The Tortoise and the hare

ISSUE 50 | May 2015

Pension reforms – Challenges and Opportunities

Give the Chancellor 8/10 for his April pension reforms

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New pension reforms came into being on 6th April 2015. The materially greater freedoms that now exist have much appeal, yet they come with greatly increased complexity both in understanding and in execution. On balance these reforms are welcome, but the need for high quality advice has never been greater, both to minimise the risks, but also to maximise the opportunities that they provide.

The British have had a love-hate relationship with pensions for many decades. After some years in the doldrums, the cycle is on the upswing – or certainly deserves to be - largely due to recent changes made by the Chancellor.

Continuously moving goalposts

Successive governments have always tinkered with the pension regime. Until George Osborne stepped in, the nanny state - not trusting someone to spend money from their pot responsibly in retirement, despite having been responsible enough to save for retirement in the first place – dictated how much money could be withdrawn from a pension, and forced retirees to hand over their hard-earned pot of money to an insurance company (forever) in return for an income for life in the form of an annuity. Enter the Chancellors April 2015 reforms.

Let's take a quick looks at the new rules introduced.

Pension reforms - Challenges and Opportunities

Change 1: Freedom to take out as much as you like, when you like

Prior to April 2015, the amount that could be withdrawn from a pension portfolio was limited by the Government (using a calculation related to 15-year gilt yield), unless the individual had £12,000 of secure income such as annuities, state pension or defined benefit pensions. This withdrawal limit has now been abolished and, from age 55, retirees are free to take as much as they wish, when they wish. They will, of course, be required to pay tax on these withdrawals - beyond any 25% tax-free portion - at their marginal rate of income tax, i.e. the highest tax band that they fall into, given all of the income they earn in that tax year.

Talk of retirees depleting their pots and going wild with their cash is both condescending and laughable. Most people realise how important maintaining their pot is for their future well-being.

It is important that pension pots are not seen as ATM machines! Once the 25% tax free pension commencement lump sum is taken, all withdrawals are taxed at the pension holder's marginal rate of tax. As such, the tax consequences need to be calculated carefully, before any money is withdrawn.

Change 2: No requirement anymore to buy an annuity

Thankfully, another of the central pillars of nanny state influence has been abolished; retirees are no longer required to buy an annuity. They will be free to make the decision that is right for them. For some that may still be to buy an annuity now or delay the purchase until a date of their choosing. For others it will be taking out money - drawing down in pension jargon – from their pension pot at a sensible rate. The important issue is that retirees are now in control of that choice, and can seek guidance from their financial planner on what the best course of action might be for them. Another of the new reforms is to allow those who have already purchased annuities to sell them, although how quite this will work in practice (and without another scandal) remains to be seen.

Change 3: Pension pots can be passed on to anyone

Perhaps one of the most material changes that the Chancellor made was to allow pension pots to be handed on to anyone, on the death of the member. Prior to April 2015, a pension could only be passed on tax-free if death occurred before 75 and the plan member had not begun taking an income from the portfolio or taken the tax-free cash allowance. Outside of this narrow definition, any assets withdrawn suffered a usurious 'death tax' rate of 55%, unless donated to charity.

From 6th April 2015, if the plan member dies before 75, any income withdrawals or lump sums are tax free, provided the plan has been passed on to the 'successor' i.e. the person inheriting the plan within two years. If this transfer is delayed beyond two years then they will have to pay income tax at their marginal rate on any withdrawals.

If the member's death occurs after 75, then the beneficiary can take either a lump sum or draw down the money flexibly at any time. Where income is taken, this will be taxed at the successor's marginal rate of tax. Lump sum withdrawals will incur a 45% tax in 2015/16 (previously 55%), but will be taxed at the successor's marginal rate of tax from 2016/17.

As pension pots usually fall outside an individual's estate for inheritance tax planning, the astute reader will quickly see that these new arrangements allow for some sensible and legal intergenerational tax planning, in certain circumstances. Professional advice should always be taken as a matter of prudence when making any such choices.

Change 4: Private sector defined benefit pension transfers can be made

The new regulations also allow for those individuals with private sector defined benefit pensions to transfer the lump sum value of their pension into a defined contribution pension (e.g. a self-invested pension plan or SIPP). However, they are required to take professional advice before they do, unless the fund is below £30,000[1]. There is the potential for another scandal here too, with poor transfer values entirely possible. Advisers may also be conflicted; from a financial perspective they may stand to benefit for the transfer, whilst it may be in a client's best interest to remain in a plan with an inflation-protected income for as long as they live. It may seem tempting to transfer assets, but the preponderance of evidence is likely to favour staying put in many instances. Again, help from a trusted adviser is essential.

Conclusion

These pension reforms should be welcomed. Yet, despite their positive contribution to flexibility, and fairness, they also bring increased choices for individuals around contribution levels, the timing and quantum of pension withdrawals and their use as tax-efficient intergenerational asset transfer opportunities. These decisions are complex and important to the future financial well-being of clients and their families and should not be taken lightly. It is hard to think of a more obvious area that a good financial planning firm can add material value to its clients than by empowering them to make informed decisions on what to do with their pensions.

References

[1] This amount is currently under government consultation

Indicators

GDP Growth Projections (%)	2014	2015	2016
US	2.4	3.1	3.1
UK	2.6	2.7	2.3
Eurozone	0.9	1.5	1.6
Japan	-0.1	1.0	1.2

Source: IMF, World Economic Outlook, April 2015

Inflation Projections (%)	2014	2015	2016
US	1.6	0.1	1.5
UK	1.5	0.1	1.7
Eurozone	0.4	0.1	1.0
Japan	2.7	1.0	0.9

Source: IMF, World Economic Outlook, April 2015

Equity Summary (%)

Index	Q1 2015	2014	2013	2012	2011	2010
S&P 500 TR USD	1.0	13.7	32.4	16.0	2.1	15.1
MSCI EAFE Value NR USD	3.9	-5.4	23.0	17.7	-12.2	3.2
FTSE 250 TR GBP	6.7	3.7	32.3	26.1	-10.1	27.4
FTSE 100 TR GBP	4.2	0.7	18.7	10.0	-2.2	12.6
Russell 2000 TR USD	4.3	4.9	38.8	16.3	-4.2	26.9
Russell 1000 Value TR USD	-0.7	13.5	32.5	17.5	0.4	15.5
MSCI EM NR USD	2.2	-2.2	-2.6	18.2	-18.4	18.9
MSCI EAFE NR USD	4.9	-4.9	22.8	17.3	-12.1	7.8
MSCI Europe Small Cap NR EUR	18.0	6.5	33.4	27.0	-17.5	29.9
MSCI Europe NR EUR	16.6	6.8	19.8	17.3	-8.1	11.1
MSCI EAFE Small Cap NR USD	5.6	-4.9	29.3	20.0	-15.9	22.0
MSCI Europe Value NR EUR	14.5	5.6	21.3	16.4	-9.5	4.1
MSCI ACWI NR USD	2.3	4.2	22.8	16.1	-7.3	12.7

*Annualised Return

Source: Morningstar

Fixed Income Summary

Index	Q1 2015	2014	2013	2012	2011	2010
IBOXX Liquid Investment Grade TR USD	2.6	8.7	-2.4	11.8	9.1	9.4
IBOXX Liquid High Yield TR USD	2.3	2.1	5.9	14.1	5.9	12.6
IBOXX GBP Corp TR	3.4	12.3	1.9	15.6	5.4	8.7
IBOXX EUR Corp TR	1.4	8.2	2.2	13.6	1.7	4.7
JPM Global Emerging Market Bond Index	2.1	5.5	-6.6	18.5	8.5	12.0

*Annualised Return

Source: Morningstar

Risk Warnings

Past performance is not a reliable indicator of future results.

The illustrations are in US Dollars unless otherwise stated. Currency fluctuations may increase or decrease the returns of any investment.

There can be no guarantee or assurance that a client's portfolio will not incur a loss over any particular time period.

Fees and charges do not apply in respect of any index, indices are unmanaged, do no incur fees and cannot be invested in directly.

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Foreign Exchange

	31/12/2014	31/03/2015	Change
USD/JPY	119.7	120.1	0.3%
GBP/USD	1.56	1.48	-5.1%
GBP/JPY	186.4	178.0	-4.5%
GBP/EUR	1.29	1.38	7.0%
EUR/USD	1.21	1.07	-11.6%
USD/CHF	0.99	0.97	-2.0%

Source: FT.com

Real Assets (%)

Index	Q1 2015	2014	5 years*	10 years*
London Fix Gold PM PR USD	-1.6	0.1	0.0	10.5
Bloomberg Sub WTI Crude Oil TR USD	-14.9	-41.7	-12.0	
S&P GSCI TR	-8.2	-33.1	-6.5	-5.6
S&P Global REIT TR USD	3.9	22.8	12.5	7.3

*Annualised Return

Source: Morningstar (as of 30th April 2015)

Economic Indicators

Index	Unemployment rate (%)	Current A/C Balance*	Budget Balance*	Industrial ** Production (%)
US	5.5	-2.2	-2.5	2.0
UK	5.6	-4.5	-4.4	0.1
Euro Area	11.3	2.7	-2.2	1.6
Japan	3.5	2.3	-6.9	-1.2

*% of GDP 2014 estimate
**change on 1 year ago

Source: Economist (2nd May 2015)

Interest rates (%)

	1 month	3 month	24 month	10 year Gov't
US	0.01	0.01	0.63	2.19
UK	0.40	0.45	0.57	1.95
Euro Area (DE)	-0.29	-0.37	-0.22	0.55
Japan	-	0.02	0.01	0.37

Source: FT.com (6th May 2015)

Volatility Index (%)

Index	Current	1 year change	52 week high	52 week low
VIX	14.31	6.79%	31.06	10.28
VDAX	24.18	40.66%	24.18	10.80

Source: FT.com (6th May 2015)

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We decided to use the expertise we gained at large institutions to create a partnership that bridges this gap and provides a first class service within a wealth management firm – without the often conflicting demands of ownership by a large institution.

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The initial interest rate on an inflation-linked security may be lower than that of a fixed rate security of the same maturity because investors expect to receive additional income due to future increases in CPI. However, there can be no assurance that these increases in CPI will occur.

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