June 2014

Sippcentre

News & Views

In this month's issue

- ETF Summits
- Budget changes – more on flexibility in taking income; lump sum death benefit; minimum pension age etc
- Russ Mould - The risk versus reward ratio – plus ça change?
- SIPP capital adequacy and commercial property
- Individual protection coming closer
- ISA changes nearly here
- Illustrations – are you comparing like for like?
- AJ Bell stockbroking service available to Platinum SIPP clients
- FATCA – expect additional questions for GIA applications
- Knowledge

Welcome

Andy Bell
Chief Executive

Welcome to June's edition of News & Views.

We've now had a couple of months to mull over the radical changes announced in the Budget and in this edition I look at some of the implications, giving a flavour of the key messages I will be trying to convey in AJ Bell's response to the Treasury consultation.

Also covered this quarter are the ISA changes which come into force from 1 July and the individual protection forms coming out.

ETF Summits

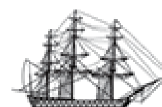
Before turning to the meatier topics this quarter it is worth highlighting the fact that our ETF Summits are being held later this month and include a great line-up of speakers from across the sector, plus a couple from AJ Bell.

The first ETF Summit is being held in Manchester on 17 June with the second in London on 18 June. Each event will give you the opportunity to hear from representatives of several leading ETF providers speaking on a wide range of ETF-related topics.

AJ Bell's own Mike Morrison will also be talking about the latest developments in the platform market, as well as the opportunities arising from the Budget pensions reforms. We still have a handful of places available – advisers can register for either of the venues by contacting their local Business Development Manager or by visiting the AJ Bell ETF Summit page on the Sippcentre website.

Speakers include:

Deutsche Asset & Wealth Management



Vanguard

Budget changes – more on flexibility in taking income; lump sum death benefit; minimum pension age etc

I have already indicated that I broadly welcome the Government's move to offer complete flexibility in taking income from pensions for those over 55 (for now – more on the potential changes to retirement ages later). I have long been an advocate of treating pension savers like grown-ups and giving them freedom in how they access their hard-earned savings.

The new pensions landscape will open many opportunities, and the need for advice – not just guidance – will be more crucial than ever. How the guidance guarantee will work in terms of method and source of delivery is still unclear but perhaps the strongest message that will need to be imparted to many will be a warning. There will be opportunists who will be rubbing their hands with glee at the thought of hundreds of thousands of pension pots becoming targets when they can be accessed in full post April 2015.

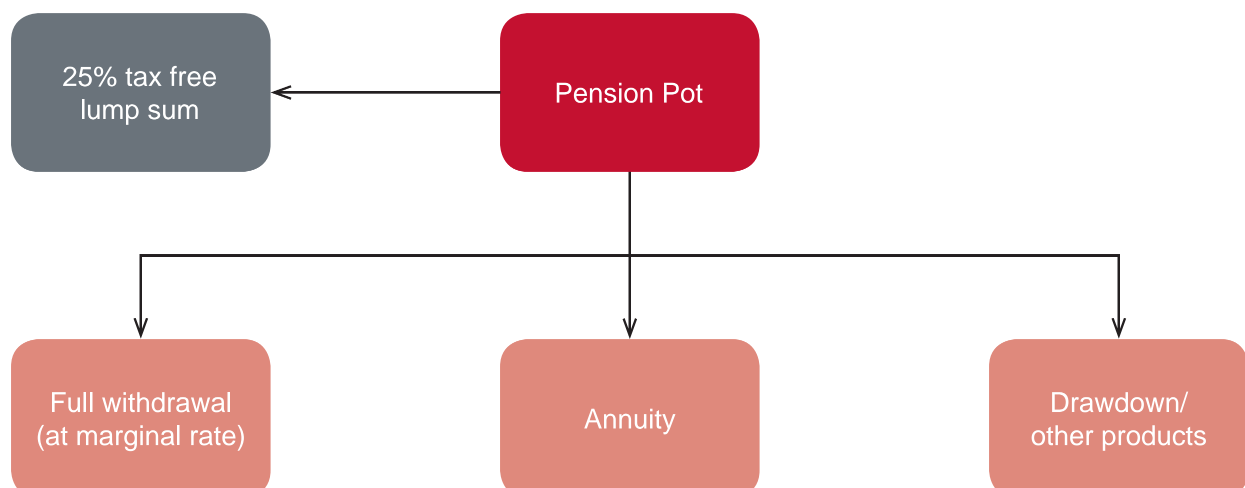
In reality there will be few cases when drawing very large sums of money out of pensions, paying high rates of tax and reinvesting the net proceeds elsewhere with more costs, and likely tax, will be the best option. Taking income and tax-free cash only when needed will be the right advice in most circumstances. For those who have not previously crystallised benefits and are under 75 there is little incentive, outside an actual need for a lump sum or income, to crystallise benefits just for the sake of taking the funds out of a tax-privileged environment.

Of course all of this could change depending on the outcome of the consultation on the lump sum death benefit charge. With the Government admitting the tax rate is too high on lump sums paid on death from crystallised funds, we can expect to see this rate coming down shortly. Suggested alternatives vary between aligning to IHT, charging at the individual's marginal rate and restoring the old 35% charge. Lower rates will reduce the incentive to take money out and invest it elsewhere – and lessen the arguments of the opportunists pushing alternative unregulated investments, both legitimate and less so.

One of the seven calls for change I made in late 2013 was for the removal of the cliff-edge 55% tax rate on lump sum death benefits paid from crystallised funds. My preference at the time was for this to be replaced with a 35% tax to be applied to all lump sum death benefits – whether paid from crystallised or uncrystallised funds. Whilst a reduction in the rate to be applied to lump sums paid from crystallised benefits will reduce the size of the cliff-edge, it is unlikely to remove it. Whilst I understand the arguments of those who do not support the addition of a tax charge on lump sums paid from uncrystallised funds, from the perspective of both fairness and simplicity, I still see the merit in setting a rate of tax to be applied in all circumstances. Uncrystallised funds have benefitted from significant levels of tax relief on the way in, and it seems an anomaly that they are completely free of tax on the way out.

Moving on from death benefits, annuities will still have their place in the new world, but will need to evolve and stand up as investments in their own right. We had already seen a move to clients using both an annuity and drawdown rather than one or the other. Taking a mix of guaranteed income, and either the additional flexibility offered by capped drawdown and the complete flexibility of the post April 2015 rules will become increasingly attractive to many.

Expanding on this point a little, it is worth highlighting that there appears to be an expectation in some parts that all clients in capped or flexible drawdown will automatically move across to the new pension flexibility rules from April 2015. A quick glance at the Government's own diagram explaining the "Future tax system for accessing defined contribution pensions at retirement" demonstrates that this is very unlikely to be the case.



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The Treasury is clearly very skittish when it comes to the prospect of recycling in the form of large contributions being paid into pensions and attracting tax relief of 40% or 45%, and then being withdrawn over the following few years in the form of a mixture of tax-free lump sums and income taxed at 20%. It is very likely that controls will be put in place which will mean that some in capped drawdown will not immediately be able to access the new pensions flexibility and/or will face tight controls on what they can do once they have accessed it. An issue worth bearing in mind when considering advising clients on the basis of what might prove to be incorrect assumptions of the post-April 2015 world. The Government is going to need to firm up on the detail of the new flexible pension world very shortly after the Treasury consultation closes on 11 June, so the most prudent course of action might be to wait and see just at the moment.

An interesting potential downside to the increased flexibility is for those who find themselves in financial difficulty. In the past pensions have been protected in the event of bankruptcy, but the Raithatha v Williamson ruling in 2012 showed that a Trustee in Bankruptcy (TiB) can potentially force the drawing of income if the bankrupt is over the minimum pension age. With the potential for no limit on the income that can be taken, the whole pension could be at risk. Hopefully a situation not too many of your clients will face, but worth considering.

One area moving in the opposite direction from the trend to liberalisation, is the prospect of an increase in the minimum pension age. The consultation is looking at increasing this from 55 to 57 in 2028, with a proposal that it be tied either five or ten years below state pension age. This approach contradicts the general ethos of letting people have more control of their own finances and will make pensions a little less attractive for some. The increase in the minimum pension age from 50 to 55 has undoubtedly been one of the, though perhaps not the main, factors in the rise of pensions liberation fraud that we have seen in the last few years. Thankfully it is a long way off, but I hope any increase in 2028 does not act as a further catalyst.

One other factor to bear in mind is that there has been no reference as to whether we will see reform of the various rules that apply at age 75 – a matter that can significantly influence advice. In practice age 75 is still likely to remain in place as a trigger for a benefit crystallisation event, even if all other pre- and post-age 75 anomalies – for example review frequency, ability to make contributions, tax rates on death benefits and removal of further benefit crystallisation events – are removed.

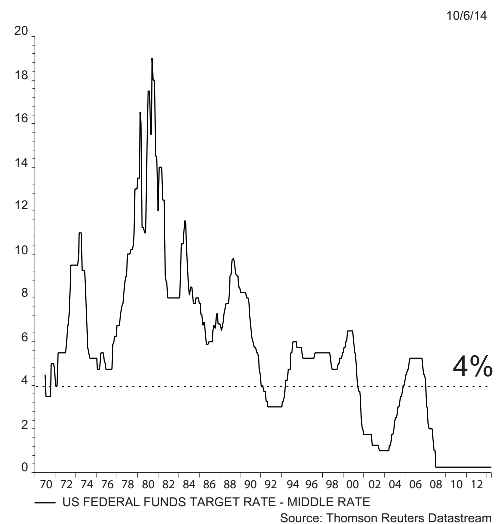
Russ Mould - The risk versus reward ratio – plus ça change?

According to fund management legend Sir John Templeton, the four most expensive words in investment are 'It's different this time.'

It is therefore fascinating to hear such luminaries as Bill Gross, PIMCO founder and Chief Investment Officer, and Ben Bernanke, former Chairman of the US Federal Reserve's Board of Governors, both arguing America's 'neutral' interest rate may be a lot lower than anyone thinks. This has enormous potential implications for clients' portfolios, irrespective of which asset classes they currently prefer.

In the past, America's central bank has tended to assume a headline borrowing cost of 4% represents a neutral policy level, a threshold at which the Fed believes it can hold inflation to near its 2% mandate and keep real-terms GDP growth at around 2%. Throughout May Bernanke reportedly spoke at several events saying he did not expect the US Fed Funds rate to return to 4% in his lifetime (he is 60, by the way). In his latest monthly investment outlook, entitled Achoo!, Gross asserts PIMCO believes 2% is now the 'neutral' policy rate, or Central Tendency Forecast for growth and inflation, not 4%.

If Gross and Bernanke are right and interest rates are lower for longer on a trend basis – or 'different this time' – then bonds still have a role to play in client portfolios and equities may not look so overheated either, even as corporate earnings forecasts for 2014 continue to slide lower.



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Lower yields

The US bond market is already paying heed to this potential scenario. Even as many commentators assert the US economy is poised to rebound strongly from its winter blues, and drag both corporate earnings and American firms' share prices along for the ride, clients are snapping up US Treasuries. The 10-year yield has retreated from 2.99% in January to 2.54% at the time of writing. UK Gilts and German bunds show a similar trajectory.

Source: Thomson Reuters Datastream

At first glance, this looks inconsistent with stock markets that are powering to fresh all-time highs. The initial conclusion to draw is the bond market is warning both economic growth and inflation will continue to undershoot expectations in the West, hardly a recipe for booming stock markets.

Yet lower sovereign bond yields do chime with the scenario outlined with Gross and Bernanke in some ways. Ultimately, the risk and reward profile of any potential investment must be referenced to cash and the so-called risk-free rate, the yield offered by US Treasuries or UK Gilts (assuming clients share the view Washington and London are both certain to pay the coupons and pay back the loans, at least in nominal terms).

Risk and reward

For example, if cash offers 2%, then AAA-rated government bonds should probably offer 2.5% to compensate for the small risk that the country in question welshes and tries to restructure the debt. Sovereign paper of lower quality should perhaps offer 3% to 5%, depending on the country's rating and track record, again adjusting for the greater chance something could go wrong and clients do not get to clip all of their precious coupons.

Good quality corporate bonds should perhaps offer 4% to 5% and junk bonds (or sub-investment grade debt) 5% to 6%, levels which are quite consistent with where these asset classes are today. Under the new scenario, fixed income goes from being an area to treat with caution to one that could offer relative calm and a safe income.

As for equities, a trend return of 4% to 6% a year may make sense overall, too. Stodgy utilities would offer 4% - through yield alone, given the limited scope for profits growth or capital appreciation. Food producers and consumer staple names would need to offer say 5% to 7% a year, through yield and capital gains, cyclicals nearer 10%. Then, in the teens, would come perhaps tech stocks and funds, since this is an industry where obsolescence risk is high and competition fierce. Resource explorers and biotech stocks (or funds) would need to offer 20%, 30% or more a year to merit a place in a client's portfolio. Many things can go wrong here – a new drug can fail to work, the new well may be dry or a mine may be appropriated in the name of resource nationalism, and so on.

Strong framework

Advisers can remind clients of this simple framework to help explain to them why interest rates are so important to the valuation of all asset classes.

The brave new world outlined by Bernanke and Gross helps explain where we are now and justify bond and equity prices alike. Do not forget both may be talking their own book, Bernanke to justify the massive monetary policy experiment he oversaw, Gross to outline his huge bond portfolio's strategy. But it is hard to escape the nagging doubt growth may remain depressed for sometime, given the globe's sovereign debts are still huge, despite a few years of supposed austerity. In addition, the UK's latest upturn is based on more mortgage lending and debt, not less, so the foundations may be far from secure.

This analysis of risk versus reward also shows what could happen as and when interest rates do begin to rise from their record lows.

As the neutral policy rate advances from 2% to 4%, the mathematical relationships with other assets remain the same – so AAA bonds would need to offer 4.5% to 5% a year, equities 6% to 8% and so on. In the case of stocks, this would come from firms either growing their profits and dividends much more quickly, or their share prices falling fast, to provide a more appropriate entry point.

Source: Thomson Reuters Datastream

SIPP capital adequacy and commercial property

The wait goes on for the SIPP capital adequacy policy statement, which is now expected towards the back end of Q3 2014, probably alongside the latest SIPP thematic review findings. Based on rumblings from the FCA, the biggest discussion point in the capital adequacy consultation revolved around the classification of commercial property as a non-standard asset, with many respondents querying whether this really was non-standard in the SIPP market, or as risky as some of the investments that led to changes in the capital adequacy regime in the first place.

On the one-hand it is an asset that is widely accepted by SIPP providers and each individual investment generally presents a risk to only a single SIPP or a small group of SIPPs (unlike the unregulated collective market where each investment is typically sold to large numbers of investors).

On the other hand there are additional costs in facilitating a transfer if anything goes wrong with the SIPP provider, such as solicitor's and surveyor's fees. Inevitably the process also takes considerably longer than transferring more liquid 'standard' assets.

The principle of the new requirements is to ensure that SIPP operators hold capital of sufficient quality to facilitate an orderly withdrawal from the market if they choose or need to. Holding a book of individual UK commercial properties is unlikely to put off a potential purchaser of the SIPP book in the same way that other non-standard assets may do. The FCA has said that it is 'mindful' of this feedback and so it will be interesting to see where commercial properties sit in the new world.

As I draft this I have only recently noted that another SIPP book has been sold. There will be more operators leaving the market as the requirements come in. This makes due diligence even more imperative when choosing a SIPP operator, if you still want to be using the same SIPP provider in two years' time.

At AJ Bell we are obviously interested to see what the new capital adequacy rules look like, but have absolutely no concern that they will present an issue. Whether commercial property ends up as a standard or non-standard asset, the tight controls we operate on what investments we will permit mean that non-standard investments will only represent a very small proportion of the assets held in our SIPP book. Also, as a business we have always held significantly more than the regulatory minimum amount of capital. No matter how the rules change we expect that to continue.

Individual protection coming closer

The reduction of the lifetime allowance from £1.5 million to £1.25 million on 6 April 2014 saw not only the introduction of an updated version of fixed protection, but also the introduction of individual protection. This is available to individuals whose pension benefits had a combined value at 5 April 2014 of at least £1.25 million and who did not hold primary protection. It can be held by those with enhanced, fixed or fixed protection 2014 although, because those forms of protection are all of greater value to clients, the individual protection will remain 'dormant' unless the other protections are lost.

Unlike fixed protection 2014, where applications had to be submitted by 5 April 2014, we still await the start of the application process for individual protection. The application form, called an APSS240, is expected out in mid-August 2014 and the application must be received by 5 April 2017.

A key issue to consider in relation to any decision to apply for individual protection is the need to value all of the assets as at 5 April 2014. It almost goes without saying that it will be much more difficult to value those pension benefits in 2017 than it is now, so if you think one of your clients is likely to want to apply for individual protection, there is a strong argument for getting the paperwork done and dusted as soon as possible.

As just one example, if a commercial property is held in the pension we would recommend that the valuation is obtained on the property as soon as possible. Even though the deadline for individual protection applications is nearly three years off, it is notoriously difficult to obtain a valuation back-dated by more than a month or so from a surveyor. If in 2017 you are asking for a 2014 valuation to support an individual protection application, I can only wish you the best of luck.

Anyone who applies for individual protection will retain a lifetime allowance equivalent to the value of their pension benefits at 5 April 2014, but subject to a maximum of £1.5 million. Lump sum rights will be protected to a value of 25% of the protected personal lifetime allowance.

In practice individual protection will be most useful for those who have pension savings over the £1.25 million threshold and receive employer contributions/benefit accrual with no alternative benefit on offer. Unlike enhanced protection, or either of the fixed protections, individual protection allows benefits to accrue, albeit the lifetime allowance charge will apply to any growth above the 5 April 2014 level. But 45% of something is nearly always better than 100% of nothing.

Further information regarding individual protection can be found in our Individual protection – Frequently Asked Questions document.

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ISA changes nearly here

From 1 July the ISA subscription limit increases to £15,000. For those who have already paid in the existing limit of £11,880 they will be able to top up with the additional £3,120 from that date. The Junior ISA limit increases from £3,840 to £4,000 so a top up of £160 can be paid here.

The simplification of ISAs is welcomed and means that the new £15,000 limit applies whether held in cash or stocks and shares. Restrictions in moving from stocks and shares ISAs to cash ISAs is also removed.

From 1 July our ISAs will offer the flexibility to hold assets from cash to AIM-listed shares.

Illustrations – are you comparing like for like?

In a previous issue of News & Views I wrote about the importance of looking under the bonnet of some third party platform comparison tools. They are a useful guide in your due diligence work but some are just not able to cope with the changes brought in by the RDR. In particular some could not cope with the fact that a platform fee only applied to some but not all funds, and were routinely adding additional costs in circumstances when they would not apply.

A number of queries that have crossed my desk in recent weeks have given me cause for similar concerns when it comes to the illustrations offered by some platforms and providers.

From 6 April 2014 FCA rules have required illustrations to "be in real terms and be accompanied by information explaining why price inflation has been taken into account and that price inflation reduces the worth of all savings and investments".

Before 6 April 2014 we were also required to provide information in real terms but alongside this could, and did, provide figures without taking the effect of inflation into account. We, and many other providers, have inferred from the rule change that we must not show non-inflation adjusted figures in our illustrations. However it appears that some firms have taken a more liberal interpretation of the rules and continue to obscure the 'real terms' figures by displaying them alongside, or beneath, the figures using the old method. It goes without saying that this has a massive impact on the figures coming out of the illustration tools of different providers.

It is up to individual providers to determine how they want to interpret the FCA's rules and I do agree with the views of many that there is a risk that simply displaying figures in real terms may put people off saving rather than incentivise them.

I'm not going to say that the illustrations offered by some other providers breach the regulations but would just urge caution and a bit of bonnet lifting if the results of different provider illustrations look out-of-kilter.

AJ Bell stockbroking service available to Platinum SIPP clients

Since launching our investment platform, one of the requests that advisers have frequently made of us is whether it is possible to use the AJ Bell stockbroking service in conjunction with our Platinum SIPP and SSAS.

Platinum was our first product, with the SSAS service established from the first days of AJ Bell and the SIPP following shortly after in 1997 – the days before online SIPPs like Sippcentre helped to revolutionise the SIPP market. The SSAS offers access to some of the investments that are not available to SIPPs – the most commonly used being lending to an employer. The Platinum SIPP offers broadly the same range of investments as Sippcentre but, because of access to dedicated fee-based consultancy support, we will consider some more complex investment scenarios than we might allow in Sippcentre.

Of course the fact that some of a client's SSAS or SIPP is invested in, say, a loan or a more involved property purchase does not prevent other assets from being invested in simpler investments like stocks, shares and funds.

If you have AJ Bell Platinum clients and you have been using the Sippcentre GIA then I'm pleased to confirm that we are now able to offer you access to the AJ Bell stockbroking service.

If you'd like to find out more about this opportunity, or the AJ Bell Platinum products more widely, you can contact our Platinum consultants using the following link http://www.ajbellplatinum.co.uk/our-consultants/.

FATCA – expect additional questions for GIA applications

Although they have been bubbling away for a number of years now, and have been covered in previous issues of News & Views, it is still possible that readers may not have heard of a set of US tax regulations which are likely to have an impact on all GIA investors over the next year or so.

Broadly speaking the Foreign Account Tax Compliance Act (FATCA) regulations require financial services providers to establish whether their GIA clients have to be treated as a 'US person' under various tax and residency requirements.

Thankfully, the relevant tax authorities were persuaded that UK-registered pensions and ISAs represented a low risk in terms of tax avoidance, meaning that the requirements will only have relevance to GIA customers.

The impact will be relatively minor for individual account holders – they will generally only have to answer one additional question in application forms, asking them to confirm their residency status. Accounts opened for non-individuals (trusts, companies, charities etc) are likely to be faced with a more complex form to complete.

The reason for mentioning this now, is that some of these new requirements come into force from July 2014. If, from July 2014, you are faced with what appear to be more onerous requirements to open a GIA account, particularly for non-individuals, please pass on any thoughts you have on the requirements to President Obama, rather than me!

Knowledge

150% of GAD maximum drawdown rates for June 2014 per £100,000 of fund (3.00% gilt yield)

Age	Annual income
55	£7,200
60	£7,950
65	£8,850
70	£10,350
75	£12,450

Pension allowances

	2014/15 tax year
Annual allowance*	£40,000
Lifetime allowance	£1,250,000

* Carry forward of up to £50,000 available for each of the last three tax years.

ISA subscription limits

	2014/15 tax year
ISA	£11,800*
Junior ISA	£3,840**

* increasing to £15,000 on 1 July 2014
** increasing to £4,000 on 1 July 2014

Inheritance Tax

	2014/15 tax year
Nil-rate threshold up to	£325,000

Inheritance Tax is charged at 40% above the nil-rate threshold. The 40% rate is reduced to 36% where at least 10% of the net estate is left to a charity.

Any unused nil-rate band may be transferred to the deceased's spouse or civil partner.

Capital Gains Tax

	2014/15 tax year
Annual exempt amount	£11,000
Capital Gains Tax rate (if the higher rate threshold has been reached)	28%
Capital Gains Tax rate (if any basic rate band has not been used)	18%

Income Tax rates/thresholds

	2014/15 tax year
Basic rate	20%
Higher rate	40%
Additional rate	45%
Tax allowance	£10,000
Higher rate threshold	£41,865
Age-related allowance (for those born 6/4/1938 - 5/4/1948)	£10,500
Age-related allowance (for those born on or before 5/4/1938)	£10,660
Personal allowance income limit	£100,000
Additional rate threshold	£150,000

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