Financial Planning infobyte 2016

# Newsletter

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## Averaging and ravaging pension funds

There is a dilemma for people who do not have the security of annuities or final salary pensions and are looking to their pension pots to finance their retirements. Will the pot be big enough, or too big, and what level of income will it sustain?

When pension funds are accumulating they benefit from what is known as ‘pound cost averaging’ - regular contributions buying more investment units when markets are low, and fewer when they are high.

In retirement, this advantage goes into reverse (as pension funds are ‘ravaged’?). If withdrawals are made when markets are down, the fund will need to grow by more than the amount of the reduction to return to its original value. For example, a 10% fall in the value of a £100 fund would reduce the value to £90, but an 11% increase from that level would be needed to regain the original value of £100.

Further complicating the situation is the fact that losses made as a result of market falls early in retirement will be exacerbated by withdrawals and are likely to have a lasting impact on the future value of the fund.

So, clearly, financial planning is required and this will need to take account of a multitude of variables – notably age, health, life expectancy, attitude to risk, capacity for loss and prospects for inflation and investment returns. The plan will also need to be reviewed on a regular basis.

Academics have been pondering the question of whether, all other things being equal (which they never are!) there is a “safe withdrawal rate” – that is to say a rate which will be sustainable for as long as is required.

American researchers have concluded that a withdrawal rate of 4% per annum is sustainable, but applying the same principles to the UK investor, the rate comes out at nearer 3%, from which adviser charges would need to be deducted.

However, these figures are based on the assumption that retirement will take place at age 65 and withdrawals are spread over a period of 30 years. So, clearly, for later retirees the level of sustainable withdrawals will rise progressively.

But even for 65 year olds, there are ways of improving the odds. For example, a cash reserve could be maintained – perhaps equal to two years’ withdrawals – which might avoid the need to withdraw funds when markets are down. Alternatively, it might be possible to draw less when markets are down and more when they are buoyant.

The older the retiree when withdrawals commence, the greater the sustainability of the income will be, and bearing in mind the fact that pension funds are exempt from inheritance tax, it makes sense to encash ISAs and other investments first.

There is also a major role for annuities as a source of secure income, which may again reduce or defer the need to draw down from pensions. However, the purchase of annuities should ideally be left until age 75 for those with funds large enough to be in draw down.

## ‘Help to Buy’ ISAs

A new tax-free savings account has been introduced to help first-time home buyers save up for the deposit on their purchase.

‘Help to Buy’ ISAs are similar to cash ISAs, but benefit from a top-up from the Government. Savers, or their parents, can invest up to £1,200 initially and then up to £200 per month and the Government will then add a bonus of 25%, with a maximum of £3,000. So anyone who has invested £12,000 will have their investment topped-up with the maximum bonus of £3,000 to a total of £15,000.

There are conditions attached. The property must be purchased for occupation by the ISA holder and cannot be rented out; and it must be their only home. Also, the value of the property purchased must not exceed £450,000 in London or £250,000 elsewhere.

Bank and Building Society providers are already quoting attractive interest rates, but the 25% guaranteed return alone has been described as "*just about the best risk-free investment rate out there*".

### Crowdfunding ISAs

The Government is also planning to permit ISAs to invest in the fixed interest securities of "crowdfunding" schemes in the autumn of 2016, and has announced that it will consult on whether investment should be permitted in equity securities.

Crowdfunding is a method of raising finance for small businesses which enables them to promote themselves direct to potential investors, usually via websites which contain details of the businesses, the amount of funding they need to raise and how this will be used.

Some of the businesses listed qualify for the special tax reliefs available to Enterprise Investment Schemes and Seed Enterprise Investment Schemes.

From the investor's point of view, the advantage of cutting out the middleman and investing direct is that the returns are higher than would be expected from deposits or cash ISAs. But higher returns mean higher risk, and the Financial Conduct Authority is keeping an eye on this sector.

### Taxman targets the affluent

HM Revenue & Customs has established an "affluent unit" to crack down on tax avoidance. Until now, this has concentrated its attention on people earning over £1m per year, but the net is now being widened to catch everyone earning over £150,000p.a. (the threshold for the 45% tax bracket).

The unit is particularly interested in people who own property or bank accounts abroad or who have invested in devious tax-saving schemes or whose tax bill looks surprisingly low relative to the value of their assets.

Anyone who feels that they might be the subject of HMRC attention is advised to contact their tax office, and if it transpires that they have fallen foul of the law this might help to mitigate any penalty.

**If you would like to discuss any of these matters further please contact:**


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