

Your independent window on financial issues

Market volatility – where do you stand?



Markets can go up and down

During the past six months or so, we have seen stockmarkets swing significantly, with the FTSE100 soaring as high as 6,103.7 (3rd May 2011) and falling as low as 4,791 (9th August 2011).

This represents a range of 1,312.7 points, or 21.5% of the high point, during the period. It could lead some investors to wonder what is happening, and whether shares are a good basis for long-term investment.

The point is, of course, that investments should always be seen within the context of a pre-determined timeframe. If you are likely to require access to part of your capital within the space of a few months - or even a few years - then investing in assets that can be highly volatile or which have significant dealing costs is unlikely to make sense. Part of your assets should be kept in an easily accessible format, which usually means cash deposits. This part of your investment portfolio is unlikely to keep pace with inflation, but that is a price many are prepared to pay in order to have peace of mind.

Investing for the longer term

In general, volatility over a short to medium period is not something that should be of great concern; provided you do not need access to your money immediately, there is time for its value to recover. And, of course, the longer you hold investments, the less significant dealing costs associated with purchasing and selling assets become, compared with overall growth.

Assets such as shares (including collective investments like unit trusts) and property should be seen as longer-term investments. What matters is not how much values may fluctuate over the short term, but how they perform over the longer term. Looking at the FTSE100, the index is worth around twice as much (ignoring inflation), as it was twenty years ago; a not unrealistic timeframe for investments.

Low values can help

Over the shorter term, lower values can actually be of assistance to investors. For example, with the FTSE100 standing about one-quarter lower now than it did at the start of 2000, investors today can purchase many more shares for their money than was the case almost twelve years ago. This means that the potential for gain, should share values return to their long-term trend, is far greater simply by virtue of the current 'undervaluation'.

Of course there are other factors that need to be taken into account, including dividend growth and the relative strengths of various market sectors, when making investment decisions, but that is the strength of seeking independent financial advice - we are always pleased to offer you our professional and individual support.

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Career average pensions

One of the recommendations made to the government by Lord Hutton was that public sector pension schemes should be altered from 'final salary' to 'career average'.



Pensions should be rewarding

Final salary pension schemes are a form of 'defined benefit' arrangement whereby the pension available is based on an earnings formula - most commonly, one sixtieth, eightieth or hundredth of 'final salary' for each year worked. In practice, the final salary may be averaged over the last three years prior to retirement.

The responsibility for meeting the guaranteed payments - and future indexation - rests with the employer, who sub-contracts the administration to trustees, often an insurance company. The member carries little financial risk, although in the event of the scheme running out of money and the employer not being available to make good any shortfall, a replacement income from the Pension Protection Fund may be limited for those with higher pensions, capped at £29,897.42 (2011/2012).

How will career average (revalued) schemes work?

The difference with career average schemes will be that, instead of looking at the 'final' salary, each year of scheme membership will be considered individually and an appropriate proportion - the accrual rate - notionally set aside as a future benefit, to be revalued on an agreed basis, but probably in line with CPI inflation.

The accrual rate might be 1%, 1.5% or higher; for example, new entrants to the Civil Service are currently offered an accrual rate of 2.3%.

Will anyone be better off?

It has been pointed out that many high-flyers will be worse off, because their increased earnings later in their careers can currently result in disproportionately large salaries in the run up to retirement, which massively boosts their pension entitlement. This is one of the problems that is exercising the minds of public sector employees, who are concerned that the switch (which will only affect future earnings) will leave them much worse off.

The other side of the coin is, however, that those lower down the pay scale, whose incomes tend to rise only gradually over their entire career, could find that they are no worse off - and may even be better off, depending on the accrual rate and how inflation works.

What might you do, if you are affected?

Nobody can really afford to ignore their pension planning, even if they are members of a defined benefit pension scheme - and most of us are not. Employers have been closing these schemes in their droves, because they impose a massive financial liability on the business that many simply cannot afford to carry.

Consulting a professional independent financial adviser will enable you to determine how your pension arrangements are affected by any changes. Even if you are not directly affected by a switch to career average pensions - perhaps because yours is already a defined contribution scheme, where the benefits depend on what is paid in plus investment growth net of charges - you should take the opportunity to check whether your retirement plans are on track.

It is important to take professional advice before making any decision relating to your personal finances.

Protecting investments

There is no such thing as a risk-free investment, but you can take steps to minimise the risks associated with saving for the future.



Investments should be protected, but not at the cost of poor returns

With all investments, to have any chance of making a profit you must accept some risk. This falls into a number of categories, not least of which is that if the growth rate is lower than inflation - which applies to most savings accounts - then the real value of your money will be falling.

In practice, most investors are concerned about the risk that their money will disappear - in part or entirely - or, to a lesser extent, that their chosen investments will perform less well than some of the alternatives that they might otherwise have selected.

How to avoid losses

Since with-profits investments became less popular, it has been difficult for investors to choose assets that do not include the risk that some value could be lost. More sophisticated investors may be able to minimise the downside risk by using derivatives, or options, to protect their portfolio, but this strategy relies on the solvency of the counter-party and is therefore far from risk free.

A more practical approach

For many investors, thinking carefully about how and where they invest can provide a degree of 'protection' against poor investment decisions. By choosing a range of different assets, you do not guarantee that the value of your investments will not fall, but rather give yourself the chance that, if some do perform weakly, others will do better. So, even if you miss out on the benefits of having selected only the 'best' performing asset, you should also avoid the downside of having selected only the 'worst' performing investment class.

Spreading risk can be achieved in a number of ways including selecting funds that invest in different types of companies, or that focus on various parts of the world. You can also consider investing in property - including commercial property - and even physical gold. This latter asset class can potentially perform strongly during periods when shares do not, but factors such as storage and transaction costs need to be considered.

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Defer your state pension

According to Money Management magazine (quoted in The Sunday Times 3/7/11) deferring the state pension by five years would increase annual income from £5,311 to £8,072.

This, (according to Money Management) is equal to a return of 8.7% a year compound - highly attractive in today's low-interest-rate climate.

Of course, you have to live for at least nine and a half years after starting to take the pension in order to benefit, but with so many of us living longer than previous generations, this may not be unreasonable.

Why might you wish to wait?

While some people wish to retire as soon as possible, others feel that they will be able to work well beyond even the increased state retirement age (which will reach 66 for both men and women by April 2020). Between April 2034 and April 2036, the state retirement age increases to 67, affecting anyone currently up to their mid-40s. Then between April 2044 and April 2046 it rises further to age 68.



An attractive potential return

What if you need the income?

Whenever you are due for your state pension, the potential rate of return available could make a decision to defer taking it by half a decade potentially attractive.

While this might not appear to be practical for everyone, the flexibility allowed under current legislation now makes it easier to effect a gradual transition into retirement by starting to draw a private pension while still in part-time (or even full-time, if you wish) employment.

For those who do not wish to work longer, but are still attracted by the idea of delaying their basic state pension, making personal provision to 'fill the gap' is by no means impractical. One method could be by building up an additional pension plan intended to generate an income for the five years between starting their occupational or other personal pension plan (provided it generates at least £20,000 a year) using the new 'flexible drawdown' facility, which would enable them to utilise the entire fund.

Those whose guaranteed income is less than £20,000 a year could still put aside sufficient money into a personal pension to generate an additional 'basic drawdown' income between the ages of, say, 65 and 70, but this would require a larger fund as the income is limited to 100% of the level that could be purchased as an annuity at the time. However, after the basic state pension starts, the income drawn under basic drawdown could be reduced to zero, with the balance of the fund rolling up for future use.

An alternative approach

Another way of funding for the 'five-year gap' might be to use Individual Savings Accounts (ISAs) which can generate an income. Unlike pensions, there is no tax relief on the money you put in, but ISAs do grow largely free of UK taxes on income and capital gains and there is no tax on the money you take out.

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

During the third quarter of 2011 the FTSE100 fell back by 13.74% due to the ongoing failure of Greece to resolve its budget deficit; an issue compounded during August by the inability of the US to agree an increased budget until the eleventh hour.

The mid-cap FTSE250 fared even worse, losing 17.72% of its value over the third quarter. It now stands almost 7% lower than a year ago and 15% lower than at the start of 2011, affected by similar influences to the FTSE100 and other markets.

Sterling lost 3.07% of its value against the US dollar during the third quarter, making export there less expensive, but gained 5.21% against the euro, which will not help exporters. Since the EU represents more than half our exports - compared with about 16% for the US - this is not good.

Brent Crude 1-month futures continued to fall during the third quarter, ending at US\$103.95, 7.58% lower. Meanwhile gold, which had performed strongly in the face of nervous stockmarkets, suddenly fell back during August - perhaps due to a 'dash for cash' - to gain only 8.27% over the quarter.

Do you have money abroad?

For many decades, the wealthy have kept money in overseas banks - most popularly in Switzerland - that offered a high degree of discretion over the details.

The result of this has been to make it difficult for the UK tax authorities to obtain their 'pound of flesh' on any interest generated. While it may appear a good idea for all of us to minimise the amount of tax we pay, this must be tax avoidance - e.g. using pension contributions to obtain tax relief - rather than tax evasion - not declaring income at all.

The end of an era

It is not that Swiss banks are suddenly going to start telling UK authorities about individuals who hold accounts with them, but that it will soon be possible for HM Revenue and Customs to ask them for information about specific UK taxpayers where this is targeted. In other words, the UK tax authorities will not be able to go on 'fishing expeditions' to see who they can catch in a general trawl.

What is the new arrangement?

With the exception of those UK-based Swiss banking customers who already co-operate fully with HMRC, who are exempt from the scheme, the accounts that UK customers hold with Swiss banks will be subject to a new withholding tax on future investment income and capital gains.

The tax will be 48% on interest and 40% on dividends, while capital gains will be subject to tax at 27%.

It is hoped that the deal will bring in as much as £6 billion to the Treasury, which should go some way towards making good the money lost to the country through tax evasion (estimated at £14 billion in 2008).

What about past income and gains?

The deal struck with the Swiss banks is that the tax will only apply with effect from May 2013. A non-specific payment will be made by the banks to HMRC of £384 million to cover past liabilities and all historic liabilities prior to that date will thereby be considered as having effectively been paid.

In order to avoid 'hot' money being moved to alternative banking tax havens, the Swiss banks have agreed to tell HMRC should their customers try to move money to avoid being caught.



No longer possible to forget to declare overseas income?

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.