

# THE ADVISER.

Issue 2 - July 2011

Welcome to the second edition of our newsletter. If you have any questions about the issues raised in this issue, please do not hesitate to contact us.

## RPI to CPI

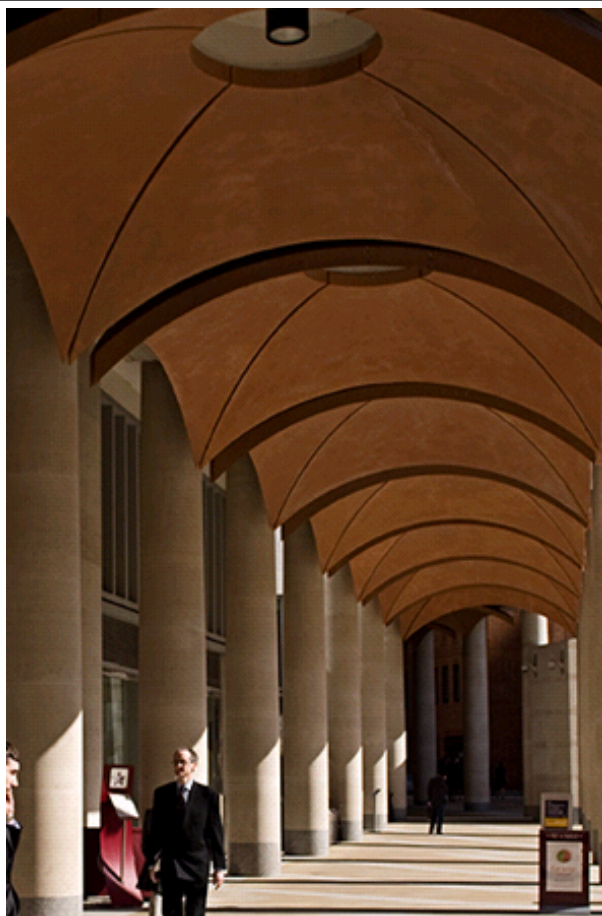
Last June, the coalition government announced that, in future, state and public service pensions would increase in line with the Consumer Price Index (CPI) rather than the Retail Prices Index (RPI). The change, announced in an Emergency Budget, aims to help the government cut the UK's sizeable budget deficit.

CPI does not include housing-related costs such as mortgage interest payments, buildings insurance and council tax. The rate of CPI has therefore tended to run below that of RPI in recent years and the government contends that CPI is a more appropriate measure of inflation because it strips out these costs (which are considered less relevant to pensioners who arguably, should have by retirement, repaid any mortgage they took out by the time they retire). To ensure consistency, the government subsequently applied this ruling to occupational pensions. However, this triggered a complex debate over whether all private pension schemes would be able to move to CPI as, according to a survey by the National Association of Pension Funds (NAPF), 61% of pension schemes have small print specifically embedding their link in to RPI.

The NAPF warned against any ensuing uncertainty, suggesting pension funds might find it difficult to plan ahead. The association believes that a switch to CPI could increase flexibility for pension funds, but suggested the implications for current and future pensioners needed to be carefully considered to make sure the full facts were understood. Movement among pension funds was swift, however, and KPMG's 2011 Pensions Accounting Survey showing that many companies have already benefited from the switch from RPI to CPI.

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## Planning for success

Step No 1: BE HONEST WITH YOURSELF

The right products and investments can make a world of difference to your financial situation – but a portfolio of unsuitable products can at the very least, be expensive - and at worst, could prove disastrous. Therefore, before you embark on any financial strategy, take some time to really consider who you are, what your circumstances are and where you would like to be. If you want to achieve long-term financial success, it is very important to be realistic and make sure you set objectives and consider the risks you can take (or can not take) in light of your situation.



## A pick up in pace

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The Consumer Price Index (CPI) increased to 4.5% during April, compared with 4% in March, its highest level since October 2008 and registered a month-on-month rise of 1% during April – only the second time that prices have risen by that much in a single month. However, the increase in the Retail Prices Index (RPI) posted a slight decline, falling from 5.3% in March to 5.2% in April.

The figures were distorted somewhat by the late Easter holiday; Easter fell in March last year, and this partly accounts for the substantial month on month rise. The increase was further exacerbated by unusually warm, dry weather, the school holidays and Easter's close proximity to the royal wedding. In contrast, wages (excluding bonuses) rose only 2.1% for the three months to March 2011. The Ernst & Young ITEM Club expects consumer spending to rise by just 2% a year between now and 2020 with debt repayments, high inflation, a lack of credit and potentially higher interest rates all expected to keep the brakes on for a while. Apparently, 70% of UK homeowners have tracker mortgages and are therefore very sensitive to interest-rate rises.

This does not get round the fact that inflation has now been at least one percent above target since January 2010. Once again, Bank of England Governor, Mervyn King had to write a letter to the Chancellor of the Exchequer to explain why – and he cited January's VAT rise, higher energy prices and increased import prices. Regardless, this puts the BoE under renewed pressure to put up interest rates as a way of cooling things down.

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## Beating inflation

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In an environment of rising prices and exceptionally low interest rates, it can be a challenge to find a home for your money that provides an attractive rate of interest while protecting against inflation. The current environment of high inflation is eroding the real value of savers' deposits – the Retail Price Index (RPI) is running at an annualised rate of 5.2%, while the Consumer Price Index (CPI) is running at 4.5%

However, National Savings & Investments (NS&I) has recently introduced new issues of its Index-Linked Savings Certificates. Interest is calculated using the RPI at the start and end of every year. The new index-linked certificates will pay RPI plus 0.50% (annual equivalent rate). RPI – which includes mortgage interest payments – is usually higher than CPI, and investors are guaranteed to beat inflation as measured by the RPI.

The certificates are designed to be held for a five-year term and no index-linking or interest is paid if the certificates are cashed in during the first year of the five-year term. The certificates are tax-free and savers can invest as little as £100 or as much as £15,000. Investments issued by NS&I are backed by HM Treasury and are therefore 100% secure. Looking ahead, inflation is expected to subside during 2012, which could reduce the appeal of index-linked investments. Nevertheless, if RPI should become negative, NS&I savers will not lose any money.



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## Losing out to inflation

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Low interest rates are great news for borrowers but for savers, they can have a devastating effect. With inflation currently running far in excess of base rates, even though the value of your capital may be safe, you need to keep a close eye on the interest rates you are earning to stop, or at least limit the rate at which the buying power of your money is being eroded.

Nowhere is this more apparent than with Cash ISAs. In a recent survey for watchdog, Consumer Focus, over 80% of Cash ISA holders were found to be earning **less than just 0.5%** a year on their savings. In most cases, the attractive introductory rates which lured savers in had come to an end and been replaced by very low "standard" rates. In some cases this change had even gone unnoticed. Whilst it is true that, whatever the conditions in the market, most people should hold at least some money in an easy access, readily available deposit account, simply to make sure they can cover unforeseen emergencies and short term needs, any saver with longer term plans should be concerned by findings like this. At the very least, you should do a review of the market and see if you can find an account paying more.

In response to the findings, Consumer Focus suggested that: "...customers who have not switched their [ISA] savings may be losing one to two per cent in interest. In total this could amount to as much as £1.5 billion to £3.0 billion per year... With those potential gains at stake, it is certainly worth shopping around.

## Sluggish prices

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The UK housing market remains lacklustre and property prices appear unlikely to show a marked improvement in the immediate future. The Land Registry reported house prices posted a monthly increase of 0.8% during April, the first time since January 2011 the figure has been above zero and the largest growth since January 2010. This follows a drop of 1.1% in March – their biggest monthly fall since February 2009. During the past year to April, house prices fell across England and Wales, however, London experienced an increase of 5%. According to the Land Registry, the average house was priced at £163,083.

That said, the Halifax reported a monthly drop in house prices of 1.4% in April, and an annualised fall of 3.7% – the largest decline since October 2009. According to the Halifax, the average home costs £160,395. The mortgage lender pointed to signs house prices are stabilising – albeit at a level below the historical average. Halifax described the underlying trend as one of “modest decline”, although the downward path is likely to be tempered by a slight improvement in the employment market and low interest rates. Borrowing rates have remained at an all-time low of 0.5% since March 2009.

Property website Rightmove.co.uk reported UK sellers raised asking prices during April to their highest levels since June 2008, reaching a level of £238,874. Average asking prices posted an increase of 1.3% in April compared with March, as a higher-than-usual number of bank holidays during April constrained supply

The Ernst & Young ITEM Club expects the household debt-to-income ratio to fall from 157% at the end of 2010 to 139% by the end of 2014. The study claimed soaring house prices during the decade leading up to the financial crisis have contributed to some householders running up very high debt-to-income ratios. Ernst & Young does not expect UK consumers to start benefiting from the economic recovery until 2013.

According to the ITEM Club, almost 70% of homeowners have tracker mortgages, and therefore UK households have a high sensitivity to movements in interest rates. Exceptionally low interest rates have provided a welcome buffer for borrowers – however, amid continuing tight credit conditions, many households are likely to have only limited ability to cope with higher interest rates. Looking ahead, a swift procession of interest-rate rises could cause particular problems for borrowers. Indeed, The Council of Mortgage Lenders forecasts 40,000 UK households will have their homes repossessed during 2011.



## Centenarians on the increase

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It has long been accepted that improvements in medicine, lifestyle and an understanding of the effects which habits such as smoking can have on our health mean life expectancy is increasing. Future generations will enjoy much longer and healthier lives on average than their predecessors.

However, figures released in April 2011 by the Department of Work & Pensions illustrate rather accurately exactly what that means. These figures suggest, of the under 16s already alive today, over a quarter are going to reach the age of 100 – and that already, the average new-born female is going to live to over 90.

As Steve Webb, Minister for Pensions, commented at the time, this means that millions of people will spend over a third of their life in retirement. However, as the DWP were quick to point out, this news also coincides with a period during which pension savings are in serious decline.

An ageing population is putting our welfare system under significant pressure as more people need not only pension income but also healthcare, incapacity support and help within the home. You can therefore have no expectation that your State Pension will provide anything other than a safety cushion when the time comes. If your retirement plans include holidays, visiting relatives and treating yourself on occasion, then its time to take control of your savings and start building up a retirement fund of your own.



## New kid on the block

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The Coalition Government has now confirmed details of the long awaited savings plan analysts had been expecting since the withdrawal of Child Trust Funds (CTF) last year. The Junior ISA will be launched in November and will extend to under 18s the same tax benefits which parents (and all adults) already enjoy. Their exact structure is subject to final legislation which may change, but this is the plan so far.

The Junior ISA will allow parents to open up a specific account in their child's name, into which they, their family and friends can contribute a total of up to £3,000 a year. These contributions will then be invested in a chosen mixture of cash and/or stocks and shares and the benefits locked up until that child reaches 18. Anyone under 18 born before September 2002 or after January 2011 (ie: those who do not have a CTF) will be eligible for a Junior ISA (and for those with CTFs, the annual limits are expected to be brought in line).

The Junior ISA could provide a significant step up for children whose family and friends get together for their benefit. Final values will always be subject to the funds you choose and the environment, both of which can have an impact on how much - or little - the investment returns. However, as an idea of what 18 years of saving might offer, assuming an average of 5% pa (net of charges), that £3,000 pa could leave the lucky beneficiaries with a contribution of over £80,000 towards their world trip, first house or hotly debated tuition fees.

## The Small Print

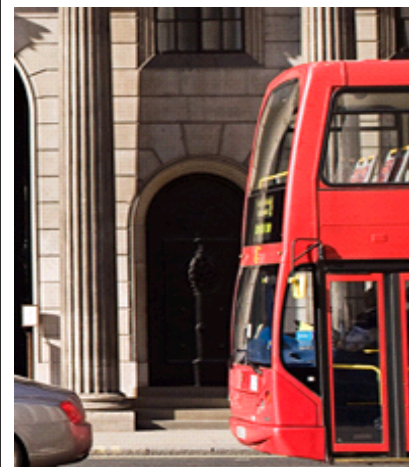
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**Investments can go down as well as up and you may not get back the full amount invested.**

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