

THE ADVISER.

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Welcome to the first edition of The Adviser, our update on developments in the world of financial services.

What is a pension?

The doom mongers keep repeating that an impoverished retirement lies ahead for us all unless we get saving now. But how many of us really understand what a pension is and what we need to do?

A pension is a long-term savings plan and its sole purpose is to provide a secure income in retirement. Essentially, a little money goes in each month throughout your working life - then by retirement, it should have built into a tidy sum. This sum is then commonly used to purchase an annuity, which will pay a regular fixed amount, usually each month and thereby supports you in your dotage.

To encourage you to start saving, the Government provides tax breaks on contributions. For example, basic rate tax payers take home £80 for every £100 earned. However, if that £80 is then placed in a pension, the Government refunds the other £20 to give £100 invested. Higher rate taxpayers get £100 invested for laying out only £60 of their take home pay.

There are two basic types of pension - a personal pension, started by an individual, and an occupational scheme, organised by an employer. The latter then breaks down further to 'defined contribution', where a set amount goes into the scheme and the payout depends on the growth of assets, and 'defined benefit' (now increasingly rare), where contributions vary but the amount the scheme pays out is agreed in advance.

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Start early

The Government Actuary's estimates put life expectancy at 91 for a female born today. As we are living longer, it therefore makes sense to maximise your pension, and the earlier you start saving, the more money you're likely to have. Indeed, the money saved into a pension between the ages of 25 and 35 can account for up to half your final amount. The main reason is the effect of compound interest, where the interest on money you save earns interest on itself over time. Start a pension at 25, say, and at 6% pa, £50 a month would provide £100,000 at retirement (age 65). Delay the start until the age of 35 and that same £50 per month produces just £50,000.

Always shop around

When you retire, it can be tempting to succumb to the first fixed rate, level annuity quote you receive. However, with the average life expectancy now between 80 and 85, your annuity might have to pay out for more than 20 years - and, despite its seeming irrelevance at the moment, inflation can seriously impact your spending power over that time.

It is therefore sensible to shop around - and there are various options to choose from if you want to make the most of your money. For example, there is an index-linked annuity, which is tied to the rate of inflation, and there is also an escalating annuity, which rises at a fixed rate each year, regardless of inflation (in other words, some years the rise may be greater, some years it may be less). For the more adventurous, you could even link your income to the ups and downs of investments (providing you are prepared to take the risk). All of these options are likely to offer a lower starting income than the equivalent level annuity, but over the long term, your ability to afford the same lifestyle could be better protected.

Of course, your circumstances may mean a mixture of annuities is appropriate. Or, depending on your appetite for risk, and size of your fund, you might even have the option to defer the annuity purchase. If you can leave that until later in life, or if you suffer from poor health, the potential for higher income from a level annuity may outweigh other issues. Whatever you decide, make sure you shop around. You can't change your annuity once you've bought it, so pick the right one.



A new option

From October this year, the Government corrected a quirk in pensions planning and allowed the inclusion of protected rights in SIPPs. This change allows those with protected rights to consolidate their pension into one place and take advantage of new investment opportunities available within SIPP plans.

Protected rights are the result of contracting out of the second state pension scheme (now known as S2P). The idea is that people divert contributions into an investment which might (or might not) outperform the Government scheme - and also save National Insurance contributions. They can also offer some additional flexibility at retirement as the minimum retirement age is lower, a lump sum is available and the drawdown and deferral options can be used as they can with a normal pension plan. This latest move means you can now also get the investment flexibility benefits of SIPPs on this section of your pension.

So what should you do if you have protected rights? It is important to talk to an expert to see what the downsides might be. Transfers take time - and cost money - so it is worth considering your options fully. You will also have to make a decision on how to invest the funds if you do transfer. Perhaps they will follow the rest of your SIPP portfolio. On the other hand, equity and bond markets have been in turmoil and there are new products being included in SIPPs all the time. This could provide a good opportunity to have a wider conversation and maybe re-adjust the balance of your entire pension portfolio as a result.

Avoiding surprises

The investment decisions made for your pension could have a significant impact on your wealth in retirement. One of the main decisions is how to blend the four main asset classes - equities, property, bonds and cash - with the aim of meeting your investment needs and balancing risk. Equities have provided the highest return over the long term, but carry the highest risk, whereas cash preserves your capital but does not protect against inflation and offers no chance of any capital gain. It is common therefore to start with a greater proportion in equities, to maximise the growth potential, but to switch the gains into more secure assets as retirement approaches.

