

## Case study 8 – Investment management planner of the year

### Your Objectives

- To fund private education for Sophia and Imogen
- Improve the return on the girls CTF's
- Increase savings provision – particularly for Clare
- To repay your mortgage in due course

### Assumptions

Financial planning is not a precise science so we need to make some assumptions about the future. The main assumption made and the rationale behind them is as follows with other assumptions being highlighted within this Report as appropriate:-

Item	Assumption	Rationale
Price inflation	3% per annum	Set at 1% per annum above the Bank of England inflation target to provide a “safety margin”
Wage inflation	4% per annum	Wages tend to increase faster than prices according to National Statistics so I have assumed a 1% per annum margin
Gross return – cash	4% per annum	According to the Barclays Gilt/Equity Study the long term return on cash has been

		1% per annum above inflation
Gross return – Bonds	5% per annum	Bonds are high risk than cash so an additional 1% per annum risk premium has been added
Gross return – commercial property	6% per annum	Higher risk than Bonds so an additional 1% return assumed
Gross return – equities	7% per annum	Historically equities' have returned 5% per annum above inflation (source; Barclays Gilt/equity study). A 4% differential has been assumed to provide a “margin of safety”
School fees inflation	4%	It is assumed to be 1% per annum above prices and equivalent to increases in earnings
Income taxation	28.11% of gross income for Sean and 5.73% of gross earnings for Clare inclusive of National Insurance Contributions	These rates assume that income tax rates and allowances remain at current day levels
Company car benefit	Assumed to be £4,000 per year for taxation	Please advise exact model and year so that

	purposes	we can confirm precise tax treatment
Mortgage	£175,000 interest only	
Pension fund expenses	1% per annum assumed	
Conversion of pension fund to income	At current annuity rates	
State Pension Age	67 years 4-months	As per Pensions Act 2007
State pension benefits	You have both been assumed to qualify for the full Basic State pension	
Your retirement age	65 assumed	
Retirement expenses	60% of pre-retirement expenses	
Life expectancy	To age 99	
Pension income	Assumes current annuity rates unchanged	

#### Note

All returns assumed are total returns – that is a combination of income and capital appreciation

#### Recommendation

I recommend obtaining a State retirement benefits forecast to check your entitlement to State pension benefits.

#### Attitude to Risk

You consider that you have a relaxed attitude to risk and are prepared to place 55% of your investment assets into equities.

### **Recommendation**

I recommend confirming your attitude to risk using a scientific multi question risk profiling system before any recommendations are implemented to confirm that you do have a correct understanding of your attitude to risk.

Most people think of “risk” as either volatility or the chance of finishing up with less than they invest. There are, however, other risks that you should be aware of:-

### **Additional Risks**

There are additional risks that you should consider:-

- **Longevity.** This is the risk that you may live for longer than your assets will support you. For planning purposes I have assumed that you will live to age 99. This well above the current average life expectancy for males (85 per the Government Actuary’s Department) thus increasing the chance that your capital will out-live you
- **Inflation.** This reduces the spending power of your income. I have assumed that an additional objective is to ensure that your income keeps pace with inflation
- **Taxation.** This will reduce the amount of money that you have available to spend
- **In connection with investments you also have:-**
- **Market risk.** This is the risk inherent in the market and one that can not be removed
- **Stock specific risk.** This is the risk associated with investing in a particular market sector or industry. This can not be removed but can be reduced by diversification.

- **Credit risk.** Is the potential failure of a debtor to make payments on amounts they have borrowed. This is particularly associated with investment in Bonds and can be reduced by diversification
- **Interest rate risk.** Is the possibility that your investment will be adversely impacted by a fall or rise in interest rates.
- **Legislative risk.** Is the possibility that a change in legislation will impact the appropriateness of certain investments for you.
- **Liquidity risk.** Relates to the ease with which you can sell or liquidate your investments. Some investments impose exit fees or have limitations on your withdrawals. Other investments may be difficult to sell due to a lack of buyers.

### **Recommended Asset Allocation**

Asset allocation is the terms used to determine what percentage of your investment capital is held in different investment assets – the main investment assets being cash, Bonds, commercial property and equities. We should assess how much cash you should keep available on deposit for “rainy day” needs and then invest the balance of your capital 55% in equities with the balance in Bonds and commercial property. The aim here is to provide a spread of risk and diversification.

### **Assumed Investment Return**

If we assume that you invest assets surplus to cash 35% in Bonds, 10% in commercial property and 55% in equities on the assumptions made this will produce a return of 6.00% per annum before tax and charges. If we assume that charges on your pension investment portfolio will average 1.00% per annum the net return is 5%.

On non-pension investment charges will be nearer to 1.50% per annum giving a return of 4.70% per annum before taxation.

### **Re-Balancing**

Your portfolio should be rebalanced back to its target asset allocation from time to time which will maintain its risk profile and also introduce a “buy low sell high discipline” as well as ensuring that liquidity is maintained. Changes should not be made too frequently to keep dealing costs to a minimum and to allow momentum to work in your favour.

### **Should Clare Join Her Employer’s Pension Scheme**

Let us assume that Clare joins her employer’s scheme and contributes 5% of salary in addition to her employer contribution of the same amount.

On the assumptions made this will accumulate a fund value of £100,994 by the time that Clare reaches age 65. If this is converted to income assuming that current annuity rates apply it will provide an income of £6,717 per year.

Assuming that Personal Allowances increase each year in line with inflation Clare will be able to receive £17,174 per year at age 65 without paying income tax. The pension of £6,717 will therefore be tax-free income.

The total outlay made by Clare net of Basic Rate tax relief will be £19,863. A tax-free income of £6,717 from an investment of £19,863 represents an annual return of 33.82%. It will be impossible for Clare to earn an equivalent return in any other way so I recommend that she should join her employer’s pension scheme.

Alternatively this would provide £25,248 in cash which could be applied towards redemption of your mortgage and a reduced income of £5,038 per year for life.

### **Provision of School Fees**

After payment of tax and National Insurance Clare will have income of £7,071 per year. We need to assess if this can be used to fund school fees payment for your daughters.

The following table assumes that school fees increase by 4% per annum from their current level of £10,000 per year per child in line with school fees inflation until both girls finish school:-

Year	Children ages				Total Cost	Your Share	Clare Income	Start	Savings Payments	
	Sophia	Imogen								
2009	5	4			£0	£0	£7,071	£0	£0	£0
2010	6	5			£0	£0	£7,353	£7,255	£0	£1
2011	7	6			£0	£0	£7,648	£15,153	£0	£2
2012	8	7			£0	£0	£7,953	£23,736	£0	£3
2013	9	8			£0	£0	£8,272	£33,049	£0	£4
2014	10	9			£0	£0	£8,602	£43,141	£0	£5
2015	11	10	£12,653		£12,653	£6,327	£8,947	£54,063	-£6,327	£5
2016	12	11	£13,159	£13,159	£26,319	£13,159	£9,304	£59,234	-£13,159	£5
2017	13	12	£13,686	£13,686	£27,371	£13,686	£9,677	£57,858	-£13,686	£5
2018	14	13	£14,233	£14,233	£28,466	£14,233	£10,064	£56,246	-£14,233	£5
2019	15	14	£14,802	£14,802	£29,605	£14,802	£10,466	£54,379	-£14,802	£5
2020	16	15	£15,395	£15,395	£30,789	£15,395	£10,885	£52,238	-£15,395	£4
2021	17	16	£16,010	£16,010	£32,021	£16,010	£11,320	£49,801	-£16,010	£4
2022	18	17	£16,651	£16,651	£33,301	£16,651	£11,773	£47,047	-£16,651	£4
2023		18		£17,317	£17,317	£8,658	£12,244	£43,952	-£8,658	£4

You can see that on the assumptions made that you can meet the cost of school fees from Clare's income and accumulate a further £49,571 over the period for which the girls are school – but see important note in the “Income” section below.

## CTF

To maximise the return on the Child Trust Funds you should transfer out of the deposit based plans into an equity based arrangement. This can either be actively managed or can be linked to an Index, such as the FTSE All-Share Index, in which case the arrangement should be “stakeholder friendly” with no more than a 1% annual management charge.

## **Income**

I estimate that Sean has net income after tax and insurance of £30,507 per year.

You have estimated expenditure of £32,000 per year so have a shortfall of income over expenditure of £1,493 per year. This will have to be made up from Clare's earnings and will have the effect of reducing the surplus at the end of the school fees payment period from £49,571 to £19,197.

If Clare follows my recommendation to join her employer's pension scheme the surplus from savings at the end of the school fees payment period will reduce to £9,822.

## **Mortgage Redemption**

If Clare continues to work until she attains say age 65 and if you save 100% of her earnings the assumptions made you will accumulate £483,544. This can be used to repay your mortgage of £175,000 leaving £308,544 to help you to live beyond retirement.

## **Investment Recommendation**

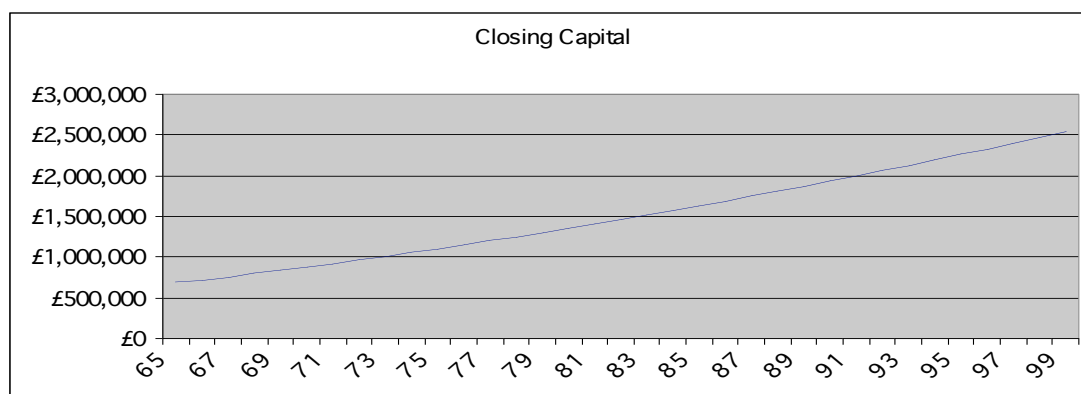
I recommend investing Clare's net income on a monthly basis in accordance with the asset allocation recommended above. The investment vehicle should be collective investments managed by full time professional investment managers. Within the equity asset class you should have exposure to both UK and non-UK investments as well as to small and large companies as well as to emerging markets. Bond exposure should be to both Government and corporate Bonds and commercial property exposure should include both shops, offices and warehouses. The aim is to have a widely diversified portfolio to maximise returns and minimise investment risk.

Clare should invest via an investment ISA to minimise the effect of taxation on investment returns.

By investing monthly you will benefit from “pound cost averaging” whereby you will buy less units when vales rise and more when prices fall.

### Lifetime Cash Flow

If we construct a model taking account of your income and expenditure, taxation and capital inflows from pension funds and savings and all capital outflows from for life the following graph shows your liquid assets from age 65 assuming that you retire at that age-



As you can see, if Sean continues to make pension contributions, Clare starts to make pension contributions and if you invest 100% of Clare’s earnings you will accumulate sufficient assets to retire at age 65 and then to maintain expenditure at 60% of current levels.

### Need to Review

Having organised your affairs I recommend that you review them on an annual basis.

## **Other Issues**

- I recommend arranging Lasting Powers of Attorney so that your affairs can be managed should one or even both of you become incapacitated
- Sean's pension fund should be switched so that equity exposure is reduce from 100% to 55% and to add exposure to other asset classes so that he is diversified
- I recommend evaluating your expenditure to see if you can reduce your outgoings so that it will be possible to live on Sean's earnings should you need to
- You should evaluate the position should either of you die to determine whether you have sufficient assets to enable the survivor to maintain their desired standard of living
- You should consider making provision to deal with long term incapacity lasting longer than 6-months
- I recommend preparing an accurate expenditure budget so that you know what your costs really are
- Unless you have particular reasons for being attached to your shares I recommend selling them and reinvesting the sale proceeds in an actively managed investment portfolio. This will generate a profit for Sean which will fall within his CGT allowance and be tax-free and a loss for Clare that can be carried forwards and offset against future profits.

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