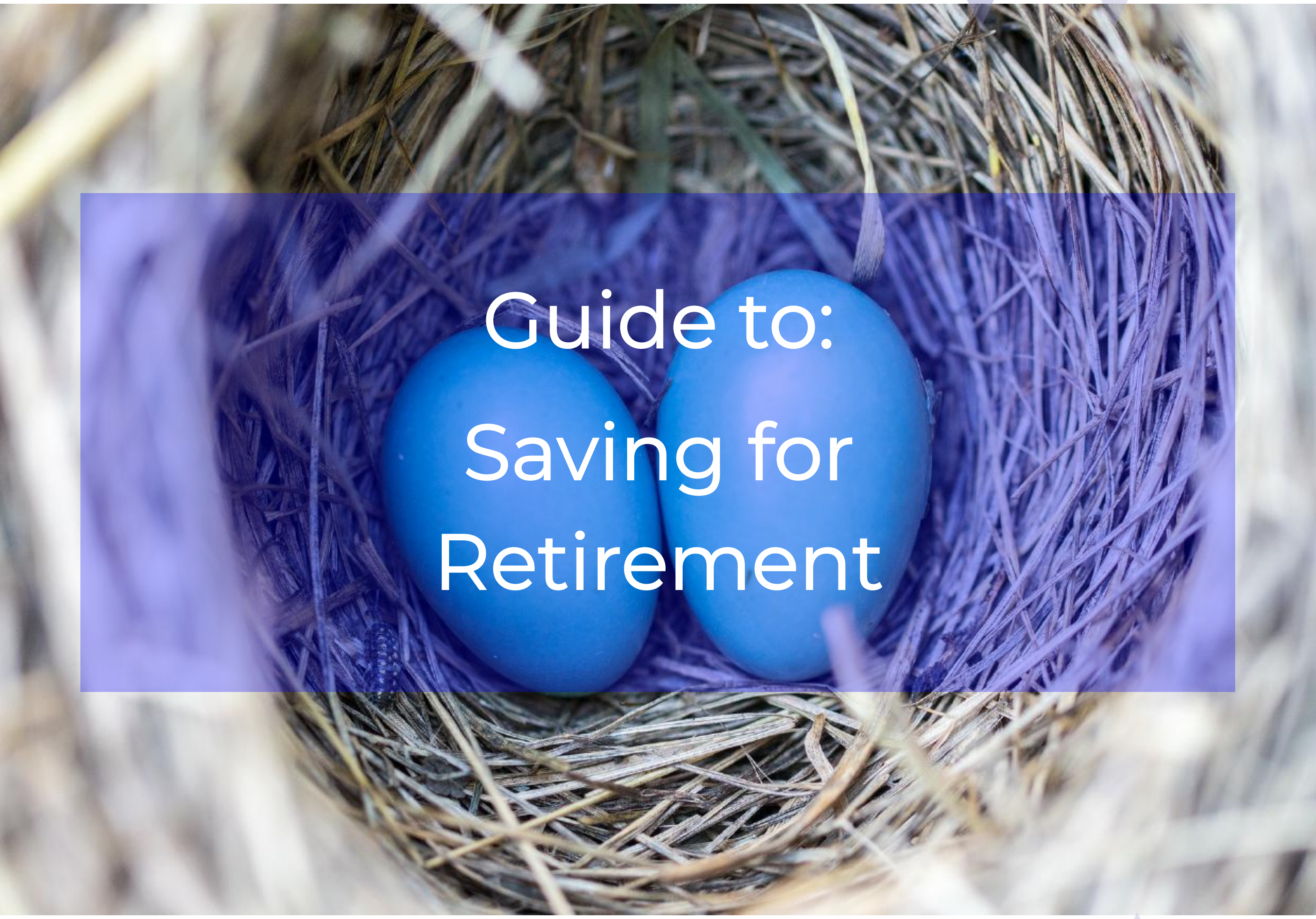
Atkins Bland

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 you want to achieve and what you need to do to achieve it.

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:.

What assets might be available to fund retirement?

The main possible sources of income you can use to fund life after work

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 before 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 get worse 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.

On this point, in September 2021 the Treasury decided to suspend the guarantees offered by the triple lock from April 2022. The reason for this was an “irregular statistical spike” in average earnings, caused by people coming back from being furloughed, which would have implied an 8% increase in State Pension in 2022. While this is entirely reasonable, the more cynical might view this as an opportunity to make similar decisions in coming years, but for less compelling reasons.

However, even with that risk, anyone receiving the basic State Pension 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 governments 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 have 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, but that the most sensible approach is to ensure that other resources are available to provide adequate income throughout retirement, and that these resources are not dependent on the success of the business and its survival in the future.

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 favored 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.

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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 planning for retirement, 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 be in a position to continue to live in their home, rather than move to a lower cost property, at least whilst 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 on 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.

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 have a debt that must be paid but the possibility of inadequate rental income to cover this.

Most 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 from region to region 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 fairly consistently due to supply tending to lag behind demand, but we have experienced periods of falling property prices and, on occasions, such falls have been severe and long-lasting.

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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.

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, the 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 available to treat this as the only form of saving for retirement.

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 favored 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”).

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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 is 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 is unlikely to be a popular choice in the future, unless rates improve considerably given the various potential advantages introduced by the comprehensive change in pension access options from April 2015.

Atkins Bland has a separate guide on 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.

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 a number of factors which differ from one person to another.

However, it is usually best to adopt a strategy which takes advantage of any relevant and suitable tax advantages, and often wise to apply an approach which does not rely 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 tax payer, 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, 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.

Such a consultation would involve an in-depth analysis of personal circumstances, objectives and an assessment of the merits of the different options which are appropriate. Following this, the construction of a suitably designed approach, intended to prevent the very common problem of somebody leaving their retirement planning much too late to be able to retire at the point they would have liked, or with the resources they would wish to have.

Other considerations

A few important points to bear in mind

Some sobering thoughts on risks

While income from most sources of retirement income has not fallen nearly as substantially as annuity rates have, the income available from deposits has fallen even further. In 1990 a building society saver could get an interest rate of around 14% with reasonably easy access to their capital. Rates in 2021 are generally no better that 1%.

To put this another way, in 1990 you could get gross interest of £1,000 without tying up your capital from a sum of about £7,200. In 2021 you would have needed over £100,000, which is nearly 14 times the amount.

Of course, inflation has also fallen, so the inflation adjusted figures show a less dramatic gap. However, for someone relying on a pot of money to generate income in retirement, the huge range of possible income yields which may be available in the future poses a substantial risk of predictions proving wildly inaccurate.

The wisdom of saving

The most logical way to mitigate the risk set out above is to build up as much overall resource as possible.

If someone is able to 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.

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 makes contribution to a pension the main foundation of their overall retirement planning.

Other considerations

What other factors should you be aware of when saving for retirement?

The main disadvantage of using a pension is the lost access until age 55. However, if money is actually earmarked for retirement, this “disadvantage” can be a benefit, especially for those who may be tempted to raid the pot otherwise!

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. 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

- Potential exemption from Inheritance Tax (IHT)

- For a basic rate taxpayer with an estate lower than the IHT threshold, 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, this tax break, for a basic rate tax payer, 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.

- There is a Lifetime Allowance (LTA) which caps the total pension benefits someone can have without triggering extra taxation. Details on this are outside the remit of this guide but it is important to be aware of this where pension benefits are substantial. Information and advice on the LTA is available on request

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.

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