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MFS

Independent means choice

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Savings come back into fashion

Rollercoaster, see-saw, helter-skelter...

The fairground ride analogies have been out in force over the last few months as the global financial crisis has brought unprecedented volatility to investment markets. Some of the short-term consequences of the turbulence are examined elsewhere in this newsletter, but there are longer-term lessons to be learnt too. Many of those lessons have a tinge of old fashioned common sense about them.

An obvious one is that lenders and borrowers need to be realistic about levels of debt. It had become too easy to borrow. Before the credit crunch, if you had wanted to borrow 100% (or more) of the value of a property, you would have had a choice of eager lenders. Now there is no lender interested in offering such generous deals. Chunky deposits and a clear ability to pay back the loan are the order of the day.

A corollary to reduced reliance on borrowing is the lesson that we need to save more. A major contributory factor to the crisis in the United States and, to a lesser extent, the UK has been low rates of saving by the public. The UK household savings ratio in the second quarter of 2008 was just 0.4% according to National Statistics. In other words, for each £100 of net income, the average household saved just 40p.

With regular savings in bank or building society deposit accounts, you can create a cash reserve that may help you through difficult times. Beyond such 'rainy day', short-term regular saving, long-term regular *investment* in unit trusts and similar share-based funds can be a sensible option. This may seem an unwelcome idea in current investment market conditions, but provided the investment is made with a long-term view, there is sound logic to it.

If you make a regular monthly investment, you are not committing all of your money at a single point. So 'market timing' – choosing when to invest – is not an issue. Instead, your monthly investment could buy more units/shares when market prices are depressed than when prices are high. This process, known as 'pound-cost averaging', means that over a period of years the average price at which you invest can be lower than the average price for that period.

Past performance is not a reliable indicator of future performance. Investments can go down as well as up and you may not get back the original amount invested.

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If you have made, or are about to make, your New Year's resolutions, one of the first, and a vital one, should be to make a full review of your financial situation.

2008 has been an incredibly difficult year as far as finances are concerned. Governments worldwide have struggled to ease the financial position in previously untested ways. While the credit crunch has raised some specific issues (see overleaf), taking a general overview of your financial planning could highlight some important questions.

Investments

If you have deposit investments, are they properly protected? The Financial Services Compensation Scheme now protects up to £50,000 of an investment in a specific bank (see page 2). Do you have more than that at risk in an institution? Should you spread these investments?

What about the stockmarket? It has been extremely volatile during 2008. How have your equity-based investments been doing? It may be time to look at these to see if your portfolio is balanced properly.

Protection

The financial situation over the last few months has adversely affected the wealth of many families and you may wish to look at the different ways of protecting your family for the future. Do you have enough life cover to protect your spouse or partner as well as your children

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Boxed in by the credit crisis?

The credit crunch started in the US, but first hit the UK over a year ago with the Northern Rock crisis and has grown in seriousness ever since. The sea change in the world's financial structure is affecting more and more people's lives.

Bank deposits The collapse of three Icelandic banks has served as this generation's reminder that even in the world of bank deposits, the rules of risk and reward still apply. The Icelandic banks were regular 'chart toppers' in the interest league tables, but it now appears that the marginal extra rate was there for a good reason.

On this occasion, individual depositors were lucky in that the government was willing to fill the gaps left by the Financial Services Compensation Scheme (FSCS), notably for deposits above £50,000. If there had not been such a crisis atmosphere, the government might have decided the FSCS was enough (see below).

Mortgages US sub-prime mortgages – property loans to risky borrowers – have been blamed by many commentators as one of the main causes of the crisis. Once those mortgages started to default, the effect was felt throughout the world because of the way in which the loans had been repackaged and sold to a wide range of institutions.

The backwash in the UK has seen banks and building societies adopt much more cautious lending policies. In some areas of the mortgage market – notably buy-to-let – there has been an over 70% contraction in the number of mortgage offerings.[1]

If your solution to a cash shortage in the past has been to re-mortgage, you may now need to re-think your options.

House prices By October 2008, house prices were falling at an annual rate of 15% according to the Halifax. That drop exceeds the entire fall of the early 1990s and looks likely to continue. The Halifax notes that the current ratio of house price to earnings is 4.92, which is still almost a quarter above the long-term average of 4.0. This view is echoed in data from the Nationwide (see graph below).

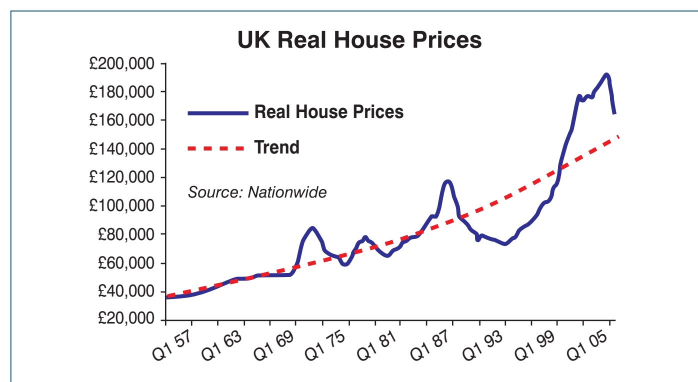
The decline in house prices is a reminder that relying on residential property – be it your home or buy-to-let – as your only retirement/savings fund can be a dangerous strategy.

Pensions The drop in share prices has inevitably reduced the size of many pension funds. For private sector final salary schemes, deficits will generally have widened as a consequence. That could mean higher employer (and employee) contributions in the future, unless there is a major market recovery. It will also increase the likelihood that these schemes will close to existing members – many have already shut to new employees.

For other types of private pensions, including personal pensions, smaller funds will normally mean lower pensions, although annuity rates have been rising (see opposite). Once again, higher contributions may be required to restore benefits to the original target levels.

If you need help in managing any of the issues raised, let us know.

[1] *Yourmortgage.co.uk, 30/09/08*



Financial services compensation – what's covered?

When things go wrong with financial products, it is good to know that there is a safety net in place to protect investors in some circumstances.

In the UK, this is provided by the Financial Services Compensation Scheme (FSCS). The FSCS is the body currently being used by the Government to bail out investors in some of the firms that are experiencing problems arising from the banking crisis.

The FSCS is an independent (though government created) institution formed under the Financial Services and Markets Act 2000. It is a compensation fund of last resort for the customers of financial firms that are regulated by the Financial Services Authority. The FSCS is funded by levies from the providers of financial services type products.

The FSCS considers claims from investors against firms that have ceased to trade and where the firms, or their owners, are unable, or likely to be unable, to meet those claims. There are strict limits to the compensation amounts (see table). If you are in doubt, it would be prudent to contact the provider for limits on specific products or deposits held.

Type of contract	Maximum amount of compensation
Deposit accounts	£50,000 per person per deposit firm Joint account limit £100,000 (Limit increased from £35,000 from 7 October 2008)
Investments	£48,000 per person per investment firm 100% of first £30,000 and 90% of next £20,000
Mortgage advice and arranging	£48,000 per person calculated as 100% of first £30,000 and 90% of next £20,000
Long term insurance (including investment bonds)	100% of first £2,000 plus 90% of balance of claim No actual monetary limit

Customers should be aware that the maximum limit will only be covered per banking licence, not per brand of bank or building society under a parent company.

There are, however, areas that are *not* covered. The FSCS does not consider any claims against firms that are still trading, which must be made in writing to the firm and could end up with the Financial Ombudsman.

If you are think the FSCS could be relevant to you, do get in touch with us.

Annuity rates reach a peak

One consequence of the credit crunch has been a rise in the yields on the fixed interest securities that underpin annuities. By September 2008, annuity rates had reached a six-year high.[1] This is good news if you are looking to convert your pension fund to a lifetime income, although the bad news could be that the credit crunch has also affected the value of your pension plan.

If you have no immediate plans to convert your pension fund into an income but are close to retirement, it could still be worth asking us to give you an illustration of what is available.

Postcode annuities

Higher rates have not been the only development in the annuity market this year. The growth of competition has prompted one of the UK's biggest insurance companies to launch postcode annuities, ie annuities based on the exact postcode of the purchaser.

The theory behind these is that the more affluent the area in which you live, the longer you are likely to draw your pension. So if you are a Kensington pensioner, you will receive a lower annuity rate than if you live in one of the tougher parts of Glasgow.

Postcode annuities are the latest example of a trend to tailor the annuity rate you are offered more closely to your personal circumstances. For example, there are now several annuity providers offering 'enhanced' rates based on a lifestyle or other factors, eg smoking or diabetes. A handful of companies go further and will quote 'impaired life' rates if you have a serious health condition, possess a sufficiently large pension fund and are willing to undergo any necessary medical examinations.

Annuity selection

If you are considering buying an annuity, your first step should be to seek independent advice. Your pension plan provider may well offer you an annuity quote, but the chances are it will not be the most competitive in the market.

It also may not be the most appropriate for your circumstances. For example, it may not allow for suitable dependants' benefits or protection against inflation.

When it comes to advice about the alternatives to annuity purchase, such as unsecured pensions, your pension plan provider is unlikely to give you anything more than the most basic of information. The alternatives are generally worth considering if:

- You have a large fund – typically at least £100,000;
- Death benefits and/or inheritance tax planning are important to you;
- You are willing to accept investment risk, which means the value of your fund and the income/payments you receive from it could fall as well as rise;
- You want to leave any unused pension fund to charity.

Please remember that past performance is not a reliable indicator of future values on your pension fund.

[1] *The Independent, 12/09/08*

Control your legacy – make a will

Many people believe that on death their assets will automatically pass to their surviving spouse or civil partner, even if they don't make a will. Where there are significant assets this is not the case: the state dictates where your assets will go.

For most people, relying on the intestacy rules is not a desirable outcome. Assets could go to people that you do not wish to benefit or awkward 'statutory' trusts could be set up over some of your assets.

There may also be unnecessary inheritance tax liabilities that could have been deferred or, with successful planning, avoided altogether.

Intestacy rules vary in different parts of the UK. Proposed changes from the Ministry of Justice from 1 February 2009 will increase the statutory legacy limits in England and Wales from £125,000 and £200,000 to £250,000 and £450,000 respectively. In Scotland the rules are different: a surviving partner has prior right to a home worth up to £300,000 and specified assets. In Northern Ireland the limits have been £250,000 and £450,000 since 1 January 2008.

From 1 February, if you die intestate in England and Wales leaving a surviving spouse or registered civil partner, your assets will pass as follows:

- If you leave a spouse or civil partner *and* children (including adopted children and illegitimate children as long as there is proof of parentage) that spouse or partner will receive assets to the value of £250,000 (up from £125,000) plus your personal chattels. They also receive a life interest (in effect, a right to the income only – not the capital) of one-half of the remainder of your estate.

The other half of the remainder of your estate goes to your children directly – so they will receive the capital – provided they are not minors. Statutory trusts are created for any minors until they come of age, when they will receive the capital.

- If you leave a spouse or civil partner but *no* children, then they will receive assets to the value of £450,000 (up from £200,000), your personal chattels and one-half of the remainder of your estate absolutely. Your parents receive one-half of the residue. If you leave no parents, your brothers and sisters – or their children – inherit.

Wherever you live, there is no acceptable substitute for proper estate planning and making a valid will that reflects your wishes as far as your assets are concerned. The Financial Services Authority does not regulate will writing and some forms of inheritance tax planning.

Investment ins and outs

Share markets around the world have seen substantial declines in 2008, with the pace of falls accelerating sharply during September and October. The spectre of recession meant that even sectors that had been performing relatively well, such as commodity producers, were pulled down. It was all very gloomy.

However, to paraphrase a common warning, investment values can go up as well as down. There have been sharp rallies in the aftermath of past stockmarket crises, such as the October 1987 crash and the post-2000 technology bust. An investor who sold out in the darkest hours had to be very quick to reinvest to avoid finding themselves in a worse position than if they had simply shut their eyes and held on through the storm.

The idea that you can time when to buy and when to sell (or vice versa) looks very attractive in theory. It also appears extremely easy when you study a graph of share price movements: buy in at the troughs and sell out at the peaks. However, practice is somewhat different. Share prices can move very fast – in either direction – as has once again been proven by the last 12 months of dizzying swings.

One major investment group, Fidelity, looked at the impact that missing just a few days of sharp rallies can have on overall returns. It found that over the 15 years to the end of September 2008, if you had missed just the best ten days of performance, your *annual* return would have been reduced by 3.25% (based on the FTSE All-Share with net income reinvested). Similar effects were observed for other major markets, such as the US and Germany.

The major investment institutions, such as pension funds, generally do not attempt 'market timing'. The professionals realise that market timing is just too difficult in the real world, even though they are watching the markets constantly and can deal instantly.

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SIPPs open up

When personal pensions were launched in 1988, one of their most important features was that they could be used to opt out (technically 'contract out') of the state earnings-related pension scheme (SERPS).

Contracted-out personal pensions then received national insurance rebates that were allocated to 'protected rights' funds. When SERPS was replaced by the state second pension (S2P) in 2002, the opt-out option continued.

Since 1988, personal pensions have also been able to receive transfer payments from contracted-out final salary (defined benefit) pension schemes and contracted-out money purchase (defined contribution) schemes.

However, until 1 October 2008, only insured personal pensions could hold protected rights funds. Thus, nearly all self-invested personal pensions (SIPPs) were excluded from receiving national insurance rebates or a full transfer from a contracted-out pension scheme. Regulations have now removed this restriction.

The new rules mean that you now have the opportunity to transfer existing insured protected rights funds into a SIPP, potentially gaining greater investment control and benefit flexibility. Your protected rights funds might currently be held in old plans to which rebates have not been paid for some years – contracting out has steadily become a much less attractive option since 1988 and is now rarely recommended. The insurers may themselves have closed to new business, taking their administrative and fund performance out of the spotlight reserved for new investments.

While it is definitely worth examining what protected rights benefits you have, a transfer to a SIPP may not be the right option. The final decision depends on several factors, including:

- Do you have an existing SIPP to which the transfer could be made?
- How long do you have before you would draw benefits from the protected rights fund?
- How do the existing pension plan charges compare with SIPP charges?
- How important to you is the wider range of investment opportunities a SIPP can offer?
- How do you plan to take your protected rights benefits?
- Will you lose any benefits or suffer penalties by making the transfer?

We can help you find the answers to these questions.

Focus on a new year review

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or grandchildren? Again, professional advice is important to ensure that such life cover is set up in the correct way.

Pensions

One major area to suffer from the decline in stockmarket values is pension funds. Most of these have some equity exposure.

If you are already retired and drawing on your funds or you are rapidly approaching retirement, you really owe it to yourself to conduct a full review of how your pension fund is performing. You do not want to suffer a drastic reduction in pension just when you find that you need to maintain your income.

You may wish to think about switching your pension funds to more 'safe' investments as retirement approaches. Pensions are complex. They combine government rules on limits regarding tax-efficient investments and the tax reliefs available with actual investment decisions. Professional advice is vital before taking any strategic decisions.

An overall financial review at this time could put you into a much better financial position in 2009.

Time to file online

If you received a paper tax return for 2007/08 in April and have not yet sent it back to HM Revenue & Customs, it is now too late to do so. The final date for submitting a paper return issued in April 2008 was 31 October 2008.

Your only option now is to file online. The cut-off date for this is 31 January 2009. You would be well advised to log on sooner rather than later.

This newsletter is for general information only and is not intened to be advice for any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The Financial Services Authority does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. The newsletter represents our understanding of the law and HM Revenue & Customs practice as at 7 November 2008.