SimplyMoney

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A better design for your financial independence

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Your independent *window on financial issues*

Do economic conditions influence *your* investment decisions?

While many commentators consider that we are either at or slightly past the worst of the recession, investors face a quandary.

For most of us, shares form the bulk of our 'active' investments; that is everything other than our homes and short term savings. Shares may be held directly, or indirectly through a collective investment such as a unit trust ... or via a tax-efficient 'wrapper' such as an ISA or pension plan.

Either way, what happens to share markets is important, which is why we regularly comment on the main UK indices (see page 3).

Whilst shares are influenced by economic conditions, they are also subject to other factors. Perhaps the most important of these is sentiment. The views of professional investors about issues such as the underlying performance of companies can be far more important than short-term considerations about the demand for—and supply of—shares in stockmarkets.

How economics matter

When the economy is shrinking in terms of gross domestic product (GDP), as we have seen for much of 2009, some investors may believe that companies will perform weakly compared with times of growth. This is of course true in general, but not in all cases. For example there are many sectors where performance is comparatively stronger in a weak economy. These might include businesses operating in essential commodities and those retailers operating at the lower end of the price spectrum.

With the Retail Prices Index (RPI) negative since the end of the first quarter of this year, investors could be forgiven for thinking that all the news is bad.

Conversely, the more relevant Consumer Prices Index (CPI) is still positive, which is important because it excludes mortgage repayments and similar housing costs. This matters because it actually means that people should be feeling better off; after all, they face lower costs on mortgages and rent which means that they are likely to have more money available to spend on other items, the prices of which could be falling.

Employment

Perhaps more importantly unemployment, while tragic for those personally involved, has not (so far) reached the levels anticipated in some 'worst-case' scenarios and this is key to sustaining the consumer demand that should reverse the downturn in GDP.

Risk of real deflation

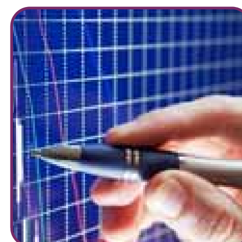
What is more worrying is that the fall in the rate of CPI might continue and even go negative, which could encourage people to hold back on discretionary spending in the expectation of even lower future prices. That could have a massive impact on the economy—and share values.

It really is in the best interests of everyone that those who are in a position to spend should do so. And without wishing to sound protectionist (because freedom of world trade is important to the UK) choosing to buy British whenever possible cannot do any harm.

It is true that we face a long haul to recover from the Credit Crunch and all the government's enforced borrowing, but investment markets can be expected to recover over the longer term.

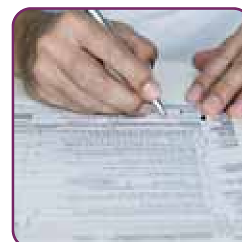
THIS ISSUE

Shopping can help!

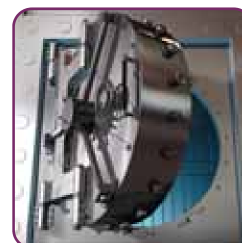


Turning a loss ...

Protection in a recession



Credit ratings



Guaranteed products?

Turn losses to advantage

News that those earning in excess of £150,000 a year will soon face a tax rate of 42.5% on dividend income highlights the beneficial tax treatment of pensions.

It also reminds us that there are times to crystallise investment losses.

Anti-forestalling regulations put in place to prevent 'very high earners' from piling in massive amounts of money in advance of the introduction next April of a 50% tax rate on their earnings—and the 20% limit to tax relief they can receive on pension contributions—means that they are limited in how much they can invest in this way.

For those with incomes below £150,000, however, the contribution limit for this year is their entire earnings (while an employer can top this up to the annual allowance of £245,000 this year—£255,000 next).

How does this help?

Many self-invested personal pensions (SIPPs) will accept what are called *in specie* contributions. These are contributions made not in cash, but in the form of shares (or some other property) already owned by the investor.

Of course, once investments are held within a SIPP, there is no UK income tax (other than the unavoidable 10% tax withheld on dividends from UK companies). Similarly, there is no capital gains tax. So by moving shares (up to the permissible limit) into your SIPP, you can protect these against future tax.

What is more if you earn, say, £80,000 a year and make an *in specie* contribution of shares worth £40,000 into your SIPP, the taxman adds tax relief of £10,000 as contributions are net of 20% basic rate tax relief. And as a higher rate taxpayer, you will also be entitled to a further 20% in additional tax relief. So your tax bill will be slashed by a further £10,000 for the year.

Will I have to pay CGT?

If the value of the assets you move into your SIPP is higher than the amount you paid for them, then they are potentially liable to capital gains tax (CGT) at the new rate of 18%. However, because there is an annual allowance on realised gains of £10,100 before the tax cuts in, your investments would have needed to have performed well for this to make a significant difference on the figures discussed.

What if my investments are showing a loss?

On the other hand, many investments purchased within the last few years could be showing a loss at the moment. By carefully balancing the investments moved into the SIPP, it would be possible to offset these losses against any gains and therefore have no CGT to pay at all.

The point is that any future gains are fully protected against the tax.

The importance of advice

Of course, the rules relating to pensions mean that you can subsequently only get back 25% of the total fund as tax free cash—the balance of the fund must be used to provide some form of retirement income, which will itself be subject to tax. But by then you may be in a lower tax bracket altogether so the impact will be less severe.

Key points

- **Dividends are liable to tax for higher rate payers**
- **Falling markets reduce taxable gains**
- **Pensions shelter against income and capital taxes**

Protection in a recession

By the time you read this article, we could be on our way out of recession; but if we are, the process is likely to be slow.

This is because government borrowing to combat the worst of the recession is so great that taxes may have to be increased in order to help clear it; this will slow the rate at which the economy can grow.

So as far as planning your family protection is concerned, thinking in terms of an ongoing recession probably makes sense. There are three principal areas for consideration (plus some thoughts on costs).

Life insurance

Probably the worst thing that can happen to any family is to lose a member. However, in the case of a breadwinner, the emotional impact is magnified by the potential financial consequences.

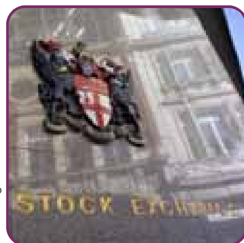
It is not just the principal earner that needs to be insured; in many families, both parents earn and even where one is able to take time off as a carer, there is a significant economic value in the contribution that they make towards the family's economic wellbeing. After all, the family still has to be fed, cleaned, ferried about and generally cared for, even if one of the parents is no longer available to do so; this means paying someone to do the job, or the remaining parent giving up some earning capacity to fulfil this important function.

Income protection

Of course, it is not just death that can hit a family's finances. Long term unemployment or illness can be devastating in so many ways and it is important to ensure that there is adequate insurance to provide a replacement income should one of the earners or family carers become incapacitated, or economically inactive.

This can be arranged in a number of ways, including through accident, sickness and unemployment insurance, or using permanent health insurance. The former generally only covers an individual for up to one or two years and is renewed annually; the latter (which will not

News in brief



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During the summer, equity markets have performed well, with the FTSE100 being some 11% higher than three months ago—now only 13% lower than a year ago.

In fact most of the main indices tell a similar story, to varying degrees, with perhaps the best result being the FTSE250.

House prices have recovered somewhat during the last three or four months, with average prices now only 2.75% lower than a year ago.

However, this may result partly from a shortage of properties for sale; prices are still high compared with average earnings.

After reaching a low point at the end of last year, oil prices have unfortunately forged ahead, now standing almost 60% higher at US$72.79 a barrel for Brent Crude 1-month futures.

This could act as a 'brake' on economic recovery, but is unlikely to prevent it.

The value of the pound, which had been rising steadily since the end of March, has recently suffered a minor reversal against the dollar and euro.

Sterling is still higher than at the start of the year, but the recent increase in quantitative easing has clipped its wings.

cover unemployment) is more usually written for a long time—such as up to 60 or 65—and usually carries a level monthly premium.

Private medical care

It may sound strange to be talking about private medical insurance in an economic downturn, but however much governments may say they will ring-fence spending on the NHS in future, unless money is correctly targeted, the service will remain under-resourced.

Unfortunately, the recession could also lead to an increase in demand for some aspects of medical care, especially if it leads to more cases of depression and similar conditions which can be resource-demanding. This means that having private medical insurance should remain a priority for many families.

Review costs

Just because insurance is important, it need not be expensive. In fact, some forms of insurance are generally less expensive than a decade ago due to enhanced medical knowledge and new treatments. This is particularly the case with life insurance and it is worthwhile considering whether the cost of existing cover might be reduced, or more cover obtained for the same cost.

Key points

- **Family financial protection remains important**
- **Some covers are even more important in a recession**
- **Some premiums can be lower than previously**

Credit ratings and you ...

With banks apparently reluctant to lend to anyone at all—despite the fact that some are in public ownership—knowing how to look after your credit rating is increasingly important.

Actually, we are told that there is no such thing as a credit rating; simply the data from which individual lenders can gather information and create their own credit score for each applicant or enquirer.

This is important because every time you seek a loan of any sort—even if you are only shopping around for the best deal—you leave a 'footprint' in the records. In theory this would not matter, but it actually makes potential lenders nervous, as they think that anyone shopping around is desperate for money and must be a poor risk. One option is to ask potential lenders to make it clear that this is a "search for quotation purposes only". The alternative is to use a mortgage broker, as these will know which lenders to approach, saving you time, effort and the risk of inadvertently adversely affecting your credit record.

Sources of information

There are three main credit rating agencies that lenders tend to use: Equifax, Experian and Callcredit. However, lenders also use a variety of other sources of information including the electoral roll and court records—looking for adverse judgements and so on.

Some of the larger lenders also share data about credit card debts, repayment histories and overdraft records with each other, to help identify 'poor' risks. They are allowed to do so thanks to a demand from the government that they should lend responsibly.

What you should do ...

Apart from avoiding shopping around, there are a number of ways to ensure that you make your credit score as positive as possible:

- Make sure you are on the electoral roll—lenders check;
- Keep your existing borrowing under control—try never to miss a payment unless you have first discussed this with the lender;
- Have a landline for your telephone—this gives a better impression of permanence than a mobile.

Another issue that you need to be aware of is that if a lender rejects an application based on incorrect information, you should challenge them and get it corrected. Simply walking away and trying an alternative lender will leave their rejection on record and produce a downward spiral of rejection.

You should also be careful not to make a joint application for credit with anyone who may have an adverse credit history, because this will instantly affect yours. If you are married to someone with a poor

credit history, this should not be a problem in itself; but applying for a joint mortgage could well tarnish your own record.

Don't be afraid to ask

Anyone can send £2 to a credit rating agency and ask to see their record. In fact this can now usually be accomplished on line and Experian (http://www.experian.co.uk/) will give you a free credit rating, although you will have to give your credit card details to get it, so it is important to cancel the subscription, if you do not want a monthly deduction from your account after the free 30 days.

Key points

- **Credit ratings are valuable commodities**
- **You can take steps to protect yours**
- **Make sure you know where you stand**

Back page briefing:

Guaranteed products?

During times of economic uncertainty investors may seek a safe home for their money.

While seeking security is a perfectly natural reaction, there are a number of reasons why it requires careful consideration.

Market fluctuations are perfectly natural; the warning that the value of investments can go down as well as up and that you may get back less that you put in is very far from being a meaningless formula.

In fact within almost all forms of investment, volatility will occur. Even investments with guarantees, such as 'with profit' plans, are affected by market downturns.

The investment facts of life

In fact this volatility can help, to some extent, because when investment values take a temporary dive, the number of shares (or 'units' in a collective investment) that you can purchase with a given sum of money will be greater than before. When prices bounce back—as they usually do—the value of your holding is therefore greater.

Where you already hold investments that have fallen in value, there can be a temptation to sell them in order to minimise your losses. But in fact, all you really achieve is to lock in the loss and forego the opportunity for recovery. Of course in some cases this is the right thing to do, especially with an investment that will clearly never recover again. The problem is knowing which these are.

In general, however, provided you are not likely to require access to your capital—or an income from it—in the short term, it can often be better to ride out the storm and await a recovery.

What about guaranteed products?

There are an increasing number of so-called 'guaranteed' investment products that appear to offer certainty over the return of your capital as well as (in some cases) the prospect of significant upside potential. They do not always, however, offer the degree of security they may appear to.

Some are backed by special financial instruments that depend on the viability of third parties in various parts of the world, rather than the company issuing the investment … and you can be sure that there is some small print somewhere that distances the product provider from the effects of any failure by the 'counterparty'.

As events in 2008 demonstrated, it is not always safe to rely on guarantees provided by foreign institutions—and even some UK ones can look shaky, although the Financial Services Compensation Scheme can often provide a degree of protection in the latter case.

Can you really have your cake and eat it?

Even if the guarantees do work—and in today's market it is to be hoped that they are more reliable than previously—they are invariably balanced by some significant restriction on the potential for gain.

In many cases, of course, this is perfectly reasonable and something that, if approached with an open mind and a full understanding of the balance of upside potential limits and downside risk protection, investors can accept.

There is no such thing as a free lunch!

What is not acceptable is any suggestion that investments are guaranteed when this is not in fact so. This has apparently been the case for some investments that might have appeared to be in cash, while they were actually invested largely in financial instruments known as derivatives, which are far less secure.

Key points

- **Seeking protection is natural in volatile markets**
- **Not everything is what it seems**
- **Professional advice is essential**

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. Rules may vary for Scotland and Northern Ireland. 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 land and buildings is generally a matter of a valuer's opinion rather than fact. 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.

Your home may be repossessed if you do not keep up repayments on your mortgage. Loans are subject to status and written details are available on request. Always seek independent advice from a qualified financial adviser. Think carefully before securing other debts against your home. Fees for mortgage advice maybe charged and for details of these please contact us. The Financial Services Authority does not regulate all the activities undertaken by the company, including taxation advice and overseas mortgages.