

Child Trust Funds' special rates

FAMILIES who elected to place their annual £250 Child Trust Fund (CTF) vouchers in an investment account have naturally been concerned at the slump in equity prices during the last twelve months.

Although the time-scale extends to the child's 18th birthday there could be a possibility of a recovery which would restore the lost investment value and produce a final satisfactory growth rate.

It must be said that, at present, that seems a somewhat remote possibility even if the time horizon is as long as 17 years.

An alternative might be found in switching to a cash savings account and there is a wide range on offer with the top annual rate of 5.50pc being offered by the Hanley Building Society.

Assuming a time-scale of 14 years an investment of £250 a year with interest reinvested (compound interest) would produce the sum of £5,882 at the end of the term.

If an extra £250 could be added each year the final total would reach £11,233 and if the extra is £500 the total would be £16,585.

In the present economic situation the guaranteed multiplying factor of compound interest seems likely to provide sounder growth than can be offered by equities which already need to make up the ground already lost.

Top rates offered by other CTF savings accounts range from 3.60pc down to 3.00pc.

ALTHOUGH the banks and others are offering savings rates slightly higher than the official 0.5pc, as we report in this issue, it is still possible in some situations to obtain even higher rates of income.

One popular method, which is available only to savers in the 50 to 75 age bracket, can produce a guaranteed return of about 11pc a year for those who are prepared to tie up their cash for the rest of their life.

By investing in a pension you not only receive an immediate enhancement of 20pc or 40pc, depending on your income tax rating, but you can then withdraw up to 25pc of the increased sum entirely free of income tax.

A 75-year-old man who pays in the maximum annual £2,880 for a non-worker will have his contribution topped by £720 to allow for the basic tax enhancement and the resulting

You can defy the credit crunch

£3,600 can be converted into a pension immediately.

This will allow 25pc (£900) to be withdrawn tax-free and when the rest is placed in an annuity it will produce about £218 a year for the rest of his life.

For a net outlay of £1,980 the annuity income will represent a return of 11pc which will be totally unaffected by any future

interest rate reductions.

Increases in NIC introduced in last November's pre-Budget Report provide an opportunity for employees to take advantage of their employer's salary sacrifice scheme.

This will enable them to increase their pension contributions by the NIC saved plus the gross salary forfeited and, in many cases, the employer's NIC will also be added.

One of the most effective ways of increasing your spendable income is to pay down existing debt wherever possible.

The comparison between earning 1pc or 2pc in a savings account and paying out 8pc or 9pc in a loan is huge.

Unless it is possible to obtain a return from savings after tax which beats repayment rates for debt the case for paying down debt is clear.

Investor's Notebook

A TRACKER for your £7,200 ISA investment this year could resolve doubts about the choice between managed funds, equities and bonds.

But while it solves that problem it raises several others as there are so many trackers to choose from.

The answer could be an Exchange Traded Fund (ETF) which are also numerous but one could be selected from the portfolio offered by Barclays Global Investors, the world's biggest, with annual charges as low as 0.50pc

★★★★★

LOYAL savers at Alliance & Leicester are being short changed as they languish on 0.1pc savings rates while new ones, says Moneysupermarket, are being offered rather more at 3.1pc.

Abbey pays 3pc to new eSaver Direct customers while those who still have its old easy-access account receive 0.1pc

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COSTS of investing are not usually noticed in a bull market but they become more critical in a downturn.

A recent paper by Alistair Blair the *No Free Lunch* columnist for *Investors Chronicle* and author of books on investing, focuses on the charges levied by unit trusts.

A typical annual management charge of 1.5pc might look very reasonable to most investors but, as Blair points out, if a fund grows by 6pc that 1.5pc represents 25pc of the growth.

Clients will appreciate that life assurance and pension plans are generally long-term investments and there may be penalties for terminating such plans prematurely; that past investment performance is no indication of future prospects and values can fluctuate; that in relation to house purchase their home is at risk if they do not keep up the payments on a mortgage or other loan secured on it. Some of the products and services mentioned in Money Planner might not be among those regulated by the Financial Services and Markets Act 2000.

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A necessary adjustment

AN important consequence of the restoration of the equity yield gap, which was signalled on October 7 last year, is likely to be a fundamental shift in investors' expectations.

Conditioned throughout the 50-year equity bull market, which also came to an end last year, it was not at all surprising that they became identified almost exclusively by the pursuit of capital growth.

With little likelihood of another bull market in the near future the rational course for investors will be to seek security of income, the traditional pursuit of investors in the conditions now restored by the return of the equity-gilt yield gap.

In this issue we consider the possibilities of reverting to investing in selected single equity shares, a common enough practice before the onset of the bull market, as a means of building up a sound portfolio.

Regular readers will recall our recent features on corporate bonds and we continue in this issue with special reference to bond funds.

VCT tax breaks

UNEXPECTED but deserving beneficiaries of the credit crunch seem likely to be Venture Capital Trusts (VCTs) which are poised to find more opportunities to invest in new businesses while the banks await government help.

The slump in equity markets also makes VCTs look attractive to investors for the generous tax benefits they offer.

Savings accounts can provide refuge from interest cuts

IN announcing a further reduction in the Bank of England's official interest rate on March 5 the government effectively guaranteed that there will be another, or others, to follow this year.

Since October 8, when the official rate was cut from 5pc to 4.50pc, the rate has been reduced to 3pc (November 6); to 2pc (December 4); to 1.5pc (January 8); to 1.00pc on February 5 and now to 0.5pc.

These six successive cuts over a five month period contrast significantly with the six months from April to October when the rate was held at 5pc.

If the cuts in rates since October were intended to stimulate the economy they have demonstrably failed.

This is hardly surprising considering that it was always accepted and the Bank's governor, Mervyn King, has frequently reiterated, that any cuts in rates take about 18 months to have any effect.

Even before the latest rate reduction most commentators were viewing the procedure as

an irrelevance to the far more pressing need to restore bank lending.

Although a further injection of £350bn into the banking system in January was specifically intended to enable the banks to increase their lending a few commentators were already beginning to question the government's enthusiasm for this neo-Keynesian solution.

As one remarked: "It seems to have been forgotten that the prescription of a debt-financed fiscal stimulus stood the best chance of working in a more or less closed economy.

"But this is a global world where uncoordinated profligacy by national governments is more likely to cause currency market volatility than a return to growth."

This view seemed to be supported by the International Monetary Fund (IMF), the world's leading economic watchdog, which reported at the end of January that "Britain will suffer the worst recession of any advanced nation, because of its reliance on the financial sector, as the economy shrinks by 2.8pc this year".

Among other advanced economies the IMF forecast that America's will fall by 1.8pc; France's by 1.9pc and Germany's by 2.5pc.

For UK savers, at least, there are more encouraging prospects than the official rate of 0.5pc now seems to offer and we feature the best of them inside.

Pensions limits frozen until 2016

IN a measure introduced by last November's pre-Budget Report pension saving will be limited from next year

As from April 2010 the lifetime allowance will be capped at £1.8m until at least April 2016 which means that anyone whose pension fund exceeds this amount will be liable to tax at 55pc on the excess.

The annual contribution will be limited to £255,000 for five years from 2010-2011.

The restriction has been imposed to cap the tax breaks that top earners might hope to use to avoid the new 45pc income tax rate.

It will mean that more individuals with pension funds already above £1.25m

could face a 55pc tax charge on some of their pension savings by 2015, assuming a reasonable fund growth of 6.5pc.

The lifetime limit for the current tax year is £1.65m; for 2009/10 £1.75m and for 2010/11 it is £1.8m where it will remain until 2015/16.

In this issue

- Investment outlook
- Special savings accounts
- Pensions or ISAs?

- Corporate bonds
- Venture Capital Trusts
- Child Trust Funds
- Survive the credit crunch

AS THE UK is poised to experience "the biggest economic crisis for more than 60 years" it is already becoming clear that many people, perhaps the majority, seem to have difficulty in appreciating the significance of the transformation that is overtaking the investment markets.

The recession will obviously inhibit economic expansion and it will be a long time before credit becomes available on a scale needed to fuel another bull market.

Of necessity, investors will need to revert to the principles which obtained about 50 years ago and, instead of pursuing growth, they should seek security of income.

Investors need to adjust to new conditions

This should still be capable of achievement through equities (in addition to the bond market, which we deal with elsewhere) by investing in income funds and, ideally, allowing the income to grow at a compound rate by reinvesting it each year.

Equity growth does not need to depend on a bull market: it can be achieved through investing in selected securities with proven earnings growth and sound management provided the time horizon is long-term which, in addition to the reinvestment of dividends

ensuring the beneficial effect of compound interest, would also qualify for occasional free scrip issues to increase the shareholding.

Unit trust funds have developed an almost universal acceptance in recent decades but there are signs of a growing awareness that their fee charging structure is in need of reform (*Please see Investor's Notebook on the back page*).

The lamentable performance of so many funds over the last two years has provided further grounds for dissatisfaction and

there is a respectable argument in favour of investors engaging in direct participation in the market.

It is important for all investors to operate through a stockbroker (high street or online) in order (a) to maximise their returns and (b) to participate in exchange traded funds (ETFs) and other investment media which otherwise would be inaccessible.

ETFs which, in the UK are operated mainly by Barclays Global Investors, are basically index funds which provide instant access to stock markets throughout the world and their annual charges are usually below 0.50pc.

Best savings accounts

WITH the official bank rate down to 0.5pc many savers will be tempted to look again at the rates offered by Permanent Interest Bearing shares (PIBs) issued by building societies on which yields of 11.75pc (Cheltenham & Gloucester); 9.63pc (Britannia) and 8.95pc (Leeds) are currently typical.

Pibs have a sound security record but the market is not very active and there can be problems if holders want to get cash in a hurry which means that they might not necessarily get the price they bought at.

For those interested in conventional savings accounts the good news is that there are better rates on offer than the official 0.5pc suggests and, even better, with inflation rates falling the pound in the savings account really will buy more.

Bonus accounts

At the top of the league offering instant access are some accounts which pay a bonus after the first 12 months.

The best of these, including the bonus, are Egg Savings 3.35pc; Bradford & Bingley BS 3.10pc and ING Direct 3.00pc.

Other **online accounts** are offering 2.84pc (Newcastle); 2.80pc (Saffron Walden); 2.75pc (Norwich & Peterborough; Yorkshire BS and Intelligent Finance)

Cash Isas

Top rate of 3.51pc is offered by RBS and NatWest with Halifax and Standard Life each paying 3pc.

Kent Reliance pays 2.82pc and 2.77pc as well as 2.41pc while principal BS pays 2.70pc and Yorkshire BS 2.30pc.

Crunch boost for VCTs

VENTURE Capital Trusts (VCTs) are poised to benefit from the credit crunch as they can expect more opportunities to invest in new businesses while UK banks are unable to lend money.

VCTs, which offer capital to smaller companies looking to expand in return for a share of the profits, have fared poorly in recent months.

On average, the capital raised by VCTs was down by about 20pc in 2008 compared with the previous year and in the current tax year they have been trading at discounts ranging up to as high as 50pc.

But the slump in equity markets has made VCTs look increasingly attractive to private investors.

It has brought about a subtle change in the promotion of VCTs.

Whereas their investment

potential formerly took precedence it is now the tax breaks offered to VCT participants which tend to be given greater emphasis.

The tax advantages of taking part in a VCT share offer are considerable although the rule change introduced in the 2008-9 budget restricted VCTs to investing in companies only with gross assets up to £8m.

A further restriction reduces companies which can receive VCT investments to no more than 50 employees.

Income tax relief of 30pc is given in the year the money is invested in a primary VCT provided it is held for at least five years.

Neither capital gains nor dividends are taxed if the investment is retained over this period.

Such tax breaks are proving to be a much needed unique selling point for VCTs.

With banks unwilling to lend and new share issues having problems in coming to the market VCTs are able to drive a hard bargain.

Bond funds back in favour

IN little more than a year the average yields obtainable on investment grade corporate bonds have shot up from 0.6pc to about 3pc above government bonds (autumn 2007-2008) so it is not surprising to find that they have suddenly become headline news.

We drew attention last summer to the attractive yields available on many UK corporate bonds but the main interest of the market is now focused on corporate bond funds.

They have become popular with investors for what many will consider to be the wrong reasons.

As they are "funds" they therefore enjoy professional management (with appropriate charges) which gives the impression of security which is not always present or, to be fair, even claimed.

Inevitably, one of the concerns of their managers (as well as of their investors) is the default factor, referring to the number of holdings

within the fund's portfolio which might turn out to be worth little or nothing.

That is because not all of the holdings can be considered to be "investment grade" but they compensate for that by offering higher interest coupons.

In the current liquidity crisis both Goldman Sachs and Deutsche Bank have calculated that "23pc of investment grade issuers will default on their corporate bonds over the next five years".

Despite that apparent disadvantage it is reported that in December and January corporate bonds

were the UK's top sellers.

An interesting alternative to a conventional corporate bond fund is the Barclays iShare Sterling Corporate Bond SLXX exchange traded fund (ETF).

The SLXX ETF tracks the iBOXX Sterling Liquid Corporate Long Dated Bond Index and has 47 holdings.

These range from high quality issues such as BP and Rabobank, down to credits in the mid-to-lower ranges of investment grade status, such as Xstrata and Axa.

As at February 19 the flat yield was 7.42pc and the gross redemption yield was 8.46pc.

Dividends are paid quarterly and the total management charge of 0.2pc a year is typical of ETFs.

An important advantage of corporate bonds, especially for basic-rate taxpayers, is that they can be placed in an ISA to provide tax-free income, provided the redemption date is at least five years in the future at the time of purchase.

Pension credits can become debits

A means-testing system introduced by the government five years ago for people aged 60 and over is proving to be costly to many people who have pension savings.

The Pension Credit introduced in 2003 guarantees everyone with the age qualification an income of at least £124.05 a week for individuals and £189.35 for couples.

Unfortunately many people who might be better off receiving the pension credit will not be eligible because their pension income and personal savings will disqualify them.

Dr Ros Altman, a former government adviser on pensions policy and governor of the London School of Economics, claims that basic-rate taxpayers could be better off saving for retirement through an ISA rather than a pension.

"Unless they can rely on being wealthy or can be sure they will not fall back on means-testing in later-life those on basic-rate tax, which is nearly 90pc of taxpayers, have significant probability of finding pensions poor value."

Clearly this is a dilemma for those pension savers of 60 and over but for everyone in the younger age brackets there are distinct and unique advantages in saving for a pension.

All contributions are enhanced at your tax rate which means that for basic rate taxpayers each £80 of contributions will be worth £100 in the growing pension fund.

In addition, you can withdraw 25pc of the accumulated fund on retirement totally free of tax.

Money Digest

RECENT personal finance pages have featured:

RATHER than looking for a quick return to "business as usual" in 2009 we should all be well advised to prepare for structural changes that fundamentally alter the outlook for policies, for managing risks and for delivering returns.

— *Mohamed El-Erian, Chief Executive of PIMCO, the world's biggest bond fund*

★★★★★

THIS ghastly episode will only end once senior bank executives are forced, under threat of custodial sentence, to FULLY DISCLOSE to one another and the authorities... the extent of their sub-prime liabilities.

— *Liam Halligan, Sunday Telegraph*

★★★★★

CONSENSUS fears of deflation are overdue. Inflation is a far greater danger. I believe that politicians have already decided that inflation offers the least painful way to repay debts in the medium term.

— *Ros Altman, Financial Times*

★★★★★

EVENTS are moving fast in Europe. A great ring of EU states are in either a 1930s depression already or soon will be. Each is a victim of ill-judged economic policies foisted upon them by elites in thrall to Europe's monetary project — either in EMU or preparing to join — and each is trapped.

— *Ambrose Evans-Pritchard, Sunday Telegraph*

★★★★★

AMERICA'S current financial problems are even greater than those that confronted President Franklin D Roosevelt. Total credit outstanding was 160pc of gross domestic product in 1929 and rose to 260pc in 1932; the USA entered the crash of 2008 at 365pc and the ratio is bound to rise to 500pc.

— *George Soros, Financial Times*

★★★★★

THERE is a better way to go but it is in the opposite direction. The aim must be not to increase debt but to reduce it.

— *Niall Ferguson, Financial Times*