Autumn Issue 2013

MoneyWorks

Nicholsons

Don't be quick to rule out a rising income in retirement

Lifetime annuities have always been a popular choice for retirees seeking a guaranteed source of income for life but according to a recent ABI report, 43% of people don't take any financial advice before buying an annuity and the vast majority choose a level income that will not increase in payment.

However, whilst a non-escalating annuity will pay the highest level of income initially, because the income will never increase the effect of inflation could seriously erode its buying power over time. The value of money has almost halved in the last 20 years and even if the Government's target inflation rate of 2% is met, the buying power of a level annuity bought today could easily be less than half of what it was at outset if someone enjoys a long retirement.

If we also consider that retirees spend a greater proportion of their income on things that tend to increase in price at a faster rate than inflation (for example, energy bills and food prices have both increased well beyond Consumer Price Index rates in recent years) the benefits of choosing an increasing annuity is something that needs to be given serious consideration.

To help illustrate the point, if you are a 65 year old in good health with a fund value of £500,000, you could buy a single life annuity of around £30,000 pa that won't increase compared to a starting income of about £18,000 that would increase every year in line with inflation. Whilst, on the face of it then, the much higher level annuity may look more attractive, it is not inconceivable that this income might need to be paid for at least 30 years and even if you don't live for another 30 years you could still 'make a profit' depending on what the actual rate of inflation is. For instance, if inflation was 4% every year it would take 15 years for an initial annual income of £18,000 to overtake a non-increasing income of £30,000 pa and a total of just over 25 years for the cumulative amount of income received to outstrip the non-increasing annuity.

In our experience, the vast majority of people who choose a level income when purchasing an annuity do so because they like the idea of having more to spend earlier in their retirement when they are likely to be more active but also because they are put off by the amount of time it will take to be 'in pocket.' When looking at the time it will take to be 'in pocket' though many people underestimate their life expectancy – and the wealthier you are, statistics suggest the longer you are likely to live.

Whilst, however, the risks of inflation in retirement can often be underestimated and what might seem a good level of income on the first day of your retirement could look quite paltry

20 years later, a level income may be the right answer if you have a shorter life expectancy and/or other assets to call on when inflation starts to bite. And, if you do have a medical condition or lifestyle that is likely to result in a shorter life expectancy an enhanced or impaired life annuity may be available to boost your income even more.

The main problem though is that many individuals will consider their position today and not think much further ahead - and even those that do consider the future often underestimate their life expectancy. For example, the average life expectancy of a 65 year old is currently about 20 years but many retirees may fail to fully consider that because this is an average this will include a high proportion of less affluent people with health problems who, statistics suggest, will not survive anywhere near 20 years.

Statistics show that individuals with substantial pension pots are far more likely to live well beyond the 'average' and if you are a couple planning your retirement there is also an increased likelihood that at least one of you will live a long time. Either way though, where health issues are not present at the time of planning, it would probably be

Money Works is published by
Nicholsons
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sensible to consider a cautious approach and assume that you (and/or your spouse) will live well into your 90s at least.

Once you take a potentially longer life into account, choosing a lower starting income that will rise each year may look quite appealing. Even if you think a higher starting income that will never increase would be preferable, you should still look to have a fallback position when inflation inevitably starts to eat into the buying power of that income. There is also no reason of course why you couldn't choose to buy a level annuity with some of your fund and an escalating one with the balance.

In summary though, how best to take your retirement benefits is probably one of the biggest decisions that you will make in your life and it is important to be aware that annuities are only one of the options you can consider. Making a decision without first taking advice from a professional could lead to the wrong outcome, and if an annuity has been purchased it is vital to remember that this is not something that can be changed at a later date.

Are you a well-balanced investor?

By now most people will be acutely aware of the ups and downs in the investment markets, (particularly since the financial crisis unfolded) and the impact volatile market conditions can have on their investment portfolio. For many people it seems to make sense that those investments that are falling should be sold (in order to minimize any further losses) and, conversely, that the most attractive investments to place money in are those that are rising in value.

Unfortunately this sort of behaviour goes against the grain of how investment decisions should ideally be made as essentially you will always be buying when prices are high and then 'cashing out' at a loss. To really make money you should be buying investments when they are cheap and selling when they are expensive, however, even the most experienced investor will struggle to time the markets accurately.

So what is the answer? A key strategy is of course to spread your investment across a range of asset classes (e.g. cash, equities, bonds, property etc) so that you have a diversified portfolio and are spreading your risk. However, over time the shape of an investment portfolio will change from its original asset allocation due to each asset class performing differently and your long term returns can be heavily influenced by whether or not the portfolio is periodically 'reset'

Let's assume that we have a relatively simply portfolio split 50% shares and 50% fixed interest (bonds) and that the returns on each asset class for the next 3 years are as follows:-

Yr	Shares (50%)	Bonds (50%)
1	+20%	0%
2	-10%	+20%
3	+5%	-10%

The table below shows how the different performance of each class each year changes the actual percentage of the portfolio invested in each area at the start of each year should the portfolio not be 'rebalanced'

	No rebalancing		Rebalanced	
Yr	Shares	Bonds	Shares	Bonds
1	50.00%	50.00%	50.00%	50.00%
2	54.55%	45.45%	50.00%	50.00%
3	47.37%	52.17%	50.00%	50.00%

The last step is then to calculate the returns in each scenario based on the amounts allocated to each type of investment at each stage during the term. As you can see below two portfolios that started life identically can produce quite different returns depending on whether they are 'rebalanced' to the original asset allocation model.

Yr	No rebalancing	Rebalanced
1	10.00%	10.0%
2	3.64%	5.0%
3	-2.85%	-2.5%
p.a. (compound)	3.47%	4.00%

The actual benefit of rebalancing depends to a degree on how asset classes behave in relation to each other or, to use the correct terminology the degree of 'correlation' between them. In reality this simply means how two different investments (or asset types) move in relation to each other.

Asset allocation, although not the only factor, can be a significant influence on the overall returns from your investments. It is also important to remember that asset allocation is one factor which determines the risk profile of your portfolio and it is therefore important to ensure that your investments are regularly reviewed and that consideration is given to whether any changes need to be made to ensure that your investment portfolio remains adequately diversified.

Please feel free to contact us if you would like to arrange for an investment review or if you require any advice or guidance on the above issues.

The value of investments can fall as well as rise and you may not get back the full amount invested.

The lifetime cap on residential care costs is not all it seems

Whilst the final details are still subject to consultation, announcements made by the Government earlier this year will mean that, from 2016, the maximum an individual will be expected to pay towards any residential care costs will be subject to a lifetime cap. Whilst these changes will remove some of the uncertainty regarding the overall cost of care this headline figure is not necessarily the full story.

The reforms are based on the recommendations put forward by the Dilnot Commission back in 2011. The Commission had been tasked with reviewing the current system of social care funding and suggesting how it could be reformed to make it fairer. The Commission originally recommended a cap on lifetime care costs of £35,000 and that only those with assets of £100,000 or more should receive no local authority assistance towards the cost of care.

What are the changes that will come into force in 2016?

One of the issues surrounding the Dilnot Commission recommendations was that this would have required additional Government funding of over £1.8bn per annum – In these austere times this always looked like a potential sticking point and the Health Secretary confirmed that "challenging economic conditions" meant that the recommendations could not be taken forward in full.

From 2016 the main changes will now therefore be:

- A £72,000 cap on eligible care costs - this would apply to costs an individual has to pay to meet their eligible care and support needs in England and would be introduced in 2016.
- An increase in the means-tested threshold. Under the current rules, help with care costs is only available once assets have fallen below £23,250 but, from April 2016, this will be increased to £118,000 (or £27,000 where the value of a home is not counted).

An interest-bearing universal payments system to ensure that no-one will have to sell their home in their lifetime to pay for residential care will also be introduced in April 2015.

The 'true' cap on care costs

Understandably, there is widespread confusion around how the cap on care costs works. You might be forgiven for believing that once you have spent £72,000 on care that the local authority would foot the bill for any further costs.

The reality is somewhat different as the cap relates only to care costs and not to general living costs (e.g. accommodation, food and other 'hotel' type costs necessary to live in comfort). Removing these costs significantly reduces the probability of reaching the cap. A recent survey by Saga highlighted that 69% of people thought that accommodation costs would count towards the cap

Furthermore the cap only relates to the local authority's rate rather than the full cost of care. If you cannot find a nursing home which will provide care at the local authority rate or you choose a more expensive home then you would have to 'top up' the difference. As many people in care will find themselves paying in excess of the local authority rate they will therefore still need to budget for considerable care costs.

Means-tested thresholds

Currently anyone with assets exceeding £23,250 will not receive any local authority assistance towards the cost of their needs and are expected to meet these costs themselves.

From 2016 financial support for care home costs will be available to an individual if they have assets of less than £118,000. Where the value of a home is not counted the Government intends to provide assistance to anyone with assets below £27,000.

Where a person has assets which exceed £17,000 but are less than £118,000 (or less than £27,000 where a property is not included in the assessment) they will be expected to contribute all their income towards the cost of their care. They will also be required to make a contribution from their assets above £17,000 which will be calculated by reference to a fixed formula.

In both the above scenarios individuals receiving residential care will remain responsible for their daily living costs if they can afford to pay them. This will be set at a standard amount of around £12,000 per annum.

Summary

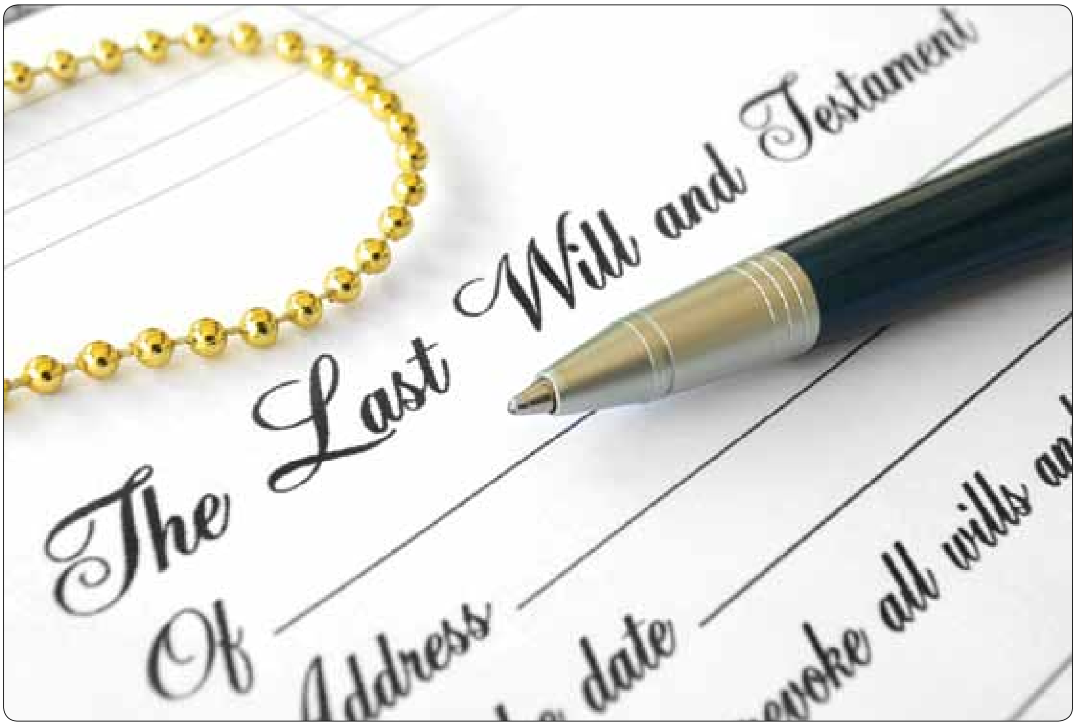
Whilst the reforms are to be welcomed it is unfortunate that the original proposals put forward by the Dilnot commission have not been carried forward un-amended. In addition it is likely that the majority of people will still find themselves above even the increased threshold for means-testing and the fact that the cap excludes general living costs will mean the 'true' cap will be considerably higher.

It is therefore still essential to put a financial plan in place to meet potential long term care costs in the future as the level at which the cap has been set will mean that only a relatively small percentage of people will receive financial support as a result. Please feel free to contact us for further guidance or for advice on any of the issues raised in this article.

A legacy of confusion

Recently estate planning specialists have warned of the need to learn lessons from the recent furore over a £520,000 bequest to 'the government of the day'. The situation arose because a retired nurse who lived in a council housed bequeathed her estate to the 'government' via a clause in her will worded as follows:

> *'I Bequeath all my estate both real and personal… whichever Government is in office at the date of my death for the Government in their absolute discretion to use as they may think fit'.*



Whilst this statement initially appears clear and succinct, on a closer reading the question arises as to what exactly the donor intended her money could potentially be used for? Was it, as the two political parties initially decided, that the monies could be split between them (the Conservatives and Liberal Democrats) and put into their party funds for future election battles? Or was the intention for the monies to be used for the good of the nation? Or, given she was a retired nurse, did she really intend it to be used for the NHS? None of this can be known as the wording of the will did not give sufficient indication.

By initially placing the monies into their 'coffers' the political parties had, in theory, done nothing wrong as they had absolute discretion to use the monies as they saw fit. However, as a result of the political fallout and negative press, the monies have since been passed onto the treasury to pay down some of the national debt and ease what was potentially a huge political embarrassment. Of course whilst it can be argued that the Governments initial use of the legacy was in all probability contrary to the testators true wishes, arguably some responsibility lies with the draftsman of the will in either not obtaining a clearer understanding of what the donor actually wanted or leaving too much open to interpretation.

What this does illustrate is that a will is a very important document that can give rise to many problems not just for the beneficiaries but also the executors of the estate as it is their job to carry out the wishes of the deceased. It is therefore essential that care and consideration is given to the precise words that are used to give effect to those wishes.

Even where instructions are clearly defined it is also worth considering that there can still be potential practical implications where those instructions are too inflexible.

For example, in 1928 an anonymous donor set up the National Fund to inspire the government to move quickly to pay off the UK's debt. No doubt this was on the back of calls from the government in 1919 after the first world war for the wealthy of the nation to help reduce the government's debts. The national fund was started with £500,000 and the donor specified that 'the fund should be held in trust until the country had collected enough money to pay off the whole debt'.

Now this seems a very generous and specifically worded legacy that could not cause confusion or create any doubt as to how and where the monies should be used, but (there always is a but!) the monies are still in trust and there is no expectation in the future that these monies will be used towards the intended request.

It may seem inconsequential given the bequest was only £500,000, but as the trust was set up in 1928 and due to some good investment decisions, the trust is now currently worth £350,000,000 and is paying out fees of upwards of £1m a year. Despite attempts by the trustees to get the trust changed to allow either some of all of the monies to be used if not for the national debt then at least for some charitable basis, the legislation and the terms of the will are quite clear and specific.

This is another example of a will/bequest that although quite clear in its intentions had not allowed for the wider implications if the original request could not be fulfilled. The result was that no contingencies or imposed timeframes were factored in. For example the national debt request could have been caveated with 'until the country had collected enough money to pay off the whole debt, however if 100 years has passed and enough money has not been collected then the residual funds should be used to clear as much of the debt as possible'.

Hopefully this article highlights how critical the words that are used are when writing wills or other legal documents such as trust deeds. Careful consideration needs to be given to ensure that such documents accurately reflect the intentions of the donor and are drafted with sufficient consideration of other possible and unintended consequences.

The Financial Conduct Authority does not regulate Will writing or trust advice.

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.
The value of your investments can fall as well as rise and investors may not get back the full amount originally invested. Past Performance is not a guide to future performance.
Equity investments do not include the same security of capital which is afforded with a cash account.