Investment &
Investment Strategy

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CHILDREN

Investment for children in general has three distinct objectives

1 Encouraging the savings habit

2 Providing the Nestegg

3 School Fees

Encouraging the savings habit

Although many institutions provide attractive rates on children's deposit accounts the primary objective, initially at least, is easy access. It is important that the child should be able to do the saving themselves without parental help. This means that the bank, for want of a better word, needs to be easily accessible and open outside school hours.

The Post Office has many advantages, simply because of the opening hours and the number of branches. It should be noted that many banks also have arrangements, which allow their accounts to be operated through the Post Office.

Children are taxable individuals in their own right, with their own tax allowances. Interest on their accounts should therefore be tax-free and tax should not be deducted from the interest. When the account is opened, ask whether you need to fill in a form to enable the interest to be paid without deduction of tax, but see the £100 rule below.

A Second Account and the £100 Rule

Although children are taxed separately from their parents, if the interest they receive on money given to them by their parents is more than £100 <u>the whole of that interest</u> is deemed to be the income of the parents. They then lose the right to have the interest paid gross. This includes pocket money as well birthday gifts from parents etc.

However this rule does not apply to money given to them by someone else, to money won as a prize, or money they have earned. It is therefore wise to open a second account for them to pay presents and prizes into. It shows a clear separation of the two kinds of money and prevents problems with the Inland Revenue in the future.

In the case of the second account, ease of access may not be a high priority and it is then worth going for the highest rate of return.

If parents are particularly generous, the money should either to be put into tax-free investments or investments which do not pay interest as such.

The Nestegg

As long as one of the purposes of the nestegg is not to pay school fees, the objective is to provide the child with a lump sum at some point in their life. This may be 18, if it is to fund for further education or 25 if it is to provide a step onto the housing ladder.

In either event parents may wish that access is restricted or at least difficult before that time and that the money is not frittered away on small items of frivolous expenditure

In most circumstances an ideal investment is

1 Risk free

2 Easily realisable, and
3 Easily divisible so that a part of the money can be used to meet the minor emergencies of life.

If an investor can compromise on any of these objectives enhanced returns are achievable. In the case of a nestegg it is possible and even desirable to compromise on the last two of them. Depending on the age of the child it may be possible to compromise on risk as well, depending on the time horizon, which in turn depends on the age of the child.

Achieving the objectives

1. **A trust** is in many ways the ideal solution, as the child has no direct access to the money until a specified time. In the interim the trustees have virtually complete freedom to invest the money as they see fit and may release money early if the circumstances justify it. On the other hand a trust is expensive to set up, the trustees will have to devote time to running the trust which will cost the family time and or money. Gifts to trusts in excess of the tax free "nil Rate Band0 (Currently 312,0000) will generally incur a 20% Inheritance Tax charge and the trust itself may be subject to periodic Inheritance Tax charges. Husband and wife can, however, transfer up to £624,00 between them to a trust, Inheritance Tax free. A trust adds to the complexity and so a relatively large nestegg is needed to justify it.

2. **Child Trust Funds** are an initiative by the government to provide a nestegg for children, however it is only available to children born after 1st September 2002. The government will have provided a voucher worth £250 to start the plan and a further £250 on the child's seventh birthday (these figures are doubled for low-income families). Parents or anyone can add up to £1,200 per annum and the funds are tax-free. The child will have full access to the money from age 18.

3. **Friendly Society Children's po**licies are a more limited alternative but available to all children. The person making the gift must commit to making regular contributions of a fixed amount (between £5 and £25 a month) for the duration of the policy, which is for a period of between ten and twenty five years. The fund is tax-free but the child can surrender the policy from age 16. However there may be tax and other penalties on early encashment, which act as a discouragement from doing so.

4. **Insurance company endowment policies** may be written in trust for children but there may be Inheritance tax implications for which provision must be made. In some communities it was common to use such policies on the parents life to make advance funding for major family occasions such as weddings.

5. **Personal pension** contributions can be made in respect of children of up to £3,600 per annum gross. There is in effect tax relief on contributions at the basic rate and the fund is tax-free. The money cannot be accessed until age 55 and then only a quarter of it can be taken in cash. The money is then subject to the pensions tax regime which may change in the future. Although limiting access to the money is frequently a positive objective where children are involved, quite such a long lock in period might be seen as going too far.

6. **Second-Hand Life Policies and Trust Reversions** offer another alternative investment. With second hand policies the maturity date is defined but with reversions it is whenever the life tenant dies. Both offer potentially good returns and a degree of lock in to the investment, which may be attractive for an investment for children. See separate page on this.

7. **Vintage Port** and fine wines may seem somewhat offbeat but as investments they have some attractions. Vintage port in particular has advantages. Very few years are declared vintages. In the early years, it is virtually undrinkable but the wine improves with age and all things being equal will increase in value for that reason. Selling and storage will however involve some costs and there is always the risk of the child drinking the investment. The youngest vintage considered ready for drinking is 1983 and so the time frame is good. Generally the better the wine the longer it takes to mature. One site rates the best vintage to be 1927, which gives an idea of the life of these wines. The best of recent years is 1994 but 2003 is a close second. See a good wine merchant about buying and storage.

School Fees

School fees are a big long term commitment stretching over 15 to 20 years. At various times paying them will involve saving in advance followed eventually by borrowing. If Grandparents can help it make things easier.

It worth bearing in mind that public schools tend to be registered charities and can therefore invest money in a more tax efficient way than parents. However, this could well involve making a commitment to a particular school, which may prove undesirable.

How the cost of school fees is met will depend very much on the circumstances of the particular family. Every family undertaking such a commitment needs advice tailored to their particular circumstances.

YOUNG ADULTS

This page is about which investments are generally most suitable for young adults. Financial objectives are bound to be short term, such as saving for weddings, setting up home and having children. However, as someone who was very serious as a young man I strongly recommend that you also invest in yourself and invest in big experiences rather than little ones.

Although this is an ideal time to start investing in your pension most people in this age group have much shorter-term objectives such a getting on the housing ladder. If you do have the money to invest in personal pensions you should consider a high-risk high-return strategy. In most cases the spare cash will not be available. However if you can join a company pension scheme to which the employer also contributes you should seriously consider joining even if it involves short-term sacrifices. If free money is on offer you need a good reason not to take it.

Given the short-term time horizons, investments need to be simple and flexible.

The number one rule is "do not get into debt". The only debt you should have might be debts from student loans. Life will get serious in time and you do not want to be saddled with debt when that happens. You should be saving and investing possibly in yourself but if you are getting into debt you are storing up trouble.

1) Take out a cash ISA. Interest is tax free even if you take the money out next year you will still have got one year's interest tax-free. Interest rates are competitive. Read the press or explore the Internet to find the best deals.

2) Most building societies offer enhanced interest rates on regular saving plans, use them. The great enemy of saving is inertia. By setting up a direct debit or standing order the money is saved without you having to do anything. What requires positive action is withdrawing the money. Generally one withdrawal a year is allowed without penalty and so to add flexibility open more than one.

3) Take out an equity/Bond ISA but invest in short bonds where any rise in interest rates will cause capital losses that relatively small and temporary. However most funds make an initial charge and so unless the you plan to hold the funds for at least 3 years the initial charges will absorb the benefit of the tax relief.

4) If you are a high rate taxpayer think of Index Linked Savings Certificates. They provide against inflation taking off and the proceeds are tax-free. If you can get 6% on a deposit a higher rate taxpayer will end up with net interest of 3.6%. As at the time of writing (July 08) Index linked Savings Certificates give 1% over inflation that mean that if inflation exceeds 2.6% it beats the deposit account. For a basic rate taxpayer the deposit account would give 4.8% net of tax and inflation has to exceed 3.8% to beat it.

Identify your short-term financial objectives. Once they are achieved you can afford to invest some money for the long term, say the next ten years. Consider making regular investments in the stock market by paying a fixed sum each month into a regular savings arrangement. Equity prices are particularly volatile and expect short term capital losses but if you can afford to take a ten year view the immediate effect will that you will on average you will be buying shares at less than average value. It will also serve as practical education in what can happen to investments and help you make more informed decisions in the future.

If your personal future looks bright and you have the cash investment in personal pensions is extremely tax efficient and your long time horizon will enable you to take greater risks and hopefully achieve higher returns in the long run. However in most cases shorter-term objectives will take priority and this means the sort of flexibility that pension plans cannot offer.

Young Families

Life is now more serious. You have commitments and security has become the central issue. The calls on your money are numerous. Buying a house, servicing the mortgage, and setting up a home are the first priorities. You will be finding that children are very, very expensive, both in terms of direct costs but even more so in terms of indirect costs. Someone needs to look after them 24 hours a day and this is bound to reduce your joint income considerably or else it will generate very high nanny costs.

It is a fact of financial life that the less money you have, the more you need to spend protecting against shear bad luck. If you have a lot of money insurance is unnecessary because you have a buffer that enables you to bear the risk yourself.

Now is the time to identify what the threats are to your financial security. Luckily insurance is cheap while you are young. Although it is relatively easy to work out what the financial loss to the family will be if the breadwinner is killed or seriously injured, the loss of the person primarily responsible for caring for the children could prove equally devastating, financially as well as emotionally. Cooking cleaning changing nappies and taking the kids to birthday parties might seem financially insignificant but in reality the replacement cost of such services is considerable.

There are two risks and three forms of insurance to deal with them. Remember that many employer provide various forms of insurance to deal with some or all of these risks as part of the benefits package so use those policies if you can as its cheaper and the underwriting requirements tend to be less strict. One point to bear in mind is that if you subsequently change employers many insurers providing these group policies allow you to take out an individual policy to continue with the same cover without any underwriting requirement at all. This may be important if you have made a claim in the past or are concerned about the current state of health of either yourself or your partner. Thinking about it later and going into the market might prove expensive if the insurer has reason to suspect that you are high risk.

Life Insurance

Simple term insurance is cheap. Take into account any benefits from work as many employers provide a death benefit of four times salary and reduce the sum assured to allow for it. If you or your partner spends most of their time looking after children consider how much it would cost to replace those services on an annual basis and multiply by a factor of at least ten, particularly if the children are small.

Permanent Health Insurance

This provides a replacement income if you cannot work. It is wise to aim to replace most of your net income but take into account any benefits provided by your employer and likely state benefits when deciding on the level of cover. In order to reduce the cost you should consider how long you could go if you were unable to work. A long waiting period reduces costs and makes sure that you only insure what needs to be insured. See Self Insurance.

Private medical insurance

This covers the cost of private treatment and means that a Consultant will deal with your medical problems quickly and efficiently but it is not cheap. The NHS will in general be less efficient and take up more of your time. You are likely to be dealt with by more junior doctors but you will still get reasonably good health care and because you are already paying for it through the tax system it will be almost free at the point of delivery. Private Medical Insurance is attractive. If the breadwinner gets cover as a benefit from work, it is well worth considering extending that cover to the whole family, if only because everyone in the family is important. However, medical

insurance is in part about improving your standard of living, and attractive as it is given the availability of NHS treatment, income replacement through Permanent Health Insurance is probably a higher priority.

Self Insurance

The person that sells an insurance policy is paid commission, it costs the insurer money to administer the policy, there is a margin for profit and what is left is used to pay claims. Insurers profit from the process and policyholders lose. However in life things can happen that can have devastating financial consequences. It is sensible to insure against such eventualities.

Small things go wrong all the time and you need to have some easily accessible savings in the form of deposit accounts or savings certificates because they enables the family to be able to deal with minor emergencies when they occur. You then only have to insure against the big risks.

It is not primarily about getting the very best investment returns it is about having financial security and flexibility. As a rule of thumb it is useful have six months net salary as reasonably easily accessible savings. Some of this should be in accounts with no penalties on early encashment but the rest can be in accounts where more notice is required and more interest can be earned on the money. For example with that level of savings you can think about having a six month waiting period on Permanent Health Insurance, that way you have the insurance you need and costs are minimised. For investment of this money see Young Adults

Once sufficient liquid assets have been accumulated investment strategy moves to more long-term considerations as discussed on the page describing investment objectives for the mature family.

MATURE FAMILIES AND PRE RETIREMENT

You will have reached the stage where you feel that you have achieved a level of financial security. Although retirement is significantly more than ten years in the future it is becoming the focus of your financial planning.

All the things that apply to the younger family also apply to the more mature family but hopefully the mortgage has become more manageable and some liquid savings have been built up to deal with emergencies.

Pension Planning is the big one. If you retire at age 65 you then can expect to be retired for getting on for 25 years. Yes that is what recent mortality improvements will mean if the trend continues. Many if not most people retiring at 65 will live to age 90 and beyond.

How much will you need?

In practice a level of income is the target rather than a capital sum. What you need is a conversion factor to get from one to the other. This is provided by annuity rates. The right annuity factor depends on what age you are when you retire whether you are male or female, whether you need to make provision for your spouse or partner and crucially it depends on what the level of interest rates is when you retire.

In practice the key factor, if inflation protection is taken into account, is the yield on Index-Linked Gilts. Currently this rate is depressed due to pressure from the Pensions Regulator for pension schemes to invest in these stocks. This means that a factor of about 25 provides a rough estimate, assuming inflation protection and a spouses pension.

If you want to live on a pension of two thirds your salary that means that when you retire you will ideally need savings equal to about say 16 years earnings, if that money is in some pension arrangement and there are no other sources of income.

Assuming you have income of £50,000 a year you would be aiming for an income of £33,333 in retirement.

What does that mean as a target cash sum?

Total Pension Cost/Value
Capital value of pension =33,333 x 25
=£833,000

However other sources of income need to be allowed for

Basic State Pension
The basic state pension is £4716.40 per annum
BSP it is worth in these terms =4716.4*25
=£118,000
This leaves £715,000 to find

Other Pensions
Assuming you have pensions from other sources such as SERPS and previous schemes of £10,000 this is worth £250,000

This leaves £465,000 to find.

Other Savings
By this stage you should have other savings which I will assume amount to half a year's salary at £25,000

As these are savings from taxed income they are tax paid but you will be a basic rate taxpayer in retirement and so it needs to be grossed up for this rate of tax.

Value Adjusted for tax = 25000 x100/80
= £31,000

This leaves £434,000 to find.

Assuming you are saving with this target in mind and assuming that you will earn an investment return of 2% over inflation, you need to divide this by the following factors to arrive at an annual rate of premium/contribution which should increase in line with RPI or your salary.

Years to Retirement	Factor	Annual Contribution
10	11.05886	39,250
15	17.46578	24,750
20	24.53954	17,750
25	32.34955	13,500
30	40.97242	10,500

These figures may be depressing but we are talking about providing an income that keeps pace with inflation for the rest of your life. Investment returns might be a lot higher assuming a degree of risk is taken. However, taking risks means that investment returns may be negative in some years. A 2% real rate of return is not an unreasonable assumption but even so your actual investment return will depend on market conditions when you retire and how defensive or risky your portfolio is in the years immediately beforehand.

The important thing is that some sort of idea of the size of the investment required is needed even if the figures are not absolutely accurate.

If you want to minimise risks all the money should be invested in long Index-Linked Gilts. The investment return will not be all that great, maybe 1% over inflation or less but you can calculate the amount you reed to save by dividing the amount by the period to retirement in years ignoring investment return. However you should end up with pretty well the pension you expect, and short of the government defaulting on its debt there will be no big surprises.

The other point is that these are gross investment contributions into a pension arrangement. They attract full tax relief and if you are a high rate taxpayer the net cost will only be 60% of the above figures. The figures are also useful for another purpose. You will note that the table above would indicate that for someone with only ten years to go to retirement, they need to save two-thirds of their gross income into a pension arrangement. If they do that they will be considerably better off after retirement than they would have been while they were working. The figures are also still not good for someone with 15 years to go to retirement.

Someone near retirement who has made limited provision might have to consider three options, none of which are particularly attractive.

1 Lower the target pension

2 Increase their joint income by making sure that both partners are working.

3 Plan to retire later

Where to Invest

The thing to remember is that you are not really saving for a specific capital sum at retirement. What you are saving for is an income for the rest of you life after you retire, so that you can meet the cost of continuing to live in the manner you expect.

Almost all the money you spend is in pounds sterling and so it seems obvious that you should invest in sterling investments to protect against currency risk.

However, maybe I should tell you what I did yesterday. This morning I dressed in clothes made in Thailand and Malaysia, I drove to work in a Japanese car powered with Arab oil. When I got to work, I turned on a computer made in China. At work I spoke to an insurance company's call centre in India. After work I went to ASDA and bought meat bred in Ireland, some sugarsnap peas grown in Kenya and some bread made with wheat grown in the USA. I then went home and watched a television made in Korea.

The point is that ultimately a large proportion of your cost of living will be determined by the cost of producing the goods you consume and many, if not most of these costs, will be determined by cost one overseas economy or another.

Taking an international view of investment does not add to the risk, it actually reduces it because ultimately many of your costs are in foreign currencies. It is just that you pay in pounds sterling because that is the currency you have in your wallet.

In the situation envisaged you should be thinking in terms of equity type investments but overall much depends on how old you are and the level of risk you feel comfortable with.

When considering how to invest the money it is well worth trying to see how things will look when you actually do retire as that has implication for exactly how you invest the money beforehand. See retirement.

For a more general discussion of risk and risk reduction strategies see the pages on risk

How to Invest

From a tax point of view investment in a personal pension arrangement has many attractions. Contributions or premiums are deductible at your highest rate of tax. Roll-up is technically tax free although in effect equity dividends suffer basic rate tax because any tax credit is not reclaimable. A quarter of the proceeds can be taken tax-free although the rest will be taken as some kind of taxable pension. However, for a high rate taxpayer with a good, as opposed to a very high salary, contributions will attract relief at 40%, whereas the pension may suffer only basic rate tax.

On the other hand the money is not really easily available until you retire and you probably have some other financial commitments before retirement such as wedding anniversaries or weddings, helping the kids get onto the housing ladder etc. There are other investments with tax benefits almost as good as pensions and they are much more flexible.

It is therefore worth considering other investment options as part of savings strategy.

1 **Pay off Your Mortgage**
This may be surprise but it is probably one of the best investments you can make. Mortgage interest is no longer tax deductible. If the interest rate on a mortgage and your deposit account are both 6% then £100 pounds in your deposit account will earn £6% interest and suffer 20% tax and so you will get £4.80 (£3.60 for a high rate taxpayer), but you will pay £6 of interest on £100 of your mortgage the net cost to you is £6.00. Clearly if you are a basic rate taxpayer and use the money to reduce your mortgage you will lose the net interest on the deposit account of £4.80 but save £6 in mortgage interest and therefore be £1.20 better off. For a higher rate taxpayer the saving is twice as great. Paying of the mortgage is therefore equivalent to investing in a tax-free deposit account but you lose easy access to the money. (See Mortgages)

The money you would have spent paying off the mortgage should be invested, in a pension arrangement. It has the additional advantage that this means that money is drip fed into the stock market at a steady rate and any price volatility actually helps you because it reduces the average price you pay for your investments. However you may need to use some of it to bring back your cash float to a reasonable level.

2 **Cash ISAs**
You still need easily available cash to cover emergencies. Cash ISAs are tax-free. Use them. Do however have some money outside of an ISA so that you are not always dipping into your ISA account or accounts. You have an allowance each year and if you take money out you cannot put it back without using up this year's allowance.

3 **Index Linked Savings Certificates**
For a high rate taxpayer they are likely to beat most if not all non ISA savings accounts and the inflation protection built in makes them a must have investment for high-rate taxpayers. A high-rate taxpayer should think about conventional saving certificates too. Basic rate taxpayers should not necessarily ignore Index Linked certificates because of the inflation protect particularly in current economic conditions.

4 **Equity ISAs**
More flexible than pensions contracts. A must have investment for someone earning enough to be constrained by Inland Revenue limits on pension arrangements. Otherwise investing the money in a pension arrangement is probably better.

The above is very much an overview. In most cases a more in depth analysis should be carried out to look at your own individual circumstances.

RETIREMENT AND IMMEDIATELY PRE RETIREMENT

At this stage in your life, your primary objective is to provide for yourself and your family in retirement. A secondary objective is to provide for future generation of your family after yourself and your spouse are dead. Hopefully you are healthy and this secondary objective is a more long term one.

These pages not only deal with retirement but also with the ten years up to retirement. However, the pages on the mature family are still relevant and should be read. Retirement is the next big event in your life. In order to plan for retirement you need to see the world from the perspective of someone at the point of retirement so that you can see what risks and opportunities you need to take account of in your planning. The following therefore looks at the options from the perspective of someone retiring now.

At the end of this section the implications for someone coming up to retirement are considered but to understand the why's and wherefores it is worth reading about the issues you will face when you do actually retire.

Before the more serious business of financial planning it is worth taking stock of your life when you do actually retire. Whatever your state of health and whatever the needs of your children, when you actually retire you should use some of your cash to invest in some memories. You are entering a whole new stage in your life and for what is probably the first time in a long time you can invest a significant amount of time and money in memories. Shakespeare coined the phrase a lease of life and that is all that we have, a lease on life. It is to be enjoyed. A trip round the world is an investment well worth considering.

Money is necessary but at the end of the day it is there to be spent. Many people have been careful with money all their lives but ultimately we make money to live. We do not live to make money. Travel may not be your dream but retirement is not only a problem it is also an opportunity to make at least some of your dreams come true, even if it does mean temporarily breaking the habits of a lifetime.

Do you have any old policies?

Many old pension policies contain guaranteed annuity rates. The terminology can be confusing as many annuities have a guarantee period. If an annuity has a five year guarantee, the first five years annuity/pension payments are made anyway even if you die in that period. However these are guaranteed annuity rates which are different. That is where the policy promises to convert the cash sum at retirement on guaranteed terms or at market rates if better. Many of these policies were written when interest rates were a lot higher than they are now and life expectancy was a lot lower. The guaranteed annuity rates are therefore likely to be better than any that are on offer today.

Many of these guaranteed rates only apply at specific ages and for specific types of annuity. Check if your policy has them and take advantage of them, even if it means taking the benefit earlier or later than you intended or the escalation rate you want is not available. Make adjustments to your other policies if necessary so that the overall effect on your pension arrangement is minimised. The financial benefit is generally worth it. See also the comments on tax-free cash below.

The disadvantage of these policies is that the death benefit before retirement can be very poor and may only be a return of premium. If you are retiring now the lack of death benefit is irrelevant but if retirement is some way off you may want to consider the options.

Tax-Free Cash When to take it and When not to take it!

For most pension policies you can take a quarter of your pension in the form of tax-free cash. Given the choice of whether it is better to take tax-free cash or a taxed pension the obvious answer is to take the tax-free cash. Certainly if you intend to travel the world you will need some money to pay for it.

Even if you have sufficient capital and wish to maximise your income, taking the cash is generally the best option. You can take the cash and use the money to buy what is called a purchased life annuity. These are taxed differently from a pension annuities, as part of the income is treated as a return of your capital and is tax-free. You will therefore increase your net income this way. However, it may have Inheritance Tax implications as, for tax purposes, you will in part be living off capital.

However it is worth being aware that sometimes it isn't beneficial to take the cash and you need to check that does not apply to any of your own pension entitlements.

One possible exception is if you are a member of a company final salary scheme. In this case your basic entitlement is a pension, which you can commute. Although in general commuting to the maximum extent is still the best option whether it is in fact the best option depends on the terms of the commutation. If commutation rates are laid down in the scheme rules, or they are not be on market terms for some other reason, you might be better off taking the pension.

The other situation is where you might be better off taking the pension is if you have an old policy with guaranteed annuity rates.

In either case it worth making a rough check

1) Look in the financial press for an annuity rate at roughly the right age and on roughly the same terms as you want.
2) Find the difference between the full pension with no cash sum and the reduced pension with the cash sum.
3) Multiply the reduction in your pension by the annuity rate and reduce the result by your tax rate (i.e. take 80% or 60% of it) and that is the rough value to you of the pension.

If the cash sum is not significantly greater than the calculated value of the pension reduction, get advice on what you should do.

Inflation

Actuaries talk about inflation, so do insurance companies and financial advisers and even governments but generally in terms of a percentage rate of growth. In truth the future rate is uncertain. When you were a teenager, a boy could take a girl to town on the bus, take her to the cinema, pay for fish and chips or a drink afterwards and bring her home and get change from a ten bob note. Ten bob is now 50p and doing the same thing today would probably not leave much change out of £25.

That was forty or fifty years ago but assuming you are healthy you might expect to live for 25 or 30 years or half that period of time. Of course inflation has varied a great deal over the last 50 years. It has been as low as 2% a year and has gone over 20% a year. It was thought that inflation was almost dead but it seems that like Mark Twain "Reports of its death have been greatly exaggerated".

Inflation creates winners and losers. The winners are people who borrow. When I took out my first mortgage interest rates were almost 20%. It was a real struggle to save the money and then service the mortgage but pretty quickly my salary rose with inflation and the cost of servicing my mortgage fell rapidly. The really big winner is the Government. The real cost of servicing its huge debt falls, interest rates rise and the tax collected on the interest rises with it. Savers have to pay tax on their interest and so the real value of their savings falls and they lose out. The big losers though are pensioners whose fixed pension, which had provided them with a good standard of living, falls in value and life becomes a struggle.

How Annuities Work

As a young man with a small family and a mortgage to support you probably took out life assurance to make sure that your family were provided for if you met with a fatal accident. Term Life assurance works quite simply. Premiums are collected, most of the money goes to pay claims, some of it goes to pay expenses and hopefully a small amount goes to provide the insurance company with a profit. Light mortality over the portfolio of term insurance business increases the insurer's profit and heavy mortality reduces it. Virtually all the benefits and profits come from those policy holders who take out insurance and survive to the end of their policy having effectively lost their premiums but grateful to have survived.

In retirement the risk is not of dying early but of living too long, so that your money runs out before you die. Annuities are essentially are a form of longevity insurance. Annuities work in the opposite way to life assurance. The insurer takes in a pot of money and from that pot annuities are paid. Each year some of the insurer's annuitants die and the money in the pot is used to continue paying annuities to the survivors. In effect the annuitants who die early subsidise the benefits of those who survive. It is the opposite of life assurance where the survivors subsidise those who die early. When annuity rates are calculated, it is assumed that annuitants will die and therefore that subsidy is allowed for in annuity rates.

Most of the money goes to pay annuities, some goes to pay expenses and a small part of the pot provides the insurer with a profit. This is like life assurance really except that lighter mortality reduces that profit and heavier mortality increases it.

The model insurers use is fairly complicated and the mortality assumptions are to an extent a commercial secret. It would however be reasonable to assume that an insurer will be working on the assumption that a pot that is today shared by 1000 65 year old males will be shared by say 995 66 year old males in a years time. The cross subsidy from mortality will be just over half of one percent. However they might expect a pot shared by 1000 75-year-old males to be shared among 982 76-year-old males in a year’s time. The subsidy to the survivors from deaths has therefore risen to about one and three-quarter percent. Where there are widow's pensions as well, the effect of the subsidy is reduced but the general point is that at age 65 the subsidy survivors get from early deaths is quite small but at age 75 it is significant. In either case the pot after one year is; the pot now plus a year's interest less annuities paid out.

Annuities and Interest Rates.

Allowing for expected mortality the actuaries at the insurance company can predict how much the company will be paying out each year for the next 40 years or so and the insurers investment managers can then buy a portfolio of Gilts which can provide an income stream almost exactly matching the outflow of annuity payments. That way whatever happens on investment markets the insurer is protected.

That may all seem esoteric but it does mean that when you do retire the cost of annuities will be closely linked to gilt yields.

The cost of paying the annuities will not match the projections exactly because of random fluctuations but this effect averages out over time. However, mortality has been steadily improving for years and if mortality improves faster than expected the insurer loses money. That increasing life expectancy also means that annuities tend to get more expensive as time goes on but it is worth remembering that it is interest rates that are the key factor in determining the level of annuity rates at any particular time.

Index Linked Annuities
Index linked annuities work in much the same way except that the insurer's liabilities are matched with a portfolio of Index-Linked Gilts.

If you take out an Index-Linked annuity the pension paid out is smaller than it would be for a level pension, at least in the early years. The subsidy from early deaths for index linked pensioners is therefore greater than for pensioners with level annuities because at the end of the year their pot is larger. Clearly if you are in good health you expect to be receiving the subsidy and if you are in poor health the risk is that you will be providing the subsidy.The index linked versus level annuity question is therefore also a health question.

How it affects you

Most of the younger generation is healthy with a few exceptions but for the older generation's health is much more variable. There are old and sickly people of 70 and there young healthy people of 85.

The thrust of the pensions legislation is still to make people take out longevity insurance in the form of an annuity but if your are in poor health you will have little desire to be one of those annuitants who subsidises the long lived. On the other hand if you are very healthy you might as well take advantage of that subsidy.

Your general state of health is of crucial importance in your financial planning. It is a matter of playing the odds. Either way you are making some kind of bet on how long you are going to live. In practice people only die once, unhealthy people can live until they are a hundred and apparently healthy people can have a heart attack tomorrow.

Depending on your health the options are as follows:-

Terminally Ill

Someone who is expected to live less than 12 months as certified by a doctor can under Inland Revenue Rules commute their whole pension for a lump sum or take the fund from a pension policy. The payment should be tax-free but detailed medical evidence is likely to be required. It should also be noted that the money is likely to increase the size of your estate for Inheritance Tax purposes. On the other hand deferring your retirement may also incur an Inheritance Tax charge.

Serious Health problems

There are various strategies to deal with this situation.

1) If retirement is soon but still some years in the future, consider putting your savings into non-pensions products such as ISAs. The money will then be outside the pensions regime and if your spouse needs to have an income he or she can still buy a Purchased Life Annuity and most of the income will be tax-free.

2) Take your pension now but do not buy an annuity and take an income through an income drawdown facility.

3) Take you pension and buy an annuity through an insurer offering enhanced terms to impaired lives.

4) Delay taking your pension but make sure any pension policies provide you with a death benefit of the full fund. However be aware that the Inland Revenue can take the view that you have tried to reduce the value of your estate and charge Inheritance tax anyway. Some old policies only provide a return of premiums. If yours is like this, consider a transfer to one which gives better death benefits, or if health problems are not that serious take that particular pension early.

5) For members of pension schemes it is worth at least considering transferring out before retirement and buying an impaired life annuity. However you need to check that it is beneficial to do this.

6) Also for members of pension schemes investigate the option of reducing your pension in return for an enhanced widow's or widower's pension.

7) See options for lives in average to poor health.

Average to Poor Health

This is necessarily a difficult one because things can go either way. Again there are options ,some of them are the same as for serious ill health, such as having some savings outside the pension regime and there is always income drawdown. At least these give you flexibility until things clarify themselves. However taking income drawdown means that you are forfeiting the subsidy to your income from other annuitants who die early and you are taking the risk that annuity rates will be worse than they are today when do come to buy one. On the other hand interest rates might increase and annuity rates might improve. At the moment my view is that inflation and interest rates are likely to rise and consequently annuity rates will improve but that is an opinion and may well be wrong.

The other option for a personal pension holder is to take an annuity immediately after taking maximum cash but make sure that the annuity is level and if possible make sure that it includes a widow's or widowers pension of 100% of the members pension. If you are single or your partner is also in poor health a guarantee term of ten years is or capital protection is a poor second best option but at least the annuity will continue to be paid for ten years even if you die tomorrow. Unfortunately you won't be alive to enjoy it. It should be noted that this lump sum death benefit can only be paid if death occurs before age 75.

A level pension provides no inflation protection but it does mean that you get as much money as possible out of your pensions pot as quickly as possible. The sponces pension also means that she is protected. It also reduces the subsidy you provide to more longer-lived annuitants. However if you survive, it creates a little bit of a fool's paradise as you initially appear to have a good income but the real value of that income will decline year on year as inflation bites. However, you could save the difference between your actual pension and the one you would have got if you had made it index-linked..

Taking a level pension is particularly attractive if you have a number of small policies and you want to do amalgamate them into a single annuity. The sums of money involved might not justify doing anything complicated or carrying on with the policies. This solution can also be particularly useful for those old policies with good guaranteed annuity rates and poor death benefits.

Average to good health

Take the cash but note the comments about when this is not the best option. The low risk option is then to take out buy an index linked annuity making suitable provision for your partner, possibly with a 50% or 67% spouse's pension. You are then set for life. Shop around for the best annuity. Your current insurer probably does not offer the best annuity rates in the market.

Another option would be to take an annuity that escalates at a fixed rate. In this case the pension increases at a fixed rate that is independent of inflation. This is risky because whatever fixed rate you choose, inflation over the next twenty or thirty years could be higher than the escalation rate. On the other hand the fixed escalation rate might cost less than indexation and inflation could turn out to be less than the chosen escalation rate.

However, we are now in new financial world. In the short term the outlook might be for low inflation but governments are taking on a lot of debt and inflation is one way to reduce that debt. In the long term if serious inflation does come any fixed rate escalation may not be enough to cover it. On the other hand we might be in for a long depression with low or even negative inflation.

Buying an annuity is not necessarily the option which maximises your return in the long term. Index-Linked annuity rates may improve if yields on index linked Gilts rise and annuity rates for level and fixed escalation annuities could improve if interest rates on conventional Gilts rise. Once you have bought an annuity you are locked in.

At age 65 the subsidy from deaths is only about half a percent, and your chances of improving on gilt yields are not bad. Income drawdown would allow you to delay the purchase of an annuity and enhance investment returns in the meantime. Alternatively you might only realise some of your pension policies and adopt a phased retirement strategy. However, you are taking a risk and as with most things financial the more money you have the better you can afford to take risks and visa versa.

If funds are sufficient you might wish consider having some money to outside of your pension arrangement to provide for the younger generations in your family but this is covered a little more fully in the post retirement section.

The run up to Retirement

This section is for when retirement is less than ten years away. If it is further away it may still be worth reading but you will be reading ahead as it were. It is in any event worth reading the earlier pages on retirement.

Up until now you will have saved for a number of things such as houses, holidays, cars etc. These all have two things in common

1) They are relatively short-term objectives, in that you at least hope to make the expenditure within the next ten years.

2) The target involves spending a capital sum as a one off payment.

Although retirement may look similar, in that the target is to have a capital sum when you retire so that you can buy an annuity, but it isn't. In investment terms at retirement you are merely changing the fund manager to the insurer providing the annuity. That new fund manager will invest in matching investments, which are long term Gilts.

You can consider insurance as a gamble. If you take out term assurance you might bet £100 that you will die next year. Assuming the chance of that is a 1 in a thousand (i.e. you are young), if you win (i.e. die) you get back £100,000 and if you survive you get nothing. An annuitant might be thought of as having a portfolio of Gilts, who each year takes out his income for that year and gambles the rest that he will survive. If the chance of death is one in a hundred and there is a 100,000 worth of Gilts and the annuitant survives he will get back £101,000 worth of Gilts at the end of the year.

Of course real annuities are more complicated as there can be spouses pensions and guarantee periods but the description of the process is accurate. The insurer serves two functions in this model. The insurer is both fund manager and bookmaker.

As bookmaker insurers have been studying the odds for 300 years and so they know pretty well what the odds are next year. Just like bookmakers they know that some punters will win and some will lose. Like bookmakers they fix the odds so that in the long run the house wins. However there is one major difference with insurance, the odds are fixed for the term of the contract. In the case of an annuity that term is the life of the annuitant.

Insurers are sensible fund managers. The price they charge a 65-year-old will be the cost of buying a portfolio of Gilts, which will supply the correct income stream. That cost will depend on gilt yields at the time. If interest rates rise the cost will fall and if interest rates fall the cost will rise.

If your target is a specific level of income in retirement, that means that your target is to have the price of such a portfolio when you actually retire. The safest way to achieve that is to have such a portfolio already.

However, whatever your risk profile is, it is important that you are aware of what the minimum risk portfolio should look like if only in order that you are aware of how much risk you are taking at any one time.

Considering the main assets classes:-

Equities
Over the last century equities have outperformed every other asset class over any 20-year period according to a Barclays Capital survey of market performance since 1900. However the same is not true over shorter periods and in any event a number of economic changes have occurred over that period favouring equity investment. These economic changes could be reversed and although the statement is true, it does not guarantee that equities will outperform other asset classes over all future 20-year periods, particularly given recent events.

However, in general it is reasonable to expect that enhanced investment returns can be obtained by taking risks. The key word though is risk and so this means that most of the time you will win but sometimes you lose. The more often you take the risk the more likely you are to end up a winner overall. If you can only take the gamble a few times it could go either way. The closer to retirement you get the less time you have to make up for the bad years and so the less you can afford to have bad years.

Cash
If your target is to have this portfolio of Gilts to provide your target income, cash could be excellent investment if interest rates are going to rise. The market value of the gilt portfolio will fall and so a given amount of money will buy a bigger income. The problem is that one never actually knows that interest rates are going to rise. At any given time expert opinion is divided on

the issue. Interest rates could fall. In that case you will find that the cost of the gilt portfolio will rise and so your fixed sum will buy a smaller income and not a larger one. Cash is in this situation a tactical option but it is a high risk one.

Gilts
A portfolio of long Gilts is the low risk option because that best matches the benefits you hope to receive and is similar to the portfolio the insurer would invest in if you bought an annuity.

What do you do?

In the run up to retirement it is wise to have some sort of basic investment strategy in mind. It should be designed to balance the desire to maximise returns with the need to minimise your loses

If you assume that equity type investments are likely to make the highest returns but are afraid of the risks, the sensible strategy must be to hold a proportion of your portfolio in equities but reduce that proportion steadily as retirement approaches. You could for example start ten years before retirement and each year move ten percent of your portfolio from equities into Gilts or into a mix if 75% Gilts and 25% cash (as you will take a quarter in cash)

Whether it is the best strategy for you will depend on your own particular financial circumstances, and on your ability to accept risk. Other strategies may be perfectly valid.

That is not to say that you should necessarily follow the strategy blindly. After five years with your portfolio split 50:50 equities and Gilts you might take the view that equities are due for a run and not sell a fifth of your equity portfolio and put it into Gilts. You might do nothing. A year later according the strategy you should be going into this year with 70% in Gilts and 30% in equities. You might take the view that equity markets were high and gilt yields were likely to fall you could on the basis of your market view you are going to reduce the equity percentage to only 20% rather that 30%.

A strategy is just that. It is a standard that you might decide to deviate from for tactical reasons but you do need a strategy. If you have a positive view of equities and retirement is eight years away having 100% of the fund in equities might be reasonable but if retirement were only two years way having 40% of the fund in equities would be very risky. It is a matter of what the proportion is relative to the strategy.

Everyone is different and there is a danger in giving any advice of the basis that one size fits all. However the above strategy represents a reasonable baseline on which to base your own strategy. It is also worth reading comments on the current economic situation.

POST RETIREMENT

If someone is phasing the realisation of their pension policies or if they are taking income drawdown the issues are as for retirement. Otherwise there are three problems that can arise.

1 Estate and IHT Planning and how to leave your estate to your heirs in the most tax efficient manner.

2 Equity release and generating extra income in order to maintain your standard of living.

3 Income tax planning and the age allowance.

Estate & IHT Planning

In theory if you give away your assets and live 7 years you escape Inheritance Tax. However in practice there are other considerations.

First you need to ensure that you and your spouse have enough money to last you both out.

Control can frequently be an issue particularly with a family business. This may involve future succession, where for example there are children of a previous marriage to consider. It may involve making provision for minors or others who you wish to benefit but whose best interests may not be served by giving them direct access to the money. You may merely want to have the option of adding additional beneficiaries in the future, such as additional Grandchildren.

A number of plans are on offer providing Inheritance Tax advantages but all have some disadvantages. There is no plan that is suitable in all circumstances and it is important to identify which is most appropriate to your needs and therefore identify which plan achieves the greatest tax savings while also meeting your other objectives.

Most involve giving away something but the structure is all important as such plans are frequently impossible to unwind or at least expensive to unwind and can be costly in other ways too.

Sometimes it might be appropriate to make investments entitling the investor to business assets relief, but this carries with it risks that may not be acceptable.

This is a situation where advice tailored is to your particular circumstances is essential.

Income Release & Generating more income

The principle of equity release is simple, at least in concept. You sell the right to get some, or all of your home, after the death of both your spouse and yourself. The money generated can then be used as you please to improve your quality of life while continuing to live in your house.

There are two ways achieving this objective:

The mortgage plan involves you keeping title to your house but mortgaging the property. Frequently the interest simply rolls up until you die when the house is sold. The loan and interest is then repaid from the proceeds and the balance passes to your estate. The total available to the lender is limited to a proportion of the house value at death, although that proportion is usually 100%.

Under the home reversion plan ownership of the house passes to the provider subject to your rights.

In either case the loan or reversion will fall in and the house sold if the lives go into long term care.

The amount available under either type of plan may be similar but the practical effects for heirs at least are very different.

Under the mortgage plan the charge on your estate is initially the amount of borrowed. If you die soon after taking the loan the reduction in your estate is only slightly more than the sum you withdrew in the first place. However the longer you live the more the interest builds up and the greater the reduction in your estate. You get the benefit of all the growth in the value of your house to the extent that it is not eaten up by interest charges and there is generally a provision limiting the amount to be repaid on your death to the value of the house.

The interest rate on lifetime mortgages is generally higher than for an ordinary fixed term mortgage used for house purchase. The interest rate may or may not be fixed at the outset. The proportion of the house value given up depends on when death occurs, how house prices appreciate during the period of the mortgage and of course the interest rate charged. However, although it is not certain, you should expect the proportion of the house value given up to increase over the period of the mortgage.

It is worth checking on is who will actually be in charge of selling the house at the end of the day. You must appreciate that the company granting the loan is merely interested in getting that loan repaid as quickly as possible. As long as the loan and interest is repaid, it has no interest in getting the best price for the property; its interests are best served by a quick sale. This may not be in the best interests of the beneficiaries of the estate. However even with the mortgage structure, it is possible to ensure that some of the house value goes to the estate.

The reversion option has the benefit that the depletion in the estate is fixed at the outset, if only in terms of the proportion of the house value given up. Although this may be beneficial if the person making the arrangement is long lived, if they die on the day after making the arrangement the loss to the estate will be several times the amount received.

However when the house does eventually come to be sold all parties have an interest in maximising the sale price.

Within each of the basic structures outlined above a number of options can be built into the arrangement. As with most investment transactions those who assume risk expect to be rewarded with higher returns. and so any guarantees come at a cost. On the other hand guarantees are attractive and it is matter of finding the deal that best suits you.

Lenders assume a number of risks in this situation and consequently expect to be rewarded appropriately. Equity release is a useful tool in financial planning but it is expensive and should not be undertaken lightly.

Age allowance

People over the age of 65 have their personal allowance for income tax increased from £5,435 to £9,030 and at age 75 this increases again to £9,180. However where their income exceeds £21,800 in the tax year every £2 of income over that threshold reduces their age allowance by £1. This in effect creates a marginal tax rate of 30% until their personal allowance is reduced to basic level of £5,435. (These figures are for the tax year 2008/9 and higher figures are likely to apply in subsequent years)

Those people entitled to married persons allowance because of their age are also likely to find this allowance clawed back in much the same way.

For people with a high marginal rate of tax because of this it is worth considering the various tax-free investments or particularly at older ages an insurance bond where a surrender of 5% a year can be treated as a capital distribution for tax purposes.

HIGH RATE TAXPAYERS

As an investor boring is always good. Exciting is only good, if you like that sort of thing, and you have done the boring stuff first.

The object of any investment strategy is to maximise the amount of money you have at the end of the day after all the tax has been paid. Minimising your tax liability may help achieve that end but it should not be an end in itself.

If saving tax is your first priority a guaranteed way of achieving this is not to make any money in the first place. However this is clearly not a sensible investment strategy. Tax driven investment can easily lead to poor investment decisions. Sometimes making the profit and paying the tax may be the best strategy.

The following looks at tax efficient investments grouped by the level of risk.

Boring Investments

Index Linked Savings Certificates

These do not provide the very best investment return but they provide absolute protection from inflation, the returns are tax-free and there is government guarantee. If a higher rate taxpayer can get 6% on a deposit, he or she will end up with net interest of 3.6%. As at the time of writing (July 08) Index linked Savings certificates give 1% over inflation that means that if inflation exceeds 2.6% it beats the deposit account.

Investments are limited to £15,000 per issue but you can reinvest the proceeds from previous issues as well as the proceeds from fixed interest certificates. There are generally two issues available at any one time with different terms. Interest rates do change and therefore new issues tend to be fairly frequent which means that you can invest another £15,000 or even £30,000 in the two new issues. Because old certificates can be reinvested in new ones substantial holdings can be built up.

Cash ISAs

You want to have some cash investments and interest on Cash ISAs is tax-free. Rates are competitive generally. It is probably worth consolidating your investment into a small number of accounts. Many accounts offer stellar interest rates in the first year and poor interest rates afterwards so look out for accounts that take transfers from previous years. See equity ISA to see why a cash ISA are better.

Pensions Policies

This is a wrapper rather than an investment. Premiums are tax deductible, a quarter of the benefit is tax-free but eventually the rest must be taken as pension. The earlier you invest the better and the greater are the tax benefits. You cannot get at the money at all until you are 55 (50 before 2010). Pension arrangements can be as boring or exciting as you make them. See section on retirement). However they are here because if you are under 50 the amount you can get out next year is guaranteed. It is guaranteed to be nothing unless you die.

Once a substantial fund has been built up you may wish to move to a stockbroker managed SIPP in order to have more control and better manage your overall portfolio.

Fixed Interest Savings Certificates.

Interest rates are fair and tax-free but also offer rollover into Index Linked later.

Equity ISAs
These are worth having because at least notionally they are tax-free. However the government has changed the taxation of dividends and so dividends now effectively come with a non-recoverable basic rate tax credit rather than being tax free. Capital gains are however tax-free within an ISA. They are possibly a better vehicle for investing in bonds rather than equities because coupon is tax free. Many fund managers offer equity ISAs on competitive terms but once you have built up a portfolio over a number of years you should consider transferring to a stockbroker managed ISA. That way you have greater freedom of investment and you can manage your ISA portfolio along with your other holdings. An Equity ISA is a wrapper. The investments inside it can be as risky as you like but even with bonds there is some risk.

Friendly Society policies
Limited to £25 a month and they must be for a term of at least 10 years but the underlying fund and the benefits are tax-free. Because of the small premium size expenses tend to be fairly high. This is one of those "might as well have" investment.

Premium Bonds
The underlying yield is 3.4% with 94% of that going in prizes of less than £5,000. You can therefore, as at August 2008, expect to get a return of 3.1% to 3.2% free of tax. This is equivalent to a gross yield of 5¼%. Various small cheques coming through the post may be a mixed blessing. You may win a million pounds but you probably won't. Not bad as an investment but not wonderful either. Better returns are available elsewhere. In any event check on current rates with NSI.

Qualifying Endowment policies.
Policies must for at least ten years with a regular premium. Ideal for someone who spends money as quickly as they can make it, but feels that they should save. Loads of penalties on early surrender at which time there may be exposure to stockmarket movements. The proceeds are tax-free but the insurer pays tax effectively at the basic rate. An ideal vehicle for investing regular level amounts into the stockmarket when the outlook is volatile as that volatility will reduce the average cost of units.

Second-hand Endowments
Generally subject to capital gains tax which is now at 18%. Some risk if terminal bonuses fall but relatively safe and fair to good returns should be expected. However, there are risks see more detailed discussion Second-hand Endowments and Reversions

Zero Coupon Preference Shares
These are low risk, at least in principle. They are shares in split capital investment trusts. An investment trust is a quoted company that invests in other companies. They are like unit trusts except that they are closed end, in that once the money is raised no more is taken in and investors have to buy and sell on the stockmarket at the prevailing price of the shares. That price will be related to the value of the underlying assets but not determined by it. Share prices are frequently less than the value of the underlying portfolio although they may be higher. Unlike unit trusts, investment trusts can also borrow money, which enhances returns in good times and magnifies losses in bad times.

Split capital investment trusts have a fixed windup date, at which point the assets of the trust will be distributed to the holders of the various classes of share. The holders of the zero coupon preference shares receive a fixed sum when the trust is wound up, assuming that the value of the trust assets is sufficient to provide it. The other classes of share get the dividends and any

money left over, after the holders of the zero coupon preference shares are paid their entitlement.

If the investment trust has no borrowing and has assets sufficient to pay the zeros off two times over, the stock market has to fall by about 50% before the zeros start getting less than they are entitled to. However most of these trusts do have borrowings, stockmarkets can halve in value and in particular trusts may hold portfolios likely to show high volatility.

Zeros are not risk free investments and different trust shares have different risk profiles and so expert advice is needed when investing in them. However, with expert advice a portfolio of zeros can be constructed to provide a reasonably stream of capital gains in future tax years. Gains of up to £9,600 in the current tax year (year 2008-2009) are tax-free. Additional gains are taxed at 18%. However zeros are not so boring as the other investments listed above and are starting to get exciting.

A Bit of Excitement

The following investments involve a degree of risk. If you take risks you can expect a higher investment return. However because you are taking a risk you sometimes lose money in these investments. If you hit the wrong time in the market you can lose half or three-quarters of your original investment, although it is very unlikely that you will lose all the money you invest.

Markets generally recover eventually but not necessarily in the timeframe you need them to.

If you can afford to take the risk, taking that risk will generally be well rewarded. However you should see the pages which discuss risk in more detail. They discuss income and capital risk and ways of reducing the overall risk once you start making investments which have risk attached to them. If you are serious about investing you need a serious risk control strategy as discussed in the pages on risk.

Equities

The obvious risky investment is equities. There are advantages to a number of strategies. Tracker funds are likely to track the market and be as volatile as the market. They are a useful starter, as they take no views on which part of the market will do better than any other but the charges tend to be lower.

Having a portfolio of unit trusts is in some ways better as at any one time one sector will do better than another and by having a portfolio you are likely to build up capital gains which will enable you to take advantage of your capital gains tax allowance even when some of your investments are doing badly.

It seems obvious that you reduce currency risk by investing in the UK. However in my experience much of what I buy is grown or manufactured abroad and to a much greater extent than in the past we are part of a global economy. I therefore recommend a substantial investment overseas because that adds to diversification and reduces risk in the long term. It also increases the likelihood of having realisable capital gains somewhere in your portfolio in order to take advantage of your Capital Gains Tax allowance.

However everyone is in the global economy and if things go badly stockmarkets world-wide can be affected. This is one of those times

Property.
As someone one said of land. "They don't make it any more". This is true but demand does fluctuate and property has had a good run over the last decade after many years of poor performance. It is a major asset class and should in the long-term form part of any portfolio.

Long Gilts and Long Index Linked Gilts
These are a play on long term interest rates and inflation. If interest rates rise long conventional Gilts will fall in value. If real yields rise long Index Linked Gilts will fall in value. Index-linked Gilts will benefit from rising inflation, which probably accompanies rising interest rates. However, if real yields rise as well this will not prevent their price falling.
If the preservation of capital values is your main concern short Gilts have much to recommend them as safe investments.

If you are saving for retirement it is safeguarding your future income that is the main concern. In that case long Gilts are probably the safest investment you can get short of getting long Index-Linked Gilts.

It is important to understand the difference between income and capital risk. If the risk to capital is the main priority, cash is the safe investment and long bonds are risky. If protecting your income is the main priority long bonds are the safe investment and cash is risky.

More Exciting And Tax Favoured Investments

The following investments are risky. By investing in them you could lose serious amounts of money. Before advising on them we would expect you to have substantial assets elsewhere in less risky investments and want you to be fully aware of the risks you are undertaking. If you want to make such investments it is well worth thinking through how you control your overall investment risk. Reading the section on risk is essential

However these investments do offer substantial tax benefits or substantial investment returns should things go well.

VCTs
VCTs are investment trusts that is to say that they invest in shares of other companies and their own shares are quoted on the stock exchange. The prices are determined by what other investors are prepared to pay for the shares. Once capital is raised no more shares are issued and they are therefore known as closed end funds.

VCTs are a particular kind of investment trust in that they invest 70% of their assets in the shares and loans of unquoted companies including those quoted on AIM. Investment in new issues of shares confers tax advantages.

1) Investments of up to £200,000 in the tax year 2008/9 will attract tax relief at 30%.
2) Dividends are free of tax even for people who purchased shares in the stockmarket market after issue.
3) Capital gains on the shares are tax-free.
4) The proceeds of investments realised by the trust can be distributed as tax-free dividends.

However, the initial tax relief can only reduce an investors tax liability to nil in the year of investment and cannot be carried forward. If the investor sells his shares within five years the initial tax relief is withdrawn.

Investments in unquoted companies are more risky than in more mature companies and VCTs tend to have higher management charges and performance fees for managers. Although in principle higher risk means higher reward, the existence of tax favoured vehicles for investing in such companies distorts the market somewhat by increasing the pool of investors which may be increasing prices and therefore reducing returns.

An investor wishing to buy VCT shares can either buy a new issue or buy existing shares in the market. Given that investing in new shares attracts tax relief at 30% and buying existing shares does not, an investor will only be willing to pay 70% of the asset value to buy existing shares. New shares are therefore likely to stand at a discount to asset value of around 30% and that will be reflected in the price that an investor will get for his shares if he has to sell them.

If an investor needs to realise his investment early he is likely to have to sell at a 30% discount and repay the tax relief he received from the Inland Revenue. An investor who realises his investment within five years is therefore likely to receive less than 40% of his initial investment after tax. An example is useful

An investor buys £100 worth of VCT shares and receives tax relief of £30 and so the net cost is £70.

He then needs the money. Issue expenses were 6% so the trust has assets of £94 in respect of those shares, which trade at a 30% discount, and so the shares are priced at say £66, which is what the investor receives. The investor then has to pay the Revenue back his tax relief of £30 out of that money and so he has £36 left. The net effect is that an initial investment costing £70 net of tax returns a net amount of £36 and the investor has lost half his money.

Once the shares have been in existence for a while other factors become more important in determining the price such as the success or otherwise of the manager and discounts may narrow, particularly if the trust is thought to be realising its holdings.

Enterprise Investment Scheme

Investors who subscribe to a new issue in a company, which qualifies for the Enterprise Investment Scheme, receive a number of tax benefits. However, in order to qualify, the company has to be unquoted (although AIM quotation does not count) and it must be a trading company as well as fulfilling various more technical requirements.

The tax benefits are as follows

1) Investors get tax relief at 20% on up to £500,000 invested in any one year but shares need to be held for at least 3 years.

2) Capital Gains can be rolled over into an EIS investment and so an existing CGT liability can be deferred. Note that only the gain need to be invested, not the while proceeds of sale of the original investment.

3) Dividends are tax-free

4) If held for 2 years the shares are exempt from Inheritance Tax.

5) Capital Gains are tax-free after 3 years but not deferred gains.

6) Capital losses after allowing for tax relief can be offset against income tax or Capital Gains.

These are investments in single companies. The shares are probably untraded anywhere and so realisation of your investment may be difficult although there is nothing to prevent the company subsequently being quoted, as long as it is not planned at the time of subscription.

These companies are at an early stage in their life and the risks are therefore considerable. Whereas VCTs invest in a portfolio of companies these are single companies and so the risk is much higher. Expenses are also likely to be high. It is wise to diversify into a number of such issues although this multiplies the paperwork.

Woodlands
Gains and income from woodlands are exempt but not gains on the land on which the woods stand. Standing woodland can be held over for Inheritance tax purposes but on disposal IHT will be payable. Commercially run Woodland may be treated as a business asset. Short rotation coppice is treated as agriculture and subject to the same reliefs as in any other agricultural activity.

Capital Shares in Split Capital Investment Trusts
Split capital investment trusts generally have zero coupon preference shares with rights to a fixed sum at wind-up date. Other shares have the rights to dividends and the remainder of the assets on windup. These other rights may be split various ways but for these purposes the capital shares are those which have the rights to the remainder of the assets of the trust. At windup these shares will be last in the queue.

However once all the liabilities in respect of any loans and the other classes of shareholder are met the whole of any gains on the underlying portfolio accrues to the holders of the Capital Shares.

If the other liabilities are met 110% by the assets of the trust and the value of the trust assets grows by a further 10% by the wind up date, the interest of the capital shareholders in the trust assets will have doubled. This is despite the fact that the trust assets themselves have only grown by 10%. Of course if the trust assets fall by 10% the interest of the capital shareholders will fall to nothing.

These shares are of interests because the maximum loss is your initial investment. Someone could for example have £90,000 in Savings Certificates and invest £10,000 in capital shares. If the shares are like these described above and equities rise buy 50% the value of the capital shares at wind-up will be of the order of £60,000 and it will be as if the whole portfolio had been invested in the stock market. If on the other hand equities fall in value by 50% the loss on the holding in Capital Shares will be limited to the initial investment i.e. £10,000 and the investor will still have the Savings Certificates worth in excess of £90,000.

In practice the arithmetic is less simple as the option value is priced into these shares and the level of cover for the other liabilities will vary, but used intelligently, these shares can form part of a low risk investment strategy. It must be remembered that on their own they are extremely high risk. Indeed in most circumstances they are best avoided. They offer the opportunity to gamble on the market and have uses in a risk control strategy. However any potential investors have a clear reason for making the investment as they are a particularly risky kind of investment.

MORTGAGES

We do not advise on or arrange mortgages for the purchase of homes. We do however advise on commercial loans either those being set up or where there are early repayment penalties. However the following are points that can save you money on your mortgage. The following are points worth bearing in mind. Some of those points seem obvious but they have important implications for borrowers that may be less obvious.

Everyone expects to be paid
If you arrange your own mortgage fewer people are involved and it should make it cheaper for you. If there are complications it may be worth getting advice but at least try and do it yourself.

The interest on a mortgage is not tax deductible
The gross interest must be paid for out of your net income. This means that if you spend money repaying the capital you will be better of in the future to the extent of the gross mortgage interest saved. If you put that money on deposit you will be better of in the future to the extent of the net interest earned. In most cases the saving in gross mortgage interest will be more than the net interest on the deposit. Money on deposit gives you flexibility and can be accessed if you need it, whereas money used to repay mortgage capital may no longer be accessible. If access is not important repayment of the mortgage is a good way to invest money.

Interest Only Or Repayment mortgage?
There are actually two points to consider in favour of the repayment option.

You will note that effectively the net return on repaying mortgage capital is the gross interest rate. If instead of making capital repayments on the mortgage money is invested elsewhere that money has got to earn, after tax and expenses, a higher return than the interest rate on the mortgage. That is not to say that it will not happen, but it is a difficult target to beat.

The second point in favour of a repayment mortgage is the greater flexibility. If you subsequently decide to move, you will probably want a different mortgage with a different term. It might run for 25 years from the date of the new mortgage. If you have an endowment policy maturing 25 years after the first mortgage, clearly it matures too early and therefore premiums will be unnecessarily high. You will also need to take out a new policy for the balance of the sum borrowed. A repayment mortgage avoids all this complication.

Many mortgage lenders calculate the interest based on the capital outstanding at the beginning of their accounting year.
This might seem like some technicality of little relevance to the borrower but there are two important implications of this that can save you money.

If you make a capital repayment immediately after the beginning of their accounting year, the interest you pay will on the mortgage will not be affected until the next year because the amout of loan at the beginning of the year is unaffected. You are effectively making an interest free loan of the money to the lender for a year. Therefore make sure that, if you repay any mortgage capital, you do it immediately before the end of that accounting year and not immediately after beginning of it.

It also means that the effective interest rate on a repayment mortgage in final year is virtually double the stated rate. A simple example will illustrate the point. If you owe £1,000 at the beginning of the final year and the lender charges interest at 8%, they will charge £80 in interest for the year. You will pay £90 a month and at the end of the year you will have paid off the mortgage. However the average loan over the year will only be £500, not £1000 because after 6 months you will have paid off roughly half of it. The true interest rate is therefore almost 16%

not 8% because £80 is 16% of £500. This affect happens to a lesser extent in every earlier year because the interest is calculated on the sum owed at the beginning of the year and sum owed reduces as the capital is repaid. This means that the effective rate of interest is higher than that quoted. The effect in the early years is trivial, as the amount of capital repaid is small, but as the mortgage starts to reach maturity it becomes more significant. The moral of the story is that if you have a repayment mortgage, pay it off early.

Term Insurance is cheap
It is very cheap if you are young. I would recommend taking out a policy for twice the amount of the mortgage and for ten years longer than the mortgage. Insure both lives separately for the full amount. It is flexible if you separate. If you both die in an accident the extra money will be needed if you have children. If you do move it should cover your next mortgage as well. If you do not move but have children the cover will not be wasted.

Early Surrender Terms on Endowment Policies are penal
If you do decide to repay the mortgage, continue to pay the premiums on any endowment policies. Given where you are the effective investment is the current surrender value plus future premiums. There is a market in second-hand policies. People will buy them, continue to pay the premiums to maturity, and pay any capital gains tax due. They believe they are getting a good deal. If you keep the policy the proceeds will be tax-free and you get an even better deal than they would.

Alternatively if you change your mortgage, the insurer will probably be prepared to extend the term of the policy. In investment terms it is probably not as good a deal as keeping the policy going on the original terms but it is better than surrendering it.

PERSONAL PENSION SCHEMES

The Inland Revenue has simplified the tax treatment of pension schemes. Although this might seem to be good news in fact, it means that they have made it more complicated. The following gives a summary of the new regime. If any of this causes concern please contact us so that we can advise on the best way forward. If you have existing arrangements there are transitionary provisions which may be useful. This page is purely designed to give an overview and certainly is not intended to be definitive and simply outlines the limits.

Contributions

Anyone resident in the UK and under age 75 can contribute £3,600 a year up to a maximum of their earnings during the year and get tax relief on those contributions. Additional contributions may be made without tax relief. See Annual Allowance, which effectively restricts contributions.

Annual Allowance

Everyone has an annual allowance, which in tax year 2008/9 is £235,000. Tax relief will not be given above this limit. For money purchase arrangements this is the total of all contributions made in respect of the member including employer contributions. For final salary benefits it is the increase in the value of the benefits calculated on a specified basis. Contributions in excess of the Annual Allowance will not get tax relief and in addition members will be subject to a personal tax charge at the rate of 40% on the excess over the annual allowance.

Lifetime Allowance

Subject to any transitionary provisions everyone has lifetime allowance which is currently (2008/9) £1,650,000. For money purchase it is the value of the fund. For defined benefits this is 20 times the pre-commutation pension. This is based on standard benefits. For some defined benefit schemes a higher multiple may apply. This is a total for all pension arrangements including arrangements where a pension is already being taken. Special provisions apply to the valuation of these. Where benefits are taken from different arrangements over a period of time they will progressively absorb this lifetime allowance. Benefits in excess of the lifetime allowance will be subject to tax at 35% if taken as a taxable pension or 55% if taken as a lump sum.

On Retirement

Pension benefits need to commence before age 75 and in general the tax rules mean that an annuity must be purchased before that age. Although there is provision to have an alternatively secured pension after age 75 the tax rules make it unattractive in most cases. Before age 75 the pension element can be taken either, as a lifetime annuity, a temporary annuity while retaining a fund for later annuity purchase or by taking income withdrawal from the fund.

Generally at retirement a quarter of the fund can be taken as a lump sum tax-free but the rest must be taken as pension in one of the forms mentioned above.

Death Benefits

Before retirement lump sum death benefits can be paid tax-free. After retirement, or in Inland Revenue terms crystallisation, any benefits on death are taxed at 35%. If a member defers taking an annuity until after 75 and dies the tax consequences are more penal.

Inheritance Tax

There is no general exemption from Inheritance tax although the normal provisions taxing trusts do not apply to pension schemes and the distribution of a lump sum will not generally produce an Inheritance tax charge, particularly where it is paid under discretionary trusts. However, if you are ill and decide to defer your pension the Inland Revenue can make a charge if you subsequently die having not commenced taking a pension.

If you defer your pension past age 75 and take an alternatively secured pension then on death there will be an Inheritance tax charge as there may be if there is a payment made when a dependants pension ceases.

SECOND-HAND POLICIES & REVERSIONS

Second-Hand Life Policies.

An alternative to surrendering a Life Assurance policy is to sell it. This can be an attractive option as many companies charge penalties on early surrender. This also represents an opportunity for investors who can buy the policy and continue to pay the premiums.

Gains are generally subject to Capital Gains Tax although in some cases income tax may apply instead. Capital Gains tax has an annual allowance of £9,600 (tax year 2008/9) and will be charged at a rate of 18%. An investor can choose an appropriate term, as a number of policies are always available. The investment can be realised at any time either by surrender or resale but the process is not easy and may prove expensive, which in some circumstances might not be that unattractive a feature.

To the extent that returns depend on the Sum assured and declared bonus there is relative safety. However to the extent that returns depend on terminal bonuses there is risk, as these can be cut in adverse investment conditions. This means that a cut in terminal bonuses can result in investors losing money, the sums assured and declared bonus limit the extent of those losses.

Trust Reversions

It is also possible to buy reversions. Someone may leave a life interest in assets to a spouse with reversions to the children. That is the spouse has the right to the income from or use of the assets (such as house) during their lifetime and the assets then go to the children on the death of the spouse. Reversions can also be created with a view to providing an equity release mechanism for an owner who needs to realise from value from their homes.

The difficulties with this investment is that whatever the age of the life tenant there is little certainty as to when the reversion will fall in. In general the earlier the reversion falls in the greater the return. Potential IHT liabilities complicate matters further and there is uncertainty about the returns achieved on the underlying assets. However, as a general principle, if an investment has unattractive features that means that the expected investment returns are that much higher. This is an asset only worth considering for an investor who is relatively young and has substantial other assets allowing him or her to take a long view on the uncertainty surrounding the maturity date of such an investment.

RISK

When it comes to investment everyone talks about investment returns. There is almost always some fund that had you invested in it five years ago, would have tripled your money. There is also always somebody ready to tell you which fund it was. The unspoken assumption is that if you invest in it now you will triple your investment. Unfortunately it doesn't work that way.

There is also generally a fund that would have halved your money over the same period, but you are not told about that one. Over the next five years it might actually be a better bet but in practice you do not know and nor does anyone else.

As recent events have proved all investment is about risk as well as reward. Even money in a deposit account is at risk if the bank fails. However there are various kinds of risk and it is important to know what kinds of risk are important to you if only sao that you understand what it is you are trying to avoid.

Share prices at any given time are partly based on fundamentals such as past performance and future expectations but to a very significant extent they are determined by emotion. The emotions are greed and fear. That is true for professional investors as well as amateurs.

All investment is about risk and reward, fear and greed. If you seek higher returns that almost always mean accepting risk, and accepting risk means that sometimes you will lose money on some of your investments. There are very few fundamentally bad investments. There is a price at which most investments are good value, and a price at which they are bad value. The difference between a good investment and a bad investment is generally ultimately a matter of price. This means does the market price underprice or overprice the risk? Risk is not therefore something to be avoided. Risk and pricing risk is central to the investment process.

A lot is made of how much risk is associated with particular investments. However if you feel that making a loss on any of your investments is unacceptable, the advice must be you make only risk free investments. Even if that is the case you still need to understand the different kinds of risk if only so that you can avoid those that are important to you.

If you believe that taking risks will eventually lead to higher returns overall you must accept that some of your individual investments will lose money. In that case you not only need to understand the various kinds of risk, you also need to consider how you might control those risks.

The Kinds of Risk

One automatically thinks of risk as being risk to capital but there is another risk and that is risk to income. They are each important to someone but which is most important to you depends on your circumstances.

Inflation is another kind of risk that affects both capital and income. Protecting the monetary value of your investment may benefit you very little, if money itself loses its value.

For a young person saving up to buy a house or start a business, capital security is all that matters. If interest rates fall by half, maybe it will take you slightly longer to reach your goal, but it is not a complete disaster. If your savings halved in value it would be.

For the young person the minimum risk investment is a Post Office deposit account because that has a government guarantee and the capital is protected. The targets are short term and therefore unless inflation becomes rampant it does not constitute a great risk.

That is not to say that inflation is not risk for a young person with short term objectives just that at worst it means that after tax the interest on the deposit account may not compensate for the fall in the purchasing power of the savings already made. That decline is probably small and not disastrous and is more than made up for by the flexibility of easy access.

If inflation is a serious problem index linked savings certificates will solve the problem. If there is too much money involved for the Saving Certificate solution short index linked gilts are an alternative.

On the other hand imagine you are a seventy-year-old pensioner living in the interest from a deposit account paying 6%. Here the risks are much more complex and need to be looked at individually.

Income Risk
Everything looks fine until interest rates fall to 3%. The only way the pensioner can maintain his standard of living is eat into the capital at an ever-faster rate. The more capital he spends the less interest is earned and so the faster he needs to spend capital. Ignoring inflation the capital will be exhausted in just over 23 years. Assuming he is healthy that is just about his life expectancy. It is a matter of chance whether his life runs out before your money does. This is a disaster, which puts a completely different slant on the phrase "Your money or your life?

For the pensioner the way to avoid this risk is to invest in a long gilt such a 4¼% 2055. If interest rates double the capital value of the holding might halve but the income will come in at the same level for the rest of the pensioner's life.

Inflation risk.
If he wanted to protect the purchasing power of his income he would need to invest in long Index Linked Gilts rather than conventional ones that way the coupon (interest) would keep pace with inflation.

Capital Risk
The pensioner himself has some capital risk. He may find that he has dry rot in the house and expensive restoration work is required. If he has to sell these Gilts there is no guarantee that he will get his money back if interest rates rise and prices fall. However his primary risk is income risk and this will hopefully only affect a small proportion of hi capital.

If he wants to leave his money to his grandchildren there is a more serious capital risk for them. The price of the very longest index linked Gilts is highly dependant on real interest rates in the market. If real interest rates rose from say 1½% a yield seem recently to 4% a yield seen in the ERM crisis when John Major was prime Minister) the stock could lose half its value. However, clearly there are limits to the capital risk and the granchildren must take the place in the universe of risk.

However this does highlight one important aspect of risk. If you protect against income risk you have to accept capital risk. If you protect against capital risk you have to accept income risk. There is no way to protect against both.

The cost of Certainty

If you deposit your money with a less risky institution the yield falls. If you invest in conventional gilts as opposed to deposits it will affect yields one way or another. If you want inflsation protection income yields fall again.

In the case of our pensioner he might eleminate all his income and inflation risks but his income might fall from say 6% to say 2% or even 1%. He may simply have have substituted the risk of penury for the certainty of it.

Other Options and Risks

Clearly our theoretical pensioner had the opption of buying an annuity either level or with fixed escalation. He could have an index linked pension. This increases his income and may provide inflation protection. There is in some ways for him not capital risk because idf he does this he forfeits all right to his capital. In other words 100% capital loss is certain but he has income protection.

Clearly an annuity ids a bead investment if he killed the next day in an accident but this may be an acceptable. After all the fact that there is no money in his estate does not affect his standard of living because he is dead. Income risks have been eliminated apart from the risk that the insurer will fail and even then he is guaranteed to get 90% of the promised income.

Dependants also have certainty as to what the investment will provide them with and that what they get; nothing.

This is another aspect of risk that is worth pointing out and that is that a certainty of nothing is still a certainty and it can be planned for, at least in a portfolio. In the above example the grandchildren are not planning their lives on the basis that they will get some money when granddad dies.

In reality everyone takes some risk. This maybe to achieve a higher return. Even if they are not doing that, they are trading capital security for income risk or visa-versa. Either way it is worth identifying what your risks are and what your minimum risk investment is.

When looking at risk you should be aware that there is income risk and capital risk. Most importantly you need to know that you cannot protect against both.

Inflation is another risk. It may be high as in the 1970s, but it worth remembering that inflation can be negative and prices can fall. If prices actually fall that means that the real value of money itself rises. It happened between the two World Wars in the last century and it will happen again. Some leading economists fear that deflation (falling prices) is an immediate prospect. Although in my own view the risk resurgent inflation is the greater risk it is worth remembering that unlike death and taxes, inflation is not certain.

Real People

Most people think that they are most like the young man and are very concerned about capital security but regard the interest on their money as little more than the icing on the cake.

The reality is somewhat different. Most people spend the first half of their working life paying off student loans, saving for a house, paying off the mortgage and paying for the kids. Saving, in so far as it is done, is in order to provide some kind of security and keep the family afloat.

It is in the second half of someone's working life that serious saving and investing becomes possible. By then they have reached the stage where they are saving for retirement. That needs to be rephrased; they are saving to provide themselves with an income in retirement. At retirement they will have to either buy an annuity or provide themselves with annuity like benefits. Roughly half of those annuity benefits will be dependent on income yields and half on

capital value. Even though income generation is not critical until retirement actually happens, the ability of the fund to generate income at retirement is. This will be a function of both the capital value of the fund and interest rates at the time

Many comments on the pensions miss-selling scandal show this confusion about the nature of risk. Many people transferred their preserved benefits out of pension schemes and suffered a reduction in their pension as a result. Much of the blame is placed on equity investment returns. However, equity returns have until recently not been that bad. Not as good as was being projected, but not too bad. What has really caused most of the pain was the fall in Gilt yields. If Gilt yields had remained at 10%, most people would have suffered a small shortfall over what they could have expected from their old pension scheme but nothing major. Some would still have been better off, despite the slightly disappointing equity returns. What has really hit them however is that Gilt yields fell from around 10% to around 5% and annuity rates reflected this.

It is also the fall in Gilt yields that has put many final salary pension schemes in financial difficulties.

For most people saving for retirement both kinds of risk are equally important. In the end their target is their own zero risk investment which is a Gilt maturing about 20 years after they retire. If the amount of that Gilt that can be purchased by their pension fund falls they are losing pension and it is the loss of pension that matters. Whether the loss arises because the market value of their investments has fallen or because the price of the Gilt stock has risen makes little difference at the end of the day.

For someone who is wealthier the preservation of capital for the next generation becomes a more important consideration. They can continue to enjoy their current lifestyle whatever happens to interest rates because there is little risk of their expenditure depleting their capital to zero. In that case capital preservation becomes the primary goal, even in retirement.

Cash as an Investment
People are frequently trapped into the idea that the minimum risk investment is cash. In most cases it isn't. It is not appreciated that if you are saving for a pension and interest rates fall cash will actually be quite a high risk investment. For people providing for their retirement government debt or corporate debt is the low risk investment.

The other risk affecting cash and bonds or Gilts is inflation. Although interest rates are generally higher than the rate of inflation, taking the long view, tax commonly reduces the interest rate on deposit account or bonds to below the rate of inflation. Clearly this is a bigger problem for high rate taxpayers. Once again index linked securities protect against this but at a cost.

If you have a short-term target such as a major purchase or you want a cash float to deal with emergencies then cash is the obvious investment.

If you think the equity market is likely to have a bad time and the fixed interest market is going to have bad time as well because of weakening Sterling and weakening government finances, invest in cash deposits. It's a high-risk strategy but if you are right the rewards should be very good indeed.

Cash is another asset class and has important uses in tactical asset allocation. However in most situations it is not low risk.

Minimising risk

Most people would consider investing all their assets in the shares of a single company as being risky and therefore they would not do it. However they would invest a significant proportion of their money in a single unit trust because they know that the unit price reflects the value of a portfolio of individual shares. Diversification reduces risks.

In practice most people drift into an investment strategy. That is to say that they start off with a number of deposit accounts, which they view as being completely safe. They are possibly not quite as safe as they think, but that is where they start. They then see that equities have produced a higher return and then they move a substantial part of their investments into equity and property investments. Later on they might go into higher risk investments either intentionally or possibly without realising how much they are moving up the scale of risk. However they frequently do not give much consideration to the risk intrinsic in individual investments and therefore to the risk intrinsic in their portfolio.

With luck, this results in a portfolio containing investments with a spread of risks and at least some diversification but generally everything is compartmentalised. Personal holdings may be spread between cash and equities with some property investment. Pension policies may be either invested entirely in equities or in some managed fund. The managed fund will probably contain some bonds. Although there may be some appreciation that risk is becoming less and less acceptable as retirement approaches, that will not be reflected in changes to the structure of the investment portfolio. Crucially there will be little appreciation that Gilts (Government bonds) represent the minimum risk investment for many people.

Although diversification reduces risk, market movements in the different markets are correlated. Economic growth increases the demand for and therefore the price of both property and commodities as well as being good for the equity market. Equally the markets affect each other. A property crisis can cause a banking crisis causing an economic crisis and therefore affecting equities and commodities. Prices do not necessarily move together. There are frequently time lags but for any investor diversifying away all risks is next to impossible.

Diversification works reasonably well most of the time, but has limitations when there are major economic shifts and there is contagion between markets. The problem is that even where there is only some risk there is no limit to the losses. There is no law that states that the equity market will not lose 90% of its value. It may be extremely unlikely but it is possible.

In normal circumstances losses in one market might be compensated by gains in another or at least, the losses in one market are contained because the investment in that market is itself limited. However once one markets start rapidly affecting each other that is no longer the case.

An alternative strategy is to invest say half or two-thirds of your money in the ultra-safe investments and the rest in very risky investments such as the capital shares in split capital investment trusts or maybe a hedge fund. If things go well they go very well. If they don't you have still got the money in the ultra-safe investment and at least you have had some excitement in the meantime.

If that sort of risk profile is attractive see exciting and tax favoured investments but understand that the risk of losing your entire investment is very real. Otherwise be in less risky investments where the risk of loss is very real but the risk of total loss is very small indeed.

More on Diversification.

Diversification works but its benefits are limited and are reached very quickly. Once again you need to know what you are diversifying away. There are several levels of risk:

1) Company risk associated with the management of the particular company.
2) Sector risk. If demand for houses falls all housebuilders will be affected.
3) Country Risk. If the UK stockmarket falls sentiment will affect all shares and anyway that would indicate falling economic growth in the UK which will affect most companies. Individual countries also have political risk'
4) Worldwide affects. If the world economy goes into recession all economies will be affected either directly or indirectly because of the fall in demand for exports.

Clearly there is scope for diversification by investing internationally rather than nationally. Through equities you can diversify across sectors and across countries. Although investing overseas is inevitably more expensive it is well worth going for that extra diversification.

Diversification into property and commodities will help but that does not help in a world-wide downturn. In achieving diversification it is important to realise that cash is another class of asset and therefore offers diversification particularly if that cash can be diversified into other currencies as well. However cash is not risk free and in that scenario the only thing that will protect you is being invested in you minimum risk asset or another asset very similar to it.

A Risk Strategy

Even within asset classes there are varying degrees of risk and you need to be aware of the degree of risk associated with each of your investments.

As mentioned above most people start with cash investments and move into equities slowly which is fine. As they become more comfortable with normal equities they move into more risky investment or more risky equities but not taking an overall view of their risk profile.

Conventional wisdom is to have a spread of investments covering either the full spectrum of risk or only part of it. However other strategies are possible. For example somer investors might ignore the ordinary equities and concentrate on the high risk end through tax favoured vehicles. This can be sensible strategy if the not only increases the proportion of his portfolio in high risk investments but also the proportion in low or zero risk investments.

This generally limits downside because for most investments you maximum loss is your initial investment. With such a portfolio whatever happens you still have the safe element of the portfolio and risks are therefore controlled. In some ways they are better controlled than with a portfolio including large holdings of more investments with average risk such as portfolio of ordinary equities. In that case the risk of total loss or virtually total loss may e small but it is still there.

Any investor's risk control strategy must take account of two important factors

1) How much the investor can you afford to lose.
2) Your ability to cut losses when the portfolio starts generating losses that approach that level of affordable losses. This has two elements. The first is the investor's willingness to monitor his overall portfolio. The second is more subtle. It is about you being comfortable with selling your investments at loss in order to prevent further losses. We are talking about the ability to admit to yourself and possibly other people, such as your husband or wife, that in the event you got it wrong. It also means taking the risk that your current holdings might recover tomorrow and you might end up getting it doubly wrong. Ultimately this is the most difficult

aspect of any risk management strategy to gauge as it involves knowing yourself and being honest about it.

Risk & Reward.

Risk and reward go together, the expected return on investments is directly related to the expected risk, at least where there is an open market. This means that higher expected returns can be achieved the greater the expected risk you are prepared to take.

The key word is "expected". It is used in the statistical sense of on average. It means that if you have infinite resources and invest in high risk investments for an infinite time, you will make a higher investment return.

It should be noted that in order to change the expression from "probably make a higher return", into "certainly make a higher return", two conditions need to be fulfilled

1) You need infinite resources as otherwise in the face of disaster you might run out of money.
2) You need infinite time because otherwise you might take the money out when the market is particularly low or after a long period of poor performance.

Private individuals have limited resources and limited time horizons and so they cannot achieve certainty. Within those constraints any investment strategy involves some risk of losing money. If you have a reasonably large amount of money and a reasonable period of time to invest you reduce that risk, but you do not eliminate it.

In practice according to Barclays Capital, in the last century equities have produced higher investment returns than any other class of asset over all possible 20 year periods. However the valuation basis of equities changed during the period. At the beginning of the period equities had a higher yield than Gilts, because of the risk that dividends would be cut. At the end of the period the dividend yield on equities was lower than on Gilts because dividends were expected to grow. Given that fact it is inevitable that it would be possible to chose a time period where that would be true. It happens to be 20 years.

The second comment worth making is that that enormous change in attitude will not be repeated, although it could be reversed.

There is a final comment to make about that little word "expected". Although it is a statement about probability, the market does not explicitly work out what that probability is. It is simply implied in the price. Banks do try to estimate it in pricing their options and guarantee products. However in my experience the market frequently miss-prices risk and past events give little support for the idea that the banking system is any better.

Eliminating risk by investing in a guaranteed product.

Most such products give you a return of a percentage of the growth in the relevant equity index or just a high fixed return, on condition that the index does not fall by a specified amount. The exact terms vary considerably.

These may represent a a good investment but what you should note is that if you invested in the underlying equities you would have received dividends on top of the capital growth. It is the dividends you lose and that is what buys your guarantees. The comment was made above that equities outperformed all other assets classes over any 20 year period in the last century according Barclays Capital. It should be noted that that statement applies with dividends reinvested. You may therefore have reduced the risk but part of the price you pay is the loss of dividends.

Once one talks about equities, one talks about capital growth. However capital grow is far from the whole story. Dividends are an important part of the return you get from equity investment.

Investing in these products you eliminate much of the risk but at the cost of eliminating some of the investment return as well. You may get more than 100% of the capital growth but there is generally a ceiling on the maximum return. In addition if the market performs badly you may get no investment return at all over the period of the contract and that represents a real loss if prices are rising.

These products enable you to invest in equities and sleep at night without worrying too much. Whether they actually provide an enhanced return is a more open question.

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