KENNEDY BLACK
WEALTH MANAGEMENT

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Welcome to the second Kennedy Black Private Client Newsletter.

This Newsletter continues some of the main themes highlighted in the last edition (available on the website if you're interested), namely the recent tax changes for high earners. However, we also take the opportunity here to focus a bit more on investments with some detailed thoughts on Structured Products as well as a quick introduction to SIPPs. Don't hesitate to get in touch to discuss any topic in more detail.

Is basic-rate tax relief better than no tax relief?

High earners may be feeling a little under siege at the moment, having been hit with the double-whammy of a new 50% rate of income tax and further restrictions on tax relief on pension contributions. With this loss of higher-rate tax relief for pension contributions, many high earners are now weighing up the pros and cons of alternative investment vehicles, such as ISAs, but thinking that perhaps basic-rate tax relief on a pension contribution is still better than nothing. Unfortunately, that is not necessarily so.

To explain why, it is best to begin with the basic building blocks. The real tax benefits of a pension are three-fold:

1. Assets within a pension grow free of both income tax and capital gains tax;
2. You are entitled to take 25% of your pension pot as a one-off tax-free cash lump sum at the point of retirement;
3. There is an opportunity to 'arbitrage' different income tax rates at different stages of your life (i.e. you receive higher-rate tax relief on contributions now, but expect to pay a lower rate of income tax in retirement)

While tax-free growth over the life of the pension is definitely worthwhile, this can also be obtained elsewhere with relative ease (e.g. ISAs or simply careful CGT planning). A 25% tax-free lump sum is clearly attractive, but the relative rate of tax relief on entry versus income tax on exit is perhaps more important.

To illustrate this, if you already have retirement plans that are likely to tip you into the higher-rate tax bracket (in *today's* terms, i.e. £43,875 p.a.) then it is clearly inefficient to be receiving basic-rate relief on contributions now and paying higher-rate tax on income at retirement.

So aside from the 25% tax-free cash lump sum at retirement, there is little to justify high earners opting for basic-rate tax relief on pension contributions. While circumstances do differ, the general advice should be to maximise your ISA and CGT allowances first (which provide similar tax benefits but the additional flexibility of instant access) and then look for possible alternatives.

Unfortunately, ISAs are an imperfect solution since annual contributions are limited to £10,200 per person. Yet CGT planning can provide annual tax-free gains of a further £10,100 per person, and even after that CGT is still only a flat rate of 18%.

Thereafter, non-doms can take advantage of offshore bonds, which defer the tax liability indefinitely until, say, you retire to a more tax-friendly country. However, higher-rate UK-domiciled taxpayers may be frustrated to hear that offshore bonds are not all that attractive for them. Instead, regular premium insurance products might be a better option. 'Qualifying' life assurance policies – which permit tax-free proceeds after 7.5 years – are an old-fashioned insurance product uncovering a new lease of life as a result of the new rules.

To SIPP or not to SIPP?

Many of you have been asking us about Self-Invested Personal Pensions ("SIPPs") recently. While they offer substantial investment choice, they do not necessarily make sense in all situations. SIPPs are a particularly flexible form of pension savings plan offering a wide range of investments to choose from when saving for your retirement (including shares and commercial property). Like all pension plans they are designed for long-term savings but are intended to help you take more control over your investments. Yet, that flexibility does come at a price, and many 'standard' personal pensions are sophisticated enough to allow sufficient investment choice for all but the most demanding investor. Therefore, SIPPs should only be considered if you are genuinely going to make use of the additional investment flexibility.

Spotlight on Structured Products

You would be forgiven for thinking that the Structured Product market took a knock on the popularity front following the collapse of Lehman Brothers. Some investors were certainly surprised to find out that their 'guaranteed' products were only as solid as the investment banks backing them.

However, recent data from research website StructuredRetailProducts.com indicate that the UK market grew a massive 47% last year to £13.3 billion in size (and up 99% on 2007). The market has clearly learnt from the crisis and is demonstrating (and benefitting from) much greater transparency as a result.

There is undoubtedly a place for Structured Products as long as the structure fulfils a genuine purpose, the risk profile is appropriate and the product is fully understood. Yet comparing structured products is a tricky task for retail investors. And since products are sold in specific 'issues' the market is in a constant state of evolution.

Any investor considering using Structured Products should first ask him/herself two simple questions:

1. What sort of structure am I looking for? And, having decided that;
2. Which product offers the best value?

In terms of the first question, the market has typically been based around capital guaranteed FTSE trackers. Put simply, this means an investment where there is no downside (over, say, a five year period) but where there is a share of the potential upside in the underlying index. However, the recent introduction of a higher rate of income tax and a lower, flat rate of CGT has driven a shift towards riskier, non-income producing products (e.g. Kick-out Plans and Accelerated Growth Plans).

The choice of structure (or whether a Structured Product even makes sense at all) boils down to your personal circumstances combined with your expectations on interest rates and market volatility.

There is no easy answer here, but Structured Products can be extremely useful tools in certain circumstances: such as investors approaching retirement who want to introduce guarantees to their portfolio; higher earners looking to make full use of their annual Capital Gains Tax exemption; or simply anyone worried that stock markets look over-priced.

Unfortunately, the second question is no more straightforward. Structured Products from different providers vary enormously, and comparing them can be extremely tricky for retail investors to navigate.

I say tricky, since the variables at work here include: the credit quality of the provider; the value of the assets on offer (including the various options built in); the potential rate of return on offer and; the level of risk involved. Furthermore, since investor understanding is so important, transparency and simplicity are to be valued as well.

While it sounds complicated, providers have learnt from the recent crisis and Blue Sky Asset Management is predicting the market will grow to £225 billion over the next decade. With new products being launched all the time, the market is able to adapt to specific investor requirements and hence the rationale for Structured Products can be compelling. But as with all investments, perhaps even more so in this complicated market, buyer must beware.

Investment Rule #2:

"Invest with a long term view"

The Financial Times's Lex column recently opined, "In theory, anyone can be a Warren Buffett. The most modest retail investor may search out value, then buy, hold and slowly accumulate. What they cannot do is be a Goldman Sachs. The idea that bedroom day-traders might ever compete equally with professionals is a fiction convenient to the retail broking industry."

Similarly, it is difficult – even for the professionals – and often fruitless to try to time the market. A much more appropriate strategy for investment success is to adopt a long-term view in order to minimise the impact of volatility (rather than trying to benefit from it) and take advantage of the long-term performance of financial markets.

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