NLP Financial management

NLPFM news

News and views from NLP Financial Management

The new world of pensions

There's no doubt that recent months have been a somewhat uncertain period for adviser and investor alike in relation to pension funding and planning. The old A-Day regime, having been swept away by the previous government, was replaced by a complex set of interim rules designed to hold until April 2011, during which time consultation was under way to find a new direction. Consultation complete, the new guidelines were announced on 14 October – the date of writing. So, this is what we understand so far:

- The annual allowance is to be set at £50,000. This will be the maximum level of contributions for the benefit of an individual from all sources in any one pension input period (PIP) per tax year. However, as a sweetener any unused allowance can be carried forward from up to 3 previous tax years. Should this limit be exceeded, the government will tax the excess at the individual's marginal tax rate. Consideration is currently being given as to how this tax will be collected. Whilst this legislation is expected to be effective from 6 April 2011, in reality, it already affects any scheme member whose PIP ends in the 2011/12 tax year. It is therefore crucial to consult on when individual PIPs end as there will be transitional rules, traps and planning opportunities.
- The Lifetime Allowance (LTA) is to be reduced from £1.8 Million to £1.5 Million from 6 April 2012. This is the maximum pension fund value that can accrue to an individual during their lifetime. Some individuals may already benefit from Primary or Enhanced Protection and the government intends to give consideration on how to protect individuals close to the new lifetime limit as well as on the maximum level of tax free lump sum payments. A reduction in the LTA as above, would currently reduce the maximum potential lump sum by £75,000 and at the time of writing the government is indicating this might be the case.
- Pension contributions up to the annual allowance will continue to benefit from relief at the member's marginal rate. This means up to 50% tax relief for high earners personal contributions. In some cases this effective rate of relief can reach 60% for those earning between approximately £100,000 and £115,000.
- The multiplier used in final salary schemes moves from 10 to 16. This means that for every £1,000 increase in annual pension benefit, a contribution of £16,000 will be deemed to have been made. Thus, far lower salary increments than would otherwise have been the case, could result in tax penalties.

Whilst it is important to note the above is very much *hot off the press*, it is already clear that this change in legislation calls for professional advice as retirement planning becomes increasingly complex. As always, your usual NLPFM consultant will be on hand to lead you through the minefield.

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Preparing for the unexpected

Every business needs to prepare for the unexpected. Whilst most are insured against fire, theft and liability, how many are prepared for a loss of something equally as valuable – its key people?

Based on the Scottish Widows Business Protection Report 2009, 81% of businesses have a key person whose loss would impact on the profitability or indeed survival of that business. However, 67% of these businesses have no insurance to protect against the potential loss of profit from such an event. In fact, businesses are more likely to insure the photocopier against breakdown (29%) than they are to insure a key person on death (15%) or critical illness (13%). These statistics are even more worrying when coupled with the fact that 59% of UK businesses which do not have key person insurance believe their business would not survive such a loss.

Key Person Protection

- Do you have key people?
- If a key person were to die or suffer a critical illness preventing work for a prolonged period, would your profits be adversely affected?
- Should one of the sales team be inactive, would that reflect in your figures?
- Do directors or partners have personal guarantees at risk of being called in by the bank in the event of death or critical illness?

If YES is the answer to any of the above, insurance should certainly be considered.

Calculating Level of Cover

The level of cover should equate to funds required to replace the key person and cover loss in profits which may result from death or prolonged absence. Included in this would be the cost of recruiting replacements, necessary training and time required to regain level of profitability, together with resultant income reduction during this period.

Calculation methods include multiple of salary (5-10 times annual salary) or a multiple of profits. Normal multiples would be 2 x gross profit or 5 x net profit with higher multiples being applied for a rapidly expanding business. A more scientific approach is known as the *Proportion of Profits* Formula where cover is calculated as:

$$\frac{\text{Key individual's annual salary} \times \text{annual gross profit} \times \text{number of years to recover}}{\text{Total annual wage bill}}$$

A company would normally be able to claim tax relief on premiums paid for key person insurance. If tax relief is not available, the proceeds would normally not be taxable but this is a complicated area and specialist advice is always required.

In summary, during these difficult economic times, key person insurance is perhaps more relevant than ever to ensure continuity despite the loss of a key individual. This is indeed a case of needing to **expect the unexpected**.

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Diversification or "diworsification"?

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Many investment managers work on providing diversification for clients. This is achieved by holding a broad asset range and then purchasing differently run funds within the separate asset classes.

We follow these general principles within our own Discretionary Management Service, with an asset allocation model spreading portfolios across five asset classes – cash, fixed interest, property, equities and alternative assets. Alternative assets will incorporate absolute return funds designed to achieve growth in all stock market conditions, commodity funds and structured products. We then hold a number of funds within each asset class. For example, the equities sector will be spread across the capitalisation range, i.e. larger and smaller company funds.

This approach mitigates risk by holding assets whose performance can be uncorrelated. As an example, when the equity markets fell heavily between 2000 and 2003, the property market performed well (although this is not always a given). Another safeguard is to access funds in totally different geographical regions. All these measures reduce the overall portfolio volatility.

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Reduced volatility must of course be measured against diversifying too widely where the benefit of the out-performance of a particular fund could be lost within the overall returns. Take for example, a portfolio with a 100 funds compared to a portfolio with 20 funds. Should one fund outperform by 5% in each portfolio, the portfolio with only 20 funds will achieve far greater returns, although of course the opposite is true where there is underperformance.

We believe that whilst diversification is important, too many funds within a portfolio can be counterproductive. Our asset allocation will typically hold between 25 - 30 funds so the weightings to each fund is around 3 - 4% (excluding cash). This enables the individual funds to have significant effect on the portfolio without taking too high a level of risk.

In summary: an investment manager should be following his convictions to strive for out-performance through a sensible strategy of diversification.

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Financial advisers – do we need them?

As the internet increasingly influences our lives, the question of whether clients need financial advice becomes more relevant. My view is that clients are increasingly able to manage certain aspects of their affairs without the assistance of financial advice. I have, for example, clients who conduct their own research on the best bank or building society accounts into which they can deposit their funds. However, with time at a premium, research does not appeal to all clients nor indeed to those who prefer the security of knowing a professional has done the research.

The main role of a financial planner can be categorised as follows:

- **Key areas of client advice** – An initial consultation with a client should give an experienced adviser all the necessary information to identify the areas of advice called for. For example, an elderly client may need to focus on inheritance tax planning, ensuring the maximum amount of assets are passed down rather than focusing on investment planning where additional returns of 1% per annum are insignificant compared to a potential 40% IHT saving. Similarly, high earning clients may need to look at how those earnings are protected rather than savings strategies which could become irrelevant in the event of an unforeseen illness.
- **Breadth of Advice** – Financial advisers need to be able to offer the breadth of advice that will benefit their clients. This should include investment, pension, protection and tax planning although accountants and lawyers may need to be involved in tax advice. It is of course important that clients are assured they are working with authorised and fully qualified advisers.
- **Experience** – When it comes to financial advice, there is no substitute for experience and whilst every client's situation is unique, an adviser is more likely to be able to identify key requirements when working from a base of experience. Where an adviser has a shortfall of knowledge in a specific area, there should be colleagues within the practice with the necessary skills.
- **Independence** – It is vital for the adviser to be completely independent so advice is impartial and uninfluenced by remuneration or other constraints. The role of the adviser is as a *trusted sounding board*, capable of assessing the attitude to risk of the client and key areas that must be avoided at all costs.

In conclusion, it is our view that financial advisers have a role to play in today's world as long as they can meet the requirements identified above but they also need to recognise where it is more suitable for clients to carry out the work themselves.

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Offshore bonds – never say never again

Increase in the capital gains tax rate from 18% to 28% for higher rate taxpayers will bring renewed interest in investment bonds, both onshore and offshore. Whilst this article focuses on offshore bonds, many of their advantages are equally applicable to onshore bonds.

Whilst 28% capital gains tax for higher rate and additional rate taxpayers is still lower than the 40% or 50% income tax applicable to offshore bonds, there are a number of offshore bond advantages which mean they could be considered for many clients.

Five key tax features of investment bonds

- Tax Deferral – Offshore investment bonds generally enable tax deferment on both income and gains until encashment.
- Control of the Tax Point – There is no personal tax payable until a chargeable event occurs within a bond. Investors can therefore often time encashment to an optimum point i.e. when they are paying a lower tax rate or when tax rates are generally lower. They can also defer gains until such a time when they may become non-UK residents which could then potentially obviate tax altogether.
- Switching – There is no tax charge in a bond when investments are switched from one fund to another. This allows investors to make investment decisions, free of tax considerations.
- 5% Allowance – Investors in bonds can take up to 5% a year of the original amount invested for 20 years without triggering a tax charge. This offers a convenient “income” which can be combined with inheritance tax planning through loan trusts and discounted gift trusts.
- Assignment – Bonds can be assigned (without consideration) or gifted to others without triggering a tax charge. This is useful for tax planning and enables wealth to be passed through the generations. For example, you can assign a bond to a lower rate taxpayer and encashment of the bond results in significant tax saving.

We have generally in the past used offshore bonds to hold investments liable to income tax. This is because such investments would otherwise be liable to 40% or even 50% tax for higher rate or additional rate taxpayers but such tax can be deferred through the bonds. Tax deferral can provide significant savings over time. In addition, with the increase in capital gains tax, it may be worth considering utilising offshore bonds to hold investments liable to capital gains, especially if the rate of capital gains continues to rise as the government seeks to balance the country’s books.

In considering offshore bonds, it is important to be aware that fixed charges for such bonds can reduce returns and therefore we would normally not recommend using such vehicles for investments below £150,000.

In summary, having not promoted offshore bonds for a few years, we are now seeing increased interest in such bonds and are increasingly using these vehicles to manage investments for clients. This can be arranged through either our advisory or discretionary management channels.

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