Report for Charles & Jennifer [CS7]

(prepared in August 2012 in tax year ending 05-April-2013)

Objectives

Jennifer has recently inherited £50,000 and you would like advice on how to use this to meet the following objectives:

1. Make sure future school fees will be met
2. Help the boys with university related costs
3. Plan for retirement when Charles attains age 65.

I have identified other objectives relating to minimising potential inheritance tax (IHT) liabilities, arranging Wills and Powers of Attorney and income protection.

Assumptions

I have used the following assumptions in the preparation of this report.

PA	
2.0%	Price Inflation. HMGovernment's CPI target is 2%. Currently it is 2.4%. The Bank of England August 2012 Inflation Report projects inflation at 2% through to 2015.
3.5%	House Price Inflation. In line with wage inflation assuming an approximate historic relationship of inflation +1.5%.
0.5%	Interest rate for cash. Current Bank of England Base Rate.
2.5%	Return on Index Linked assets (inflation +0.5%).
2.0%	Return on Gilts (HMGovernment Securities) per redemption yields reported by Debt Management Office (DMO).
3.0%	Return on Corporate Bonds assume approximate historic 1.0% credit spread over gilts.
6.0%	Return on Equities assume approximate historic equity risk premium of 4.0%, being the difference between expected rate of return from equities and the risk-free rate from gilts.
4.0%	Return on Commercial Property. The 1 year total return to 31 July 2012 per the IPD UK Annual Property Index.
2.0%	Annuity Interest Rate in line with current redemption yields on long dated gilts reported by DMO.

All returns assumed to be total returns combining income and capital appreciation.

Average life expectancy is currently 81 for Charles and 83 for Jennifer.

Pension annuities calculated using PA90 tables, downrated 10 years.

Assets & Liabilities

Your house is valued at £500,000 with a mortgage of £100,000 running until 2022.

Jennifer has £50,000 in cash savings from a recent inheritance.

You both have employer sponsored pension funds, Charles's is worth £220,000 and Jennifer's £85,000.

Taking into account your life assurance policy and lump sum pension death benefits, on second death your estate is worth £905,000, which after two nil rate bands totalling £650,000, will give rise to IHT of £102,000.

I recommend placing under trust the life assurance and pension policy death benefits, reducing the estate on second death to £450,000 and avoiding IHT.

Also please note that monthly payments of £350 to your mortgage of £100,000, at an interest rate of 3.69% pa, will not repay the mortgage over 10 years. At the end of the 10 years I estimate an outstanding mortgage sum of £93,129.

Income & Expenditure

Your current income and expenditure position can be summarised as follows. For the purpose of this analysis I have ignored the future interest that might be earned from the recent inheritance of £50,000.

Current Basis		**Charles**	**Jennifer**	**Total**
Earnings		£60,000	£15,000	£75,000
Child benefit			£1,752	£1,752
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Total gross income		£60,000	£16,752	£76,752
Less	income tax	-£13,284	-£1,379	-£14,663
	employee NIC	-£4,537	-£889	-£5,426
	living costs			-£24,023
	school fees			-£24,000
	life cover premiums			-£240
	mortgage payments			-£4,200
	net pension premiums	-£2,400	-£600	-£3,000

Net surplus income				**£1,200**

I have assumed there is no expenditure concerning maintenance payments to previous partners.

I have identified your general living costs amount to £24,023 pa and will assume this is an acceptable target net retirement income in today's terms.

Please note the proposed changes to Child Benefit commencing 7 January 2013 whereby an income tax charge will apply to those on higher incomes like Charles at a rate of 1% of the amount of Child Benefit for every £100 of "adjusted net income" exceeding £50,000.

For this tax year I have assumed it will apply on a pro rata basis for 89/365 days increasing Charles tax bill by £299 to £13,583, and reducing the net surplus income to £901.

For 2013/14 I estimate Charles will incur a child benefit tax charge of £1,608, assuming his earnings increase by 3.5%, child benefit for two children increases by inflation at 2% to £1,787 and the £50,000 limit remains. I estimate a related income deficit of £376.

For 2014/15 and thereafter, I estimate Charles will incur a child benefit tax charge exactly matching the amount of child benefit received. I estimate a related income deficit of £573 for 2014/15.

There is limited ability to reduce the "adjusted net income" by making pension contributions. This is not attractive as you have little or no disposable surplus income at present.

Attitude to Risk & Capacity for Loss

You describe yourselves as moderate investors and understand the basics of equities.

Once some cash is set aside as an emergency fund, I assume you are happy to adopt our asset allocation for a low-medium risk cautious portfolio for the residue.

Your capacity for loss is also low-medium as you have good earnings but rely to some degree on the investments to meet ongoing costs.

You are concerned about inflation.

Proposed Portfolio Asset Allocation

I propose the following low-medium risk asset allocation:

	FUNDS
5%	Index-Linked Bonds
40%	Corporate Bonds
5%	Commercial Property
50%	Equities

100%	

The recommended funds already have small allocations to cash removing the need to allocate to a separate cash account. The recommended fund platform does not presently require the use of a cash account either.

I have not allocated a proportion to gilts as the outlook is unattractive, giving a bias to corporate bonds.

The equities element is invested 50% in UK, 40% overseas and 10% emerging markets.

Applying our investment return assumptions the portfolio has an estimated return of 4.53% pa, reduced by charges as follows:

	ASSUMED RETURN PA
Portfolio gross	4.53%
Less net TERs*	-0.61%
Portfolio net	3.92%
Net real return	*1.92%*

* Total Expense Ratio – a more accurate description of the annual charge for an investment fund

If in future the rate of interest charged on your mortgage exceeds the net assumed return of 3.92% pa, I would suggest you consider overpaying the mortgage.

Furthermore, please note if you receive an ongoing service from us, the cost of 0.5% pa is in addition to the assumed net fund TERs.

Pensions

Charles's pension is valued at £220,000 and I have assumed it will receive combined employer and employee contributions at 10% of salary through to retirement at age 65. I have assumed the funds are invested with a low-medium exposure to risk and an assumed annual return of 3.93%pa (portfolio return 4.53% less 0.6%AMC).

Jennifer's pension is valued at £85,000 and I have assumed it will also receive combined employer and employee contributions at 10% of salary through to retirement at age 55. I have again assumed the funds are invested with a low-medium exposure to risk and an assumed annual return of 3.93%pa.

I have assumed Charles and Jennifer take their maximum tax free pension commencement lump sum (PCLS) of 25% of fund and apply the residual fund to purchase an index-linked annuity, guaranteed for 10 years with 2/3rds spouse's pension. The projected annuity rate is 3.08% for Charles and 2.69% for Jennifer.

I have estimated pension benefits from 2022 of:

	Charles	Jennifer
Fund Value	£410,063	£146,625
PCLS	£102,516	£36,656
Gross index linked annuity pa	£9,478	£2,963

I have assumed you both have a full entitlement to the Basic State Pension which commences at age 66 for Charles and 67 for Jennifer. I recommend you each get a State Pension forecast from The Pension Service which will also identify any projected entitlement to Stated Second Pension (previously SERPS).

Cash Flow Analysis

The cash flow analysis uses the following assumptions:

- Jennifer's inheritance is used in part to invest in 2 x £5,640 Cash ISAs immediately accessible offering interest at 3.01% pa, used to top up income shortfall re school fees

- the remainder of Jennifer's inheritance is invested into a low-medium risk portfolio with net return of 3.92% pa

- earned incomes for Charles and Jennifer rise at 3.5% pa

- life cover and mortgage payments remain the same and general living costs of £24,023 rise with inflation each year

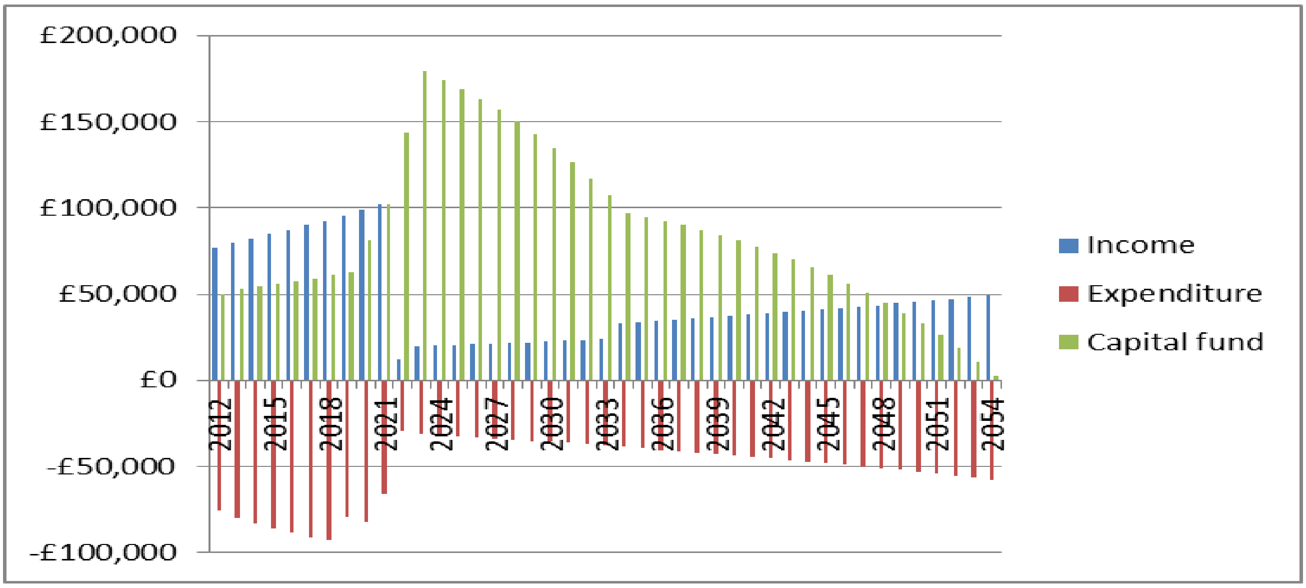
- Robert and Ian both study three year degrees at university without a gap year, whereby you pay the university costs which are similar to school fees and escalate at 5% pa

- after Robert has graduated, during the years 2019 – 2021 the surplus of income over expenditure is invested into the low-medium risk portfolio

- in 2022 the combined PCLS from pensions for Charles and Jennifer is used to repay the outstanding mortgage of £93,129, with remaining PCLS of £46,043 invested into low-medium risk portfolio

- any deficit in retirement income is drawn out of the low-medium risk portfolio, and when exhausted then out of the Cash ISAs.

The cash flow analysis shows the capital fund will last until 2054 when Charles is 97 and Jennfier 87, at which time you will need to sell the house and downsize to realise equity so you can meet ongoing living costs in retirement.



If on a personal basis you each establish protection for earnings against death or incapacity, using the premium rates detailed below, the corresponding change to the cash flow analysis is that the capital fund will last until 2039 when Charles is 82 and Jennifer 72, at which point downsizing will be necessary to release a sum of £100,000 or more to invest and provide the top-up for ongoing living costs.

One of the key aspects that makes this plan work is the investment of surplus income between 2019-2021 so there is little scope to consider early retirement.

Essentially any variation from early retirement to a higher target income will necessitate downsizing.

Investment Recommendations

I recommend you invest £5,640 each into Post Office Premier Cash ISAs providing immediate access to capital and interest at 3.01% pa. The accounts can be opened through a branch, by telephone, post or online, and are operated by telephone or post. Withdrawals are allowed and the ISAs should be drawn upon to top up your income to meet school fees.

I recommend the remaining £38,720 is invested into the following investment funds:

Asset Class	Allocation	Amount	Fund Name	TER	Rebate	Net TER
Index Linked Bonds	5.00%	£1,500	L&G All Stocks IL Gilt Index Trust	0.25%	0.00%	0.25%
Corporate Bonds	20.00%	£6,000	Fidelity Moneybuilder Income	1.00%	0.50%	0.50%
Corporate Bonds	20.00%	£6,000	M&G Strategic Corporate Bond	1.16%	0.25%	0.91%
Commercial Property	5.00%	£1,500	M&G Property Portfolio	1.66%	0.50%	1.16%
UK shares	25.00%	£7,500	L&G UK Index Trust	0.56%	0.25%	0.31%
Overseas shares	20.00%	£6,000	L&G International Index	0.88%	0.25%	0.63%
Overseas shares	5.00%	£1,500	First State Global Emerging Market leaders	1.58%	0.50%	1.08%
Totals	**100.00%**	**£30,000**		**0.92%**		**0.61%**

All of the above funds are unit trusts or open-ended investment companies which I recommend are accessed through the Cofunds platform where there is presently no initial charge and the only annual charge is the net TER.

I recommend that your unused Socks & Shares ISA subscriptions of £5,640 each for 2012/13 are invested in the Fidelity Moneybuilder Income and M&G Strategic Corporate Bond funds on the grounds of tax efficiency as these have the highest income yields which will be tax exempt under the ISA. Thereafter future ISA subscriptions should use up the remainder of these funds followed by the M&G Property Portfolio and L&G All Stocks IL Gilt Index.

All non-ISA investment holdings should be in Jennifer's name only to minimise tax chargeable on the income yields.

I prefer index tracker funds for equities as research suggests actively managed funds rarely outperform over the longer term. Also trackers have substantially lower cost. I have used actively managed funds for corporate bonds, commercial property and emerging markets equities as I am not satisfied an index tracker fund is suitable at the present time.

I have assumed new investments in the portfolio will be made keeping to the same asset allocation.

I have assumed annual portfolio re-balancing.

Protection

The main risk to your financial planning objectives is loss of income if either of you dies or becomes incapacitated.

I recommend income protection for you both against death or incapacity. Consider existing employer sponsored benefits, Death-in-Service, Income Protection and Private Medical Insurance. If not available look at personal income protection and family income benefit written under trust.

For personal income protection I recommend that you each establish income protection that will provide a replacement income in the event of long-term sickness. In view of your current savings I recommend a deferred period of 3 months meaning the policy will not pay out unless you have been off work for 3 months.

I have obtained quotes on this basis of nil commission terms with benefit and premium escalating with average earnings index. For both the cheapest cover is provided by Friends Life.

INCOME PROTECTION		
Policyholder	Charles	Jennifer
Insurable Income pa	£60,000	£15,000
Starting Policy Benefit pa	£31,992	£9,492
Starting Monthly Premium	£141.38	£41.63

For Family Income Benefit I recommend that you each establish cover that will provide a replacement income in the event of death, escalating with average earnings index payable up to 2022.

I have obtained quotes on this basis of nil commission terms with benefit and premium escalating with inflation (earnings inflation not available). For both the cheapest cover is provided by Aegon SE.

FAMILY INCOME BENEFIT		
Policyholder	Charles	Jennifer
Starting Policy Benefit pa	£60,000	£15,000
Starting Monthly Premium	£56.08	£6.21

I have not considered critical illness cover as this is a lower priority.

Other Issues

If investments do better than expected you could perhaps earmark a sum to help Robert and Ian onto the property ladder.

To minimise IHT you should put life and pension death benefits under trust.

Establish Wills in favour of each other with possible use of tenants-in-common property ownership and a nil rate band discretionary trust to the children’s inheritance against potential care costs. Appoint Guardians for the children. Look at establishing Lasting Powers of Attorney (LPAs).

Next Steps

The next steps needed to implement our recommendations are:

Item	**Who**	**When**
Cash ISAs	Client/planner	Immediately
Arrange investment portfolio	Client/planner	Immediately
Death benefits under trust, Wills and LPAs	Client/solicitor	Immediately
Income protection and family income benefit	Client/employer/planner	Immediately

Your plan will be reviewed 6 monthly.

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