FINANCIAL REVIEW

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Independent Financial Advisers

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How low can you go?

The base rate may not have moved, but some other interest rates are hitting ultra-low levels. It may be time to take a closer look at your investments.

The Bank of England base rate has now been just 0.5% for over two and a half years and shows no signs of increasing soon. The Governor of the Bank of England, Mervyn King, has even hinted that short-term rates might follow the pattern in the USA, where the Federal Reserve has said there is unlikely to be any change before mid-2013.

Although it is short-term rates which have attracted most attention, some medium and longer term interest rates have also been falling. For example, at the start of November 2009 it cost the UK Government 3.67% to borrow money for ten years via gilts (government bonds), whereas the cost two years later had dropped to 2.25%.

Where there have been falls in interest rates, these have had some significant and unwelcome effects.

Income drawdown

The rules for income drawdown – drawing an income directly from your pension fund – were revised in April 2011. In many instances the combination of this change and the decline in long-term gilt yields has substantially reduced the maximum amount that can be drawn per £1,000 of fund – the figure now closely matches prevailing annuity rates.

Difficult investment conditions over recent times have also had an impact. If you have been taking drawdown for some years and are due for a review in the near future, you could find that the maximum you can withdraw will fall by up to 50%, according to a *Financial Times* report on 16 September 2011.

Easy access deposit rates

Banks and building societies are still offering new instant access internet accounts with gross interest rates of 3% and more. However, these rates are now almost always achieved because of a special one-year bonus. After that bonus expires, a much lower rate applies – possibly down to base rate.

Fixed-term deposit rates

Back in October 2008, as the credit crisis peaked, you could have obtained over 7% from a three-year fixed-rate bond. The likelihood that base rates will continue at current levels for some time means that today's fixed rate offerings are much lower – the best rate for three years is now under 4.50%.

If the decline in yields has affected you, a review of your investments may be worthwhile. The fall in yields has not been universal. For example, over the last year sterling corporate bonds yields have generally increased because of concern about the state of the global economy and the ability of borrowers to repay. The same worries have seen UK share prices fall and dividend yields rise correspondingly since the start of the year.

The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

What risk means to you

Like most emotive words, 'risk' means different things to different people.

When such an emotive word is used in the context of money, it can cause not just anxiety but confusion. So like most financial advisers today, we try to clarify what 'risk' means – and this is usually as much to do with you as it is to do with what you invest in. Risk is a function not just of prices going up and down, but of your attitudes, needs and circumstances, as well as your capacity for financial loss.

What is a risk profile?

The end product of questionnaires and discussions on the subject of risk is usually called a 'risk profile'. It is the document we, as your advisers, will use as the basis for any savings or investment recommendations we make. Often it will include a short description of the kind of pattern of risk and return you are prepared to accept. Financial advisers generally consider a risk profile should have three components:

Tolerance of risk.

This is what you feel about risk and is usually easy for you to articulate. It is also easy to discover where on the 'risk spectrum' you are by completing a questionnaire and in discussion.

Need for risk.

This relates directly to your aims. For example, if you have an ambitious target for early retirement, you may need to generate a high return from your savings in order to have enough capital to generate your target income. In this case you would have to take high levels of risk to achieve what you want.

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Capacity for risk.

This relates to your circumstances. For example, if you are retired, you cannot replace any capital you lose with income from work, so your capacity for risk is likely to be lower than that of someone who is in employment. We are duty bound to consider especially your capacity for loss.

We will normally create a risk profile based on all three elements to provide clarity about how you plan to meet your goals.

A risk profile cannot prevent you from suffering loss, but it can ensure that you understand why you are taking on a certain level of risk, and it may help to ensure that if market prices fall, your losses are within a range you can cope with, both practically and emotionally.

Annuity rates continue to shrink

Falling government bond yields and increasing lifespans are pushing down annuity rates.

Annuity rates are currently at the centre of a perfect storm:

- Yields on long-term government bonds are at historically low levels (see 'How low can you go?' on pages 2–3).
- Life expectancy continues to increase rapidly – witness the Government's efforts to increase the state pension age.
- Forthcoming new EU rules are making it more expensive for insurance companies to underwrite annuities.

This means that if you are about to draw benefits from a pension plan, you must review all your retirement income options, including:

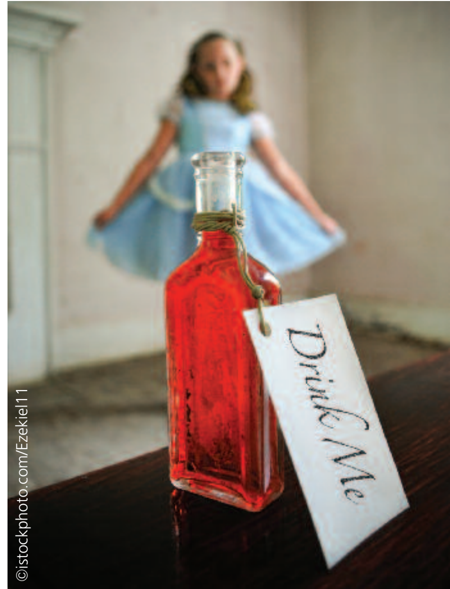
Open market annuities

You should never accept the annuity rate from your pension plan company without first checking what is on offer elsewhere. Annuity rate setting has become increasingly refined in recent years. For example, some companies now set rates according to your home postcode. If you are a smoker or in less than perfect health, you may be entitled to an enhanced annuity rate.

Phased retirement

Phased retirement involves drawing on your pension plan in stages, with each year's 'income' consisting of a tax-free lump sum and annuity payment(s). This route has the advantage of avoiding the one-off annuity purchase, but it does involve more investment risk. Part of your pension plan will remain invested after your retirement income begins and annuity rates could fall further.

Income drawdown



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Income drawdown – drawing your income directly from your pension fund – is normally only a viable option if you have other sources of retirement income. Income drawdown charges are generally higher than those which apply to annuities. It offers flexibility, but in most instances your maximum permitted withdrawal will be much the same as an annuity can provide. Income withdrawal arrangements virtually always carry investment risk and if this concerns you, an annuity could be a better option.

Phased retirement and income drawdown are high risk, complex retirement income strategies. In view of their complexities, it is particularly important that you review your objectives and options with the help of expert pensions advice. The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. The value of tax reliefs depends on your individual circumstances. Tax and pensions laws can change.

Emerging into the light?

If the developed economies are in such a mess, what about emerging market investments?

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Growth in the UK has virtually ground to a halt. It's so weak that the Bank of England has just started buying £75 billion worth of gilts. In the rest of Europe, meanwhile, peripheral economies are in such a state that there are real fears some may go bankrupt. So if the core developed nations don't present vibrant investment opportunities, what about the emerging markets?

Growth differential

Certainly, if you are looking to put money into younger economies with better growth profiles, you can find emerging markets that are likely to fit the bill. For example, China's growth hasn't dipped below an impressive annual 9% since 2001 (although it is forecast to go below 9% in 2012), while Brazil's economy, bolstered by demand for its natural resources, surged 7.5% last year to become the world's No.7. Don't forget, this is the country selected to host the FIFA world cup in 2014 and the Olympics two years later.

Debunking the 'no dividend' myth

One common misconception is that emerging market stocks don't pay dividends, making them a longer term growth play rather than income generators. It is true that some merely pay lip service to returning shareholder value – in the last week of October, India's benchmark index, the Sensex, yielded just 1.3%, while South Korea's Kospi was only 1.4%. But better returns are available – 3.5% from Thailand, and – no surprises – an alluring 4.2% from Brazil. Those returns compare favourably with 3.5% on the FTSE All-Share, and dwarf the S&P500's measly year-to-date return of 1.3%.

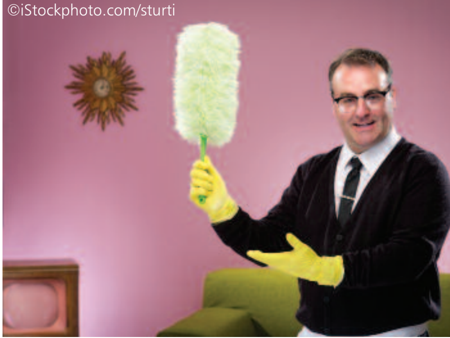
Beware of 'crowded exits' and political exposure

It's not all plain sailing. You should be aware that your fellow investors have a tendency to withdraw their money from emerging markets in concert – as was seen when the 2008 financial crisis struck – which can mean big losses. And you can easily end up with political risk in your portfolio – many flagship emerging market companies are majority-owned by their governments, leaving stockholders vulnerable to the whims of politicians in need of re-election as well as the vagaries of the global economy. There's also foreign exchange risk to consider, because emerging currencies are notoriously volatile in tough times.

With core developed economies in dire straits, emerging market stocks look an attractive option. But they bring their own risks, and should the global economy worsen they won't be immune from the consequences. Emerging market investments are high risk and therefore are not suitable for everyone. The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances.

Getting ready for 1 October 2012

It may be nearly a year away, but if you are an employer, you should be preparing for 1 October 2012.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Most new laws affecting businesses now start to operate from 6 April or 1 October. Thus 1 October 2011 brought a rise in the national minimum wage, the introduction of new rights for agency workers and the final abolition of the default retirement age.

1 October 2012 will see two more significant changes, which have been long in preparation:

- The start of a four-year phasing in of auto-enrolment – largest firms first – into workplace pension schemes for employees and other workers; and
- The official launch of the National Employment Savings Trust (NEST). NEST has been designed as the default pension where no alternative arrangement is offered by the employer.

Unlike the existing stakeholder pension access arrangements, there will be no exemption for employers with fewer than five employees: if you have just one employee, you could need to auto enrol them in a workplace pension. Broadly speaking, only individuals under age 22, over state pension age or earning less than the personal allowance (£7,475 in 2011/12) are not subject to auto enrolment.

Once an employee is auto-enrolled, you have to make pension contributions unless the employee decides to opt out. (Remember that those who opt-out must be auto-enrolled every three years.) The minimum employer and total contribution levels are set as a percentage of 'band earnings' and are being phased in over five years (see table below). However, the band has not yet been finalised because the Government is awaiting earnings inflation data. In practice the band is likely to be between about £6,000 and £40,000 a year.

Date	Minimum employer contribution* %	Minimum total contribution*+%
October 2012 – September 2016	1	2
October 2016 – September 2017	2	5
From October 2017	3	8

** Based on band earnings*
+ Employer plus employee gross contribution (i.e. including 20% tax relief)

The phasing in of auto-enrolment means that most employers with less than 50 workers will not begin to auto enrol until at least March 2014. That may seem comfortably distant, but many employers will prefer to be ready before the legislation forces them to act.

NEST is regulated by the Pensions Regulator.

Navigating choppy waters

Many people become concerned when they see stock markets displaying the kind of high volatility they have in recent weeks.

Normally, share indices move up or down by less than 1% in a day, but over the course of September the FTSE 100 Index, which measures the performance of the largest 100 UK-listed companies' share prices, experienced massive turmoil.

Today, commentators cite two main causes of volatility: the ongoing euro crisis and fears about the pace of global economic growth. In both cases, there are wide differences of opinion about what is likely to happen. Some think a Greek default will lead to the break-up of the euro, others that the eurozone will muddle through. Some think the current slowdown in economic growth in the developed world and China is a temporary interruption of a recovery, others that it signals a recession.

It is important to understand that while stock markets reflect what *is* happening today, they are not that good at predicting what *will* happen. Nobel prizewinning economist Paul Samuelson put it like this: "Commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions!"

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So if you have committed capital to the stock market for the long term as part of a balanced portfolio, you should not be too swayed by day-to-day movements. Such volatility is the price you pay for returns that have always been, over the long term, higher than those from cash deposits or fixed-interest investments.

And if you are saving regularly, then in fact you may benefit from volatility, since it can lower the average price at which you purchase investments. If you do have concerns about your savings or investments, we will be happy to discuss these with you. Past performance is not a guide to future performance. Investments can go up or down, and you may not get back the original amount invested.

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