Dividends could help with inflation

Despite a falling inflation rate, which has dropped sharply from 5.2% in September 2011 to 2.8% as of May 2012, savings account interest rates are still not able to keep pace by offering a similar net of tax return.

As such, the purchasing power of money held in savings accounts continues to dwindle, where the increasing cost of living for those who use them compounds the effect further.

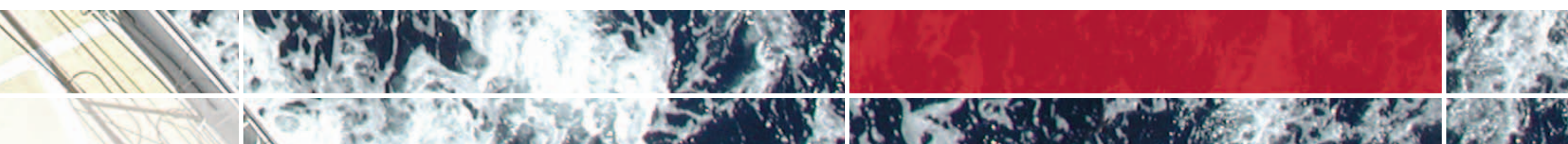
In light of such statistics, there is unsurprisingly a desire to search for more effective ways of obtaining higher return rates. This is not only in order to increase income, but also to prevent the value of assets from falling. An alternative to holding cash deposits or turning to the bond market is through dividends.

The above-inflation payout rates that they can offer, especially those within cash-rich companies, allows for favourable returns in comparison to savings accounts.

Investing in the stock market obviously contains higher risks owing to the increased exposure to the market and through volatility. However, a stable, reliable company offering solid returns can produce exceptional value through the payment of dividends, even when the share prices can move with market fluctuations.

If capital can afford to be tied up on a long-term basis, for example a period of ten years, then the risks are significantly reduced and the gains can be improved through a Unit Trust or OEIC. Currently the average dividend paid out by FTSE 100 firms equates to just under 4%, however larger companies can yield up to 6% or more.

Furthermore, picking the best dividend paying stocks over a consistent period of time has shown to be more growth-friendly than those aiming for blockbuster yields. Those prepared to wait and undertake sensible management will see greater returns and can be more assured that earning reports are not being manipulated. Despite a more difficult year forecasted, patient investment practises will be worth the wait.



Annuities and the affect of Europe

In our previous Newsletters we have highlighted that Annuity rates have been falling and the current financial crisis is not helping, coupled with Directives from Europe which are compounding the problem.

Annuities are mainly based on yields from 15 year Gilts issued by the Bank of England. However, the UK is seen as a safe haven, on a par with Germany or Switzerland, and as a result investors are buying Gilts. Demand for Gilts forces the buying price up, but has a knock on effect of lowering yields (interest). As the Eurozone crisis has intensified, Gilt yields have fallen further still. In recent weeks, as at the 18th June, yields fell by 3% alone. The yields have now reached their lowest level since the Bank of England's records began in 1703. Whilst this helps the UK Government to refinance the Country's debt at a lower cost, the impact for savers and pensioners is a reduction of income.

Another impact on annuity rates is the forthcoming European Directive, where the insurance industry is implementing gender equalisation legislation by December 2012. The European Court of Justice took the view that giving men greater annuity payouts for the same pension pot because they are likely to live shorter lives is unfair. Whilst many understand the reasoning behind this, in order to implement this Directive the insurance companies are reducing the rates of male annuitants to the same as females.

We must also not forget the impact of the European Solvency II Directive which is also scheduled to be implemented in 2014. This requires the insurance providers to hold a higher level of capital reserves to pay their liabilities. Insurance companies currently use a combination of low risk investment strategies to underpin their annuities however the Directive will mean they will have to keep more reserves and as a result they will have less capital to support current annuity levels. This in turn will mean that annuity rates, and therefore income to those considering retirement will fall in the future. Negotiations between the EU and the insurance companies are still ongoing as to the level of capital reserves being identified for this purpose.

When considering your retirement options to help reduce the effect of falling annuity rates, you should always consider the 'Open Market Option' which is an industry term for shopping around. If you receive a retirement quotation from your current pension provider that will usually be the best annuity that they can provide. For example, an annuity for a single male, in good health, aged 65 with a pension fund of £100,000 could receive an annuity income of £4,999 gross per annum from one provider. However, if that client used the Open Market Option their income could increase to £6,035.16 gross per annum, an increase of £1,040.16 per annum. The cost of staying with his existing provider in fifteen years time would be over £15,500 in lost income!

Many people also do not realise that they may even be able to receive an 'Enhanced Annuity' due to existing lifestyle factors. It is therefore important to consider three major points 1) do you smoke 2) do you take any prescription medication 3) have you been into hospital for any investigations or operations recently? Using the same example client above but having smoked 15 cigarettes a day; he could receive an annuity of £6,877 per annum, which would be a 13% increase in income from the non-enhanced annuity.

There are other retirement income options available for example, Pension Drawdown or Asset-Backed Annuity contracts but these should be approached with caution as they may not be suitable for every client and you should speak to your adviser to discuss your personal circumstances further.

Over the longer-term, city analysts are not optimistic that Gilt yields will increase, more so in the immediate term as the Bank of England appears to be pencilling in another round of quantitative easing which could reduce yields even further. This therefore highlights the importance of shopping around when buying an annuity and taking the income for long enough so that you get out what you have put in.

MARKET REPORT

GLOBAL REVIEW

The second quarter saw global equity markets surrender many of the gains made in the first three months of the year. Disappointing employment figures from the US and indications of a slowdown in Chinese economic growth turned attention to the problems in Europe. A series of electoral defeats for pro-austerity parties on the continent heightened speculation that Greece would leave the euro and news that the Spanish banking system would require a bail-out all served to undermine investor confidence.

Government bonds have been the main beneficiaries of a 'flight to safety' with short-term yields turning negative in some cases. As an example, investors have been willing to pay Germany to lend them money over 2 years such is the distrust of bank deposits. Germany can now borrow for up to 30 years at under 2% and the US and UK at comfortably under 3%. This is in stark contrast to the 6% required by investors on Italian 10-year debt and 7% for Spanish 10-year debt, a level many consider unsustainable.

UK

The UK Government has still been able to borrow money at record low levels despite the national debt surpassing £1tn in January and the country's finances coming under ever greater scrutiny by the credit ratings agencies. Control over its own fiscal policy and an independent currency have been credited. However, the Government has come under increasing pressure, most notably from the International Monetary Fund (IMF), to ease austerity measures and implement more pro-growth policies, particularly as inflation has started to ease.

Having acknowledged the "substantial progress" made to reduce the UK deficit, the IMF suggested the Government now had scope to stimulate growth via tax cuts and further infrastructure investment.

In contrast, the Organisation for Economic Co-operation and Development (OECD) has fully backed Britain's economic policies stating that the UK had no room to ease up on its austerity programme. The group kept its growth forecast unchanged at 0.5% for 2012 despite an unexpected contraction in the first quarter that saw the economy fall back into recession.

US

Economic activity in the US also fell short of expectations in the first quarter but GDP still increased by 1.9% on an annualised basis. Whilst healthy relative to the flat number posted by the Eurozone, it fell short of both the 2.5% consensus estimate and the 3% expansion returned in the fourth quarter of 2011. A fall in Government spending and slower growth in business investment were largely to blame as consumer spending rose by 2.9% over the quarter.

Any further weakness in the economy may prompt the US Federal Reserve into providing additional stimulus. With the Eurozone still in turmoil, a second month of weak job growth and a faltering housing market the pressure to act is building. This could see the extension of "Operation Twist", a program designed to push down long-term interest rates, or, as many prefer, a further round of quantitative easing that would inject additional money directly into the economy.

EUROPE

The growing tension in financial markets was relieved by the formation of a new coalition Government in Greece led by the New Democracy party. This has been seen as a vote to stay in the euro and an acceptance of austerity although the left wing members of the coalition have immediately promised an easing in spending cuts. This assumes the new administration can renegotiate the terms of the €130bn rescue package with the European Union (EU) and IMF.

On the same day that the Greek coalition was formed European leaders at the G20 summit agreed a deal to integrate its banking sector in order to stabilise regional lenders and remove the need for Government support. Earlier in the month Spain had been granted a €100bn bailout by the EU and IMF to prop up its banking sector and this pushed Spanish 10-year borrowing costs over 7%, a level considered unaffordable in the long-term. A €600bn purchase of both Spanish and Italian Government debt has now been proposed in order to reduce borrowing costs.

JAPAN

The Japanese government is still able to borrow at below 1% for 10 years despite debt exceeding 200% of GDP. This is a legacy of the country's own banking crisis, deflation and a zero interest rate policy combined with a lack of appetite from consumers and companies to borrow after more than two decades. Domestic savings are channelled into the nation's sovereign debt maintaining a steady supply of credit for the Government with recent downgrades from the credit ratings agencies having little effect.

The Government has pledged ¥20tn (£156bn) on reconstruction projects since the Tsunami in March last year. This has provided a boost to the economy with growth in the first quarter recovering to an annualised 4.1% following the sharp contraction in the final three months of 2011. However, Government spending has masked a continued lack of real strength in the economy and there have been calls for the Bank of Japan to extend its quantitative easing programme to soften any impact from the euro crisis and renewed strength in the yen.

ASIA

China's manufacturing sector has shrunk for an eighth consecutive month according to figures published in June. Economic growth is now expected to fall for the sixth straight quarter although consensus still suggests annualised growth for the second quarter of around 7%. The Eurozone debt crisis and domestic property controls have been blamed. The People's Bank of China pro-actively cut interest rates before the announcement, the first such move since September 2008.

The Reserve Bank of India surprised markets by keeping interest rates on hold at 8% in June citing concerns over inflation. The central bank had cut rates by a more than expected 0.5% in May, the first reduction since April 2009, recognising a need to boost below trend growth. India's economy grew at an annualised rate of 5.3% in the first quarter, its slowest pace for nine years. It is clear however that inflation remains the primary concern and is likely to control policy going forward.

25 June 2012

Pension tax relief remains intact

In February, it was widely reported that the Government was considering reducing tax relief on pension contributions to the basic income tax rate of 20 per cent or lowering the overall annual cap on contributions, which the coalition has already cut once before, in 2011 from £255,000 to its current level of £50,000.

Tax relief is currently available on pension contributions up to £50,000 per year. People paying tax at 40 per cent receive 40 per cent relief on contributions, which effectively means that for every £1 invested in their pension fund, they pay only 60p. In the same way, people paying tax at 50 per cent receive 50 per cent relief on contributions.

Chancellor George Osborne said in his speech on 21 March that he did not intend to make any changes to pension tax relief "in this Budget". Some commentators are interpreting that such a move is still on the table. The £50,000 cap on pension contributions was also left intact.

Although people earning more than £150,000 will see their maximum tax relief fall from 50 per cent to 45 per cent in April 2013, in line with the reduction in the 50p tax rate for higher earners to 45p from next year, they will have another year to save into a pension and get full tax relief at their income tax rate.

It had been reported that cutting tax relief on pensions from 50 per cent to 20 per cent would have saved the Treasury £7 billion a year, with Chief Secretary to the Treasury Danny Alexander commenting in February: "If you look at the amount of money that we spend on pensions tax relief, which is very significant, the majority of that money goes to paying tax relief at the higher rate."

With future changes to pension contributions tax relief likely to remain on the table, seeking expert advice on maximising the efficiency of pension arrangements is likely to be a sensible step.

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