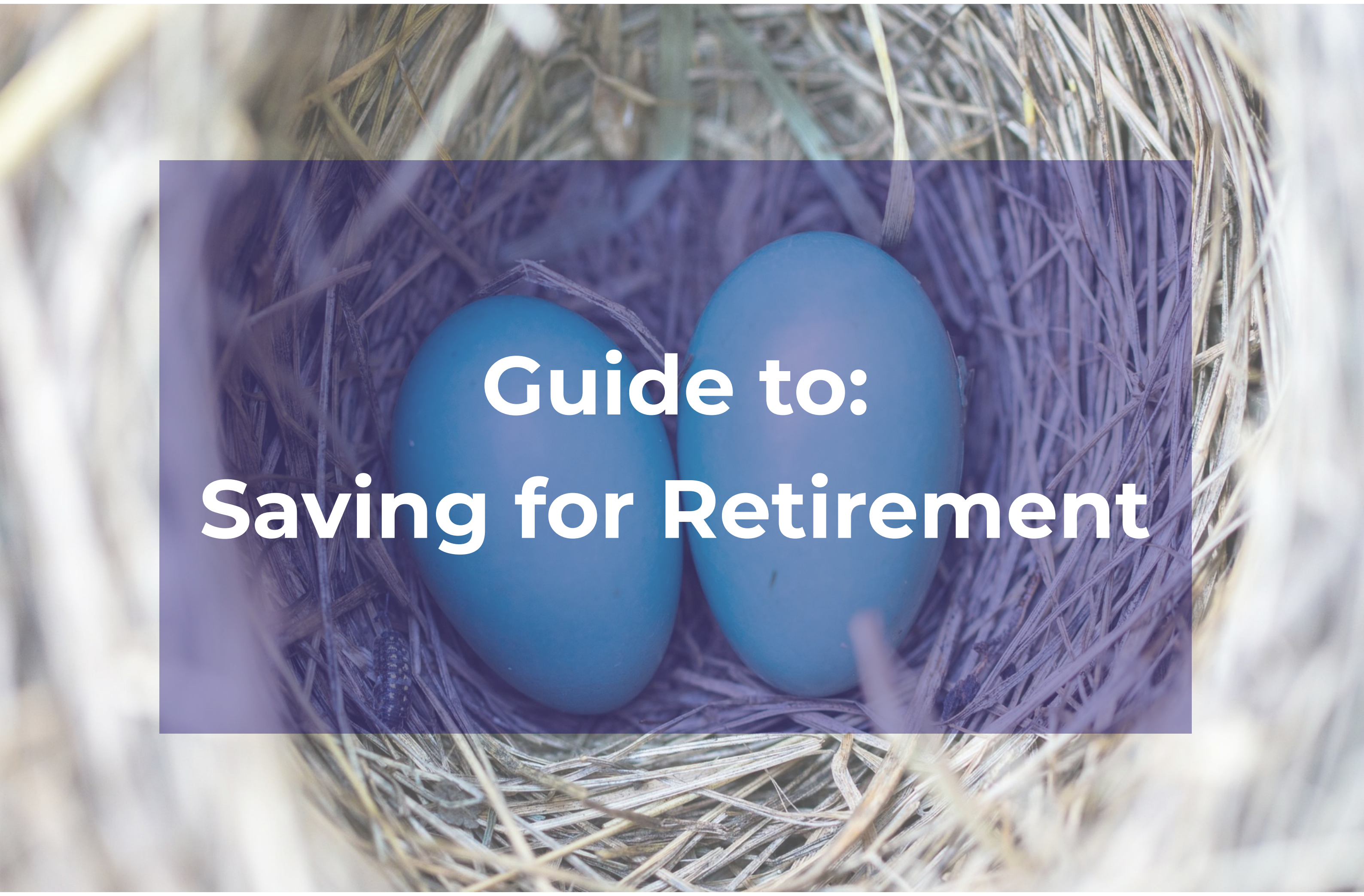
Atkins Bland

Investments • Pensions • Financial Planning



Guide to: Saving for Retirement

Introduction

Why read this guide?

Although there are a few lucky people with a career which pays them for something they would wish to do in any event, the vast majority of people are working principally to pay for their leisure time.

Plenty of this leisure time is enjoyed before retirement, but a huge amount is normally after that.

Following 40 to 50 years of working, the last thing anyone wants is to find they don't have enough money to support the standard of living they want to enjoy in retirement, and after it is too late to do anything about it.

However, without proper planning this is a real risk, as countless people have found out already, and many more will in the future.

The best way to avoid falling into this trap is to have a clear idea of what your financial goals are and what you need to do to reach them.

As Independent Financial Advisers, Atkins Bland are here to help guide you through this process and then give specific advice on any actions which should be considered.

Since you are reading this document, you are already on the right path and, if you read the rest, it should help you stay on it.

The purpose of this guide is to give some generic information on the broad options available to build up resources for retirement and the pros and cons of each.

To facilitate this, we will look at some of the various issues under two main headings within this guide.

What assets might be available to fund retirement?

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The State Retirement Pension

As things currently stand, the employed and self-employed pay an additional tax known as "National Insurance" which is earmarked to provide the resources to fund the welfare state, including the provision of the State retirement pension.

The State Pension age is transitioning from age 65 to 68, in stages, and is currently 66. It will have moved to 67 by April 2028, and anyone born after 6th April 1978 should expect to wait until their 68th birthday before achieving official pensioner status.

There is also a reasonable likelihood that the age will increase further, probably to age 70.

The Government cites increasing lifespan as the reason for this, but it could also be argued that the real reason is an inability to fund the State Pension, which must surely worsen in an aging population.

On top of that, the “triple lock” causes the State Pension to increase at the highest of inflation, average earnings or 2.5%, which digs an even bigger hole in government finances.

The affordability and fairness of the “triple lock” is regularly debated. There is a probability that it will eventually be removed, at least to drop the rather arbitrary inclusion of the 2.5% minimum.

It’s hard to argue against the view that applying the highest of price or wage inflation seems a much more rational approach.

Regardless of future changes, anyone receiving the basic State Pension and who owns a home without a mortgage should at least be able to keep the wolf from the door. It will not though, support the lifestyle most people aspire to, and more than the State Pension is needed if you want to have an enjoyable retirement.

It is also worth remembering that it is unsafe to entirely rely on the State Pension being paid, at least at its current level. Hopefully it will be but, as an unfunded scheme, it depends on the government’s ability and willingness to pay for it from current tax and NI revenues.

Inheritance

Many people believe that their retirement planning will be secure through receipt of an inheritance, but this is seldom a reliable source of retirement income.

One reason for this is the likelihood of someone needing long term care.

With increasing longevity, the probability of needing care also increases, and the cost can decimate someone’s resources, and their children’s inheritance.

Another headwind to relying on an inheritance is that, with average life expectancy generally increasing, many people do not inherit from their parents until they themselves are well into their retirement, making reliance on an inheritance to pay for retirement even less viable.

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Sale of a business

Those who run their own businesses often hope to be in a position where they can sell the business to raise substantial resources to pay for their retirement.

If such a structure proves successful it can, indeed, be a viable approach. However, relying on the sale value of a business to provide retirement resources is a high-risk strategy. This is because there can never be any guarantee that a business will survive, given ever changing economic circumstances and, even if it does, there is never any certainty as to the marketability of the business or the amount which might be raised through disposal.

In addition, there can be a tendency for business owners to be over-optimistic about the amount they can raise by selling their business, perhaps forgetting that a lot of the value attaches to them as the key driver of the success of the operation, which is not a saleable asset if they are hoping to retire.

Atkins Bland has not seen statistics, but we believe there are probably a large number of people living in relative poverty in retirement who had been relying on the sale of a business to provide resources, only to find that these did not materialise for one reason or another.

We also believe there are many people who have been forced to continue to work and run their business well beyond planned retirement age, since this is their only viable option, due to the fact that the business cannot be sold or cannot be sold for an amount which would allow them to retire in any comfort.

For those with a business which may be saleable, our advice is that this should be considered a potential bonus, rather than relied upon, and that the most sensible approach is to ensure that other resources, which are not dependent on the success of the business and its survival in the future, are available to provide adequate income throughout retirement.

Releasing equity from property

In later life, many people do realise a reasonable amount of capital through moving to a smaller property and this can, of course, generate useful resources to provide income throughout retirement.

However, it is very unusual that somebody feels comfortable to move to a lower cost and potentially, less desirable property as soon as they retire. Normally, their overriding priority is to enjoy their retirement and immediately lowering their standard of living by moving to a cheaper property is not usually the favoured outcome in this respect.

Generally speaking, the point at which somebody wishes to downsize coincides with health considerations such as the burden of maintaining a large garden, or the problem of climbing steps if disabilities have set in.

These events do not normally occur at, or even close to, retirement age but typically, well beyond this and often after the best 10 or 20 years of retirement have already passed.

Having a valuable property which could release equity by moving to a smaller property is a useful backup but is not a recommended strategy for retirement planning, unless someone is very confident that they will be happy to move from their home at an early stage in retirement.

For anyone who may want to continue to live in their home, rather than move to a lower cost property, at least while health permits, other routes to generating retirement income are clearly more desirable.

It is also possible to raise cash for spending from a property through an “equity release scheme”. However, these have potentially significant drawbacks and are normally only considered as a last resort. Planning an equity release arrangement to pay for retirement is not normally a viable approach even if, in some cases, it does become a viable option during retirement and where adequate alternative resources have not been built up.

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Buy-to-let property

Property investment has become a very popular option and for someone with adequate resources to take the obvious risks involved, this could prove a very worthwhile source of extra income during retirement.

However, if the property is mortgaged, it is usually best to ensure this is paid off before retirement, to avoid the obvious added risk of having a debt that must be serviced but the possibility of inadequate rental income to cover this, especially in vacant periods.

Many people entering the buy to let market do so with fairly heavy mortgage finance and the cost of the mortgage, coupled with the lost interest on any capital resources allocated to the purchase, will very often match or even exceed the rental income, particularly after ongoing expenses and periods of non-occupancy are taken into account.

Including a repayment arrangement to clear debt by retirement increases the likelihood of the structure being cash flow negative pre-retirement. This means many select an interest-only mortgage, which often just builds a problem for the future.

The yield from property letting varies between regions and depending on the type of property but, in the Dorset area, is not usually any higher than the potential yield from various other long-term investment arrangements and is often lower after costs are taken into account.

If someone entering this market is in the typical position where the rental yield after expenses and any taxation is no more than the cost of the mortgage finance or the lost investment return on capital deployed in the purchase, then there is a reasonable amount of reliance on future property prices and rent increases to make the investment attractive in comparison with other options.

Over the longer term, property prices in the UK have risen substantially due to supply tending to lag behind demand, but we have experienced periods of falling property prices and on occasion, such falls have been severe and long-lasting.

Anyone entering the buy-to-let market should be taking a long-term view and be prepared to sacrifice income to support the investment, since there is inevitably a risk of property prices falling to less than the purchase price or even beneath the level of mortgage finance, just as there is a risk of rental yields falling or an extended period where a tenant cannot be found.

The risks associated with substantial maintenance costs, which will inevitably arise now and then and can include very costly items such as a replacement kitchen or structural repairs, must also be considered.

As with any investment decision, the pros and cons must be weighed up with full reference to economic changes which could take place in the future, and not purely with reference to the prevailing circumstances. It is always important to assess potential risks rather than purely look at potential rewards.

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Capital resources

There are numerous ways to save money during a working life, either via regular savings arrangements or through ad-hoc lump sum investments from surplus resources not required for shorter term purposes.

These are often the resources which are best ring-fenced to provide funding for retirement, in addition to any benefits secured in various company or personal pension arrangements.

Unfortunately, the propensity to save, rather than spend, is not particularly good in the UK and statistics showing the average level of savings produce rather alarming figures. In today's consumer driven society, there is no shortage of opportunity to spend instead of save and no shortage of advertisements suggesting ways we can do it.

In the past, it was common for people to enjoy the benefit of a maturing endowment policy at, or close to, retirement age, having already cleared the mortgage in the process of house moves throughout their life. This has produced a useful cash resource and, in many cases, more or less the only cash resource beyond any lump sum entitlement from a pension plan.

However, endowment policies are largely a thing of the past and their demise has coincided with a general drop in the culture of saving for the future.

In addition, easy access to other regular savings means they often do not survive the temptation to spend the money prior to retirement.

For those who have the discipline to save on a regular basis, capital resources should be available at retirement in any event. For the many who do not have this discipline and generally operate a structure of spending most of what they earn, or even more than they earn and running on debt, it is sensible to reappraise their approach and to consider the possible longer-term implications of the 'live now pay later' culture.

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Lifetime ISA (LISA)

Introduced in April 2017, the LISA is available for anyone between the ages of 18 and 40. The government provides a 25% bonus on contributions up to £4,000 per year, equaling a maximum bonus of £1,000 per year if the full £4,000 allowance is used. This is the same as the tax relief received by basic rate taxpayers on pension contributions.

The government bonus is claimed by the LISA administrator and paid directly into the account, enabling investors to benefit from potential investment growth on the government bonus as well as their own contributions.

Both cash and stocks & shares versions are available, and anyone who contributes to a LISA before age 40 can pay in and receive the 25% government bonus up to age 50.

However, the bonus is lost, along with an additional penalty, if the money is withdrawn before age 60 unless it is used for the purchase of a first home.

Interest and investment return within a LISA are exempt from income tax and capital gains tax but if the charge for withdrawal is triggered, a LISA is likely to be unattractive compared with alternatives.

A LISA is, therefore, best suited to those saving for a first-time home or a basic rate taxpayer saving for retirement and wishing to supplement the savings they are placing into a pension plan.

There will be some people for whom the LISA is more attractive than a pension plan, but the funding restrictions mean it is not sensible to treat this as the only form of saving for retirement.

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Pension benefits

Pension plans are, of course, the mainstay of most people's retirement planning.

For the majority of us, they offer the most tax efficient way to save towards retirement, with tax relief on the amount paid in and tax favoured investment returns.

There are various types of pension plan available, some operated by employers and some available to take out privately, but these break down into two broad categories:

- Defined benefit (often referred to as final salary or average salary and becoming scarce in the private sector but still in place for most public sector workers).
- Defined contribution (often called "money purchase").

With a ***defined benefit plan***, the benefit is in the form of a pension, with the level of this determined by salary history, length of service in employment linked to the scheme and inflation rates. The income which has been built up can therefore be estimated with a reasonable degree of confidence, although future additions cannot be known in advance since employment may end or the scheme rules may change.

With a ***defined contribution plan***, the benefit is based on an invested fund and the income available is determined by how much the fund is worth at or during retirement and how much income this could generate. The current fund value is known, as are the amounts being added each month, but the future value cannot be known in advance. Perhaps even more of a factor based on the history of the last 3 or 4 decades, the amount of income which can be generated from a given amount of money is impossible to predict with any confidence at all, especially if using the fund to buy an annuity.

This is well demonstrated by the fact that, between 1990 and 2020, annuity rates collapsed by nearly two thirds. A healthy 65 year old man in 1990 would have received around £15,000 a year for his £100,000. In March 2020 he would have received only £5,200 per year.

In other words, to get the same retirement annuity in 2020 as could have been secured in 1990, someone would need nearly three times as much money.

Buying an annuity is only one way to convert a pension fund to generate income and the attraction will often pivot on interest rates at point of retirement, or if an annuity isn't bought at that stage, when options are reassessed after that.

For those choosing not to use their pension fund to purchase an annuity, the level of income likely to be available from their invested capital is easier to estimate based on past records, as income yields from invested capital have tended to remain far more stable than annuity rates, although there can never be certainty that this pattern will continue into the future.

Atkins Bland has a separate guide looking at the options for taking pension benefits, and on the issue of how much can be taken on a sustainable basis from a given level of pension fund, both of which are available on request.

Defined contribution pensions include both personal pensions and workplace schemes.

For those only paying into an Auto-Enrolment scheme at the minimum levels set by legislation it is important to remember that this is highly unlikely to build up enough to provide an adequate retirement income. This means additional saving for retirement above this minimum level should always be considered.

It is worth mentioning that money in a pension plan is not normally accessible until age 55, with that rising to age 57 from April 2028.

This can be seen as a disadvantage, but it can also be a benefit, especially for those who may be tempted to raid the pot otherwise!

How best to build up capital resources for retirement?

And do you need independent advice?

There is no definitive answer to these questions since it will depend on factors which differ from one person to another.

However, it is usually best to take advantage of any relevant and suitable tax advantages, and often wise to avoid relying purely on one arrangement.

Typically, this would involve building up resources in some form of pension plan but also taking advantage of the tax planning benefits of an ISA and, if eligible, a Lifetime ISA.

For a basic rate taxpayer, the LISA may be the most tax efficient, but funding levels are too low to use this in isolation.

The tax treatment of a pension is looked at later but, to briefly explain, while qualifying pension contributions enjoy tax relief at someone's marginal rate for income tax and 25% of the fund can later be withdrawn tax free (subject to a cap), it is important to remember that the other 75% will almost certainly be taxed on exit, other than any remaining in the pension when the plan holder dies if this happens before they reach age 75.

In this respect, an ISA is more tax efficient, but this is not enough to fully compensate for the fact that an ISA does not attract tax relief up front, provided the ability to withdraw 25% of the pension fund tax -free remains in place.

However, the tax on exit applied to a pension could be at high rates if access to more than an amount which falls within the basic rate tax band is needed in a single year. Care is, therefore, needed to consider likely withdrawal requirements when assessing which option seems most tax efficient.

A number of people also now use property investments, via the buy-to-let market, to add an extra string to their bow and this is worth considering if someone has adequate resources to take the risk involved.

The best way for someone to ensure their own retirement planning is adequate and sensibly structured is via consultation with a specialist Independent Financial Adviser.

Other considerations

A few important points to bear in mind

The wisdom of saving

The most logical way to mitigate the risk of not having enough to retire on is to build up as much overall resource as possible.

If someone can enjoy an employer contribution to their pension funding by joining a company scheme, then it is almost always sensible to do so.

Beyond this, where a contribution to a pension scheme will not secure additional benefits from an employer, then it is a question of assessing whether paying more to an employer's pension is the most attractive option or if another choice looks better. That will depend on individual circumstances and priorities and is best assessed with the aid of professional advice.

The thorny subject of taxation

Keeping taxation low by using available tax planning opportunities is obviously wise, but most tax planning comes with some downside.

To encourage savings for retirement the Government has, for many years, offered tax benefits linked to various pension plans and, for many people, the enticement of these tax breaks has made contributions to a pension the core part of their overall retirement planning.

However, the government also has a history of moving the goal posts and using pension funds as a source of extra tax revenue, so it is unsafe to rely on prevailing tax rules to remain in place.

With that proviso, for a private pension arrangement, the key tax breaks are, (broadly speaking) as follows:

- Tax relief at the highest rate someone pays on qualifying contributions.
- Freedom from internal UK Income and Capital Gains Taxes for the underlying investment funds.
- Up to 25% of the fund can be withdrawn, on reaching minimum pension age, as a tax-free lump sum, subject to a cap (£268, 275 in 24/25). The balance of the pension fund will be liable to income tax on withdrawal, unless the plan holder dies before age 75. Information on the options in this respect is in the Atkins Bland Guide to Taking Pension Benefits and is available on request.
- For a basic rate taxpayer, these tax breaks are only a little better than those that apply with an ISA, or perhaps even a unit trust savings plan designed for growth rather than income, and hence, able to work within someone's capital gains tax allowance.
- The main advantage of using pension legislation is, of course, the tax relief up-front. However, apart from the 25% which can be taken as a tax-free lump sum at retirement, for a basic rate taxpayer, this tax break is largely reversed when benefits are drawn as a taxable pension and, if access to a large amount at once might be required, the high rate of tax applied could more than eliminate the benefit of the initial tax relief.
- The main disadvantage of using a pension, once changes announced in the Labour budget in Oct 2024 come into force in April 2027, is the tax treatment on death, if after age 75. Prior to the change, pension funds were not normally exposed to Inheritance Tax. As a beneficiary inheriting a pension fund will also pay income tax on withdrawing the fund, this amounts to double taxation if the estate, including the value of the pension fund, is over the IHT threshold. Care may, therefore, be needed to review arrangements after age 75 to try to shield any pension assets that have not been used to purchase an annuity from this double tax, depending on individual circumstances and priorities.

Important notes

Any opinions expressed on the merits or disadvantages of any options are intended as a general comment only and not as specific advice to the reader.

This document is intended as a supplement to full independent advice and not as a replacement for it and should be read in conjunction with any personalised recommendations provided by Atkins Bland Ltd and with any product brochures supplied.

The value of investments will fall as well as rise, as can any income produced or generated. An investor may, therefore, get back less than invested.

Inflation can reduce the real value of capital and the income it generates.

Past investment performance is not a reliable guide to the future.

Any reference to taxation, regulation or legislation is based on our current understanding and details should be checked before any reliance is placed upon its accuracy.

The impact of taxation and tax planning depends on individual circumstances and may be subject to change, which can be retrospective.

Errors and omission excepted.

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