interest securities look unpromising at the moment – yields are at or near all time lows. That doesn’t mean that there is no place for holding cash and bonds as part of a diversified investment portfolio. But it does mean that investors should be looking for income from shares and property as well.

Dividends from equities

Dividends from equities (company shares) have traditionally provided the answer for investors wanting a reasonably dependable income. This involves them giving up some of the capital security provided by cash deposits and some fixed interest securities. The value of their capital in shares can go down as well as up, and the dividends aren’t guaranteed either. But with equities there is also the prospect

of some possible long-term capital growth. And that can be very important in boosting investment returns over the years. The difference between income and capital growth is that the income is usually reasonably regular, while any capital gains tend to come in spurts – with years of no gain or even losses followed by sharp rises.

Diversifying your investment portfolio

Most people cannot just live on the income from their investments; it is necessary to draw on capital gains as well and live on total returns from their investments. That means having a diversified investment portfolio. Part could be invested in equities to provide both income and (hopefully) long-term capital growth. But some of the portfolio should be in cash and fixed interest securities to help smooth out returns and to provide a reserve of very safe investments to draw on in turbulent times. The total returns you get from such a portfolio should provide a sustainable stream of spendable income. The Bank of England specialists expect interest rates to stay lower for longer; that will mean investors changing their investment strategy to meet these unprecedented conditions. We are here to help so please get in touch.

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LISA reappears after a summer redesign

The Lifetime ISA is back in the spotlight, after it disappeared over summer.

In what proved to be his final Budget, George Osborne announced the launch of a Lifetime ISA from April 2017. The LISA, as it was labelled, was widely seen as a stalking horse for future pension reforms, which might still emerge.

When Philip Hammond replaced Mr Osborne in July, it was unclear whether the LISA would survive. It was therefore a surprise when the government introduced the Savings (Government Contributions) Bill in early September, setting out a broad LISA framework. The Bill was accompanied by an "updated design note" for the LISA, setting out the basic LISA structure:

- You will only be able to start a LISA if you are aged between 18 and 40;
- The maximum annual LISA contribution will be £4,000;
- Any LISA contributions made before age 50 will attract a 25% government bonus, so a £1,000 bonus will be payable for

the maximum contribution of £4,000. This bonus will be added monthly if contributions are paid monthly from 2018/19;

- The range of eligible investments and tax treatment for LISAs will be the same as for the current cash and stocks and shares ISAs;
- All or part of the value built up in a LISA can be withdrawn penalty-free from age 60 onwards or for the purchase of a first home worth up to £450,000; but
- Any other withdrawals will normally attract a 25% penalty.

There has been some debate about whether a LISA contribution is better than a pension contribution (under current rules). If you are in the position to choose between the two next April, then personal advice based on your own particular situation is essential. While a LISA and a pension have the same tax benefits during the investment period, at the stages of making contributions or drawing benefits, tax rules are distinctly different.

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Is your family financially protected?

The existing system of bereavement benefits is being overhauled from April 2017. A key change will be the end of widowed parent's allowance which is currently paid until the youngest child leaves education to be replaced by just one year's payments for new claimants. What would happen if your family was affected?

Reviewing life insurance provision is arguably even more important than making sure you are financially prepared for retirement or that your investments are in good order. An early death robs a person of the time needed to achieve their financial goals. It is one thing to plan for retirement in, say 15 years, or build up a capital sum over five to ten years. It is quite another to make sure your loved ones are provided for in the way you would want knowing that the date of your death could be anytime from today onwards.

Well over a million people currently have funeral plans in force. However, the true financial loss experienced by a family when a breadwinner dies is out of all proportion to the £4,000 or so that an average funeral costs. Someone aged 35 earning £50,000 a year with a £200,000 mortgage and children aged five and seven could easily find that their partner would need £1 million simply to make up for the loss of income over the next 18 years and the repayment of half of the mortgage. Pure life insurance is not expensive – In fact, the monthly premium for an 18-year family income plan for that 35-year-old to provide £50,000 a year to their family in the event of their death could be as low as £25 a month. For them to provide £1 million in cash as an alternative using an 18-year level term insurance plan would still be possible for just under £45 a month.

How much is enough?

Of course it is not possible to quantify the value

of a person's life in purely financial terms. On the other hand, the ability to provide adequately for your family if you are suddenly taken away from them so that they can still fulfil their hopes and dreams is an act of love that itself cannot be measured.

As a minimum, it is generally important to cover any outstanding mortgage or other debts. If you are self-employed, you need to make sure that you have sufficient cover for business debts. For those with children, your priority should be to provide sufficient cover to replace your income until your children are no longer dependent and it would be prudent to assume at least age 23 for this. Parents should not overlook the fact that the surviving partner may need to meet the cost of university education or private school costs.

If you receive life insurance cover as a benefit of your employment, please bear in mind that this will need to be replaced if you change jobs and this may be at a time when your health could have deteriorated. Although there is mention of the 'breadwinner' please be mindful of the true value of homemakers and insure with that in mind. If you are single with no children, you should still be protecting your income from the risk of a serious illness or accident. Such things can undermine your ability to meet your financial objectives.

In any event, it is important to take individual advice based on your own particular situation, so please get in touch to review your life and health protection needs.

What is a £5,000 a year pension worth?

If you have pension benefits from an old private sector final salary pension scheme, they could be much more valuable than you think. So, how much is the right to a £5,000 a year prospective pension actually worth?

One of the answers to that £5,000 question – and there are many – is “a transfer value of 30 times the pension, in other words – £150,000”.

If you're surprised, then you are not alone. Two years ago such a transfer value figure would have been virtually unbelievable. Back in 2014, a multiplier of around 20:1 was common, making £5,000 a final salary pension worth around £100,000 if you were to transfer close to retirement. So why the big increase in transfer values?

The main reason is the sharp drop in long term interest rates. Since October 2014, the yield on the benchmark 30 year UK government bond (gilt) has halved. Final salary pension schemes use long term yields to assess the value of their pension liabilities and so the value of those liabilities increases when bond

yields fall. One side effect has been a large rise in company pension scheme deficits.

There have even been suggestions in parliament that employers should be allowed to break their pension scheme promises in an effort to bring down deficits and escalating contribution levels.

The pros and cons of transfer

Exchanging £5,000 of pension for £150,000 of pension fund can have several advantages, such as a possible increase of over 60% in the tax-free lump sum you can draw. However, there are significant disadvantages, too, not the least of which is that you have to forgo the promise of known benefits, usually with in-built increases once pension payment begins.

The decision on whether to transfer is a complicated one. If your transfer value is more than £30,000 – which could mean a pension of £1,000 a year – under government rules your pension provider must make sure that you have taken regulated financial advice based on your own particular situation before allowing any transfer to be made. We think that makes sense for any transfer.

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Tax evasion, avoidance and planning

While others were enjoying August sunshine, HM Revenue & Customs (HMRC) was busy publishing consultation papers on tax avoidance and tax evasion.

As Theresa May announced in her final speech to October's Conservative Party Conference:

"So it doesn't matter to me who you are. If you're a tax-dodger, we're coming after you. If you're an accountant, a financial adviser or a middleman who helps people to avoid what they owe to society, we're coming after you too.

An economy that works for everyone is one where everyone plays by the same rules. So whoever you are you – however rich or powerful – you have a duty to pay your tax. And we're going to make sure you do."

HMRC's consultations

Three months earlier HMRC had started two separate consultations on tackling promoters of tax avoidance schemes and dealing with offshore tax evasion.

The attack on promoters – and others involved in the development, sale and use of schemes – is designed to "influence [their] behaviour". That "influence" will take the form of new penalties on the promoters and their associates if a scheme fails, based upon the amount of tax that was purportedly avoided by the scheme's users.

Making "corrections"

The latest move against offshore evasion proposes a "Requirement to Correct" should you have "undeclared UK tax liabilities in respect of an offshore matter". The "correction" must be made by September 2018, after which a Common Reporting Standard (CRS) should come into force. Under the CRS, over 100 countries will automatically exchange taxpayer information, making evasion more difficult and dangerous.

HMRC is adopting a carrot and stick approach here because it would prefer tax evaders to confess voluntarily rather than after an investigation. Thus the pre-CRS tax penalties will generally be lower than those under the "Failure to Correct" regime that begins in October 2018.

The targets for these consultations have nothing to do with what might be described as tried-and-tested financial planning and advice, such as we offer. The Prime Minister and HMRC are after aggressive avoidance schemes and tax evasion – which have always been illegal.

Tax laws can change. The Financial Conduct Authority does not regulate tax advice.

Does pension beat property?

Residential property beats pensions as an investment for retirement planning, according to the Bank of England's Chief Economist. But is he right?

Andy Haldane, the Bank's Chief Economist, grabbed a few headlines recently when he suggested his favoured method of retirement savings was residential property. It is a view many people with a less profound understanding of economics would share. Mr Haldane's main justification was that in the UK demand has consistently outstripped supply, meaning prices are "relentlessly heading north".

Residential property prices have not always increased. If you had invested at the top of the last cycle (the third quarter of 2007) you would have waited nearly seven years before you saw any capital growth, even if you ignore expenses. Moreover, the government is intent on increasing those expenses; witness April's 3% increase across each band of stamp duty land tax (land and buildings transaction tax in Scotland) on buy-to-let properties.

But the best reason for not increasing the weighting of property at the expense of other asset types as part of your retirement planning was recently given in a speech by a former Deputy Governor at the Bank of England, Andrew Bailey, who is now the Chief Executive

of the Financial Conduct Authority.

Shortly after Mr Haldane's interview, Mr Bailey gave a speech looking at "the two big investments in the life cycle model – a home and pensions". He said that the main problem with buying residential property instead of a pension was the lack of investment diversification. In other words, owning your own home probably gives you enough exposure to the residential property market, not just in terms of asset value but also in terms of the amount of money you invest in your own dwelling over a lifetime.

In any event, it is important to take individual advice based on your own particular situation.

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