

# Budget 2011

The second Con-Lib Budget was delivered on 23 March 2011 and was predictably a very different affair from the emergency Budget delivered shortly after last year's general election. The new Government has introduced a very different style where most of the content was largely known due to key changes being pre-announced in December.



The aim of this article is to outline some of the potential financial planning opportunities:-

## Income Tax & Personal Allowance

Although the personal allowance, which is the amount of income you can earn before you start to pay tax, has increased by £1,000 for those under 65 the point at which individuals now pay tax at the higher rate (40%) has reduced to

£35,000 from £37,400. This means that when taking into account the personal allowance, individuals under 65 will be subject to higher rate tax on income exceeding £42,475, compared to £43,875 in the 2010/11 tax year.

The Institute of Fiscal Studies have estimated that up to 750,000 people will be brought into higher rate tax in 2011/12 as a result of the reduction in the higher rate threshold.

The Budget also confirmed the following rises in the personal allowance for those aged 65 or over:-

- An increase from £9,490 to £9,940 for those aged 65-74; and
- An increase from £9,640 to £10,090 for those aged 75 or over

One noticeable point for those over 65 is that the age-related

allowances have only increased by £450 compared to the £1000 increase for those under this age.

The age related allowance is also reduced back towards the standard (£7,475) personal allowance by £1 for every £2 your income exceeds £24,000, meaning that the additional allowance is lost by the time income reaches either £28,930 (if aged 65-74) or £29,230 (if aged 75 or over). These 'tipping points' are the same as last year due to the threshold at which age allowance starts to reduce being increased from £22,900.

For those earning over £100,000 the basic personal allowance of £7,475 is also reduced by £1 for every £2 that income exceeds this level. This therefore means those earning £114,950 or more will see their allowance reduced to nil.

Those dragged into higher rate tax this year or whose level of income will affect their personal allowance could consider:

- Reducing taxable income by making additional pension contributions
- Using ISAs to shelter interest & investment income from tax
- Transferring investments to

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a spouse if they are subject to a lower rate of tax – Such transfers should have no immediate Capital Gains Tax or Inheritance Tax implications.

- Using non-income producing investment ‘wrappers’ such as investment bonds

### Inheritance Tax (IHT)

Although there were few changes in this area, the important point is that the ‘nil rate band’ (the threshold above which IHT becomes payable on your estate on death) remains frozen at £325,000 until at least 2014/15. This means that for most married couples with assets of more than £650,000 they will need to consider some form of IHT planning.

There are a variety of ways of tackling the IHT problem: For example, it is possible to take out a life assurance policy in trust to provide funds for your beneficiaries to pay the bill. Other solutions could be to gift away some of your assets – either directly or to be held in trust. Where gifts do not exceed £3,000 in total they will be immediately exempt from IHT and larger amounts will become exempt provided you survive the gift by 7 years.

Although, since 9 October 2007, it is now possible for married couples to transfer any unused ‘nil rate band’ on first death to the surviving spouse on second death, the freezing of the nil rate band may mean that this is no longer the best option, and it is possible to instead make use of the nil rate band on first death by directing assets to a trust via your will. This is a complex area, however, and you would need to seek further advice in the context of your own circumstances.

### Pensions

There have been a number of important changes to pensions from this tax year, most notably a reduction in the ‘annual allowance’ (which is the total amount that can be contributed to pensions each tax year without incurring a tax charge) from £255,000 to £50,000.

Fortunately though, the rules allow for individuals to ‘mop up’ any unused annual allowance from the previous three tax years (2008/9, 2009/10 and 2010/11) subject to a maximum of £50,000 per year. This may be good news for high earners in particular who in the last two tax years have often been restricted to maximum

contributions of up to £20,000.

If you have significant pension funds it is also worth remembering that the lifetime allowance reduces from £1.8m to £1.5m from 6 April 2012. You may therefore need to consider how to plan for this reduction and whether to apply for ‘fixed protection’ to keep a lifetime allowance of £1.8m. The downside of this protection though is that you cannot accrue any further pension benefits on or after 6 April 2012.

### Capital Gains Tax

Since 23 June 2010 there have been two rates of capital gains tax (CGT) – 18% and 28% - whereas previously there had been a flat rate of 18%. The 28% rate will apply to those individuals whose capital gains, when added to their income, takes them above the higher rate tax threshold for income tax.

That said, the 28% rate is still less than the 40% rate for income so from a tax perspective it still makes sense for higher rate taxpayers to invest for capital growth and perhaps consider a ‘capital as income’ strategy. This can be achieved by making regular encashments, particularly as gains

need to exceed the annual CGT exemption before any tax becomes payable (currently £10,600 in 2011/12).

Such a strategy could make even more sense for individuals who earn over £150,000 who would otherwise be subject to 50% tax on income above this level.

### Summary

The above are just some of the things you could consider depending on your circumstances, however, it is essential that you seek guidance from your Financial Adviser. Much of the above focuses on tax planning opportunities but this is not the only consideration as there are other important variables to consider, such as investment risk.

Levels and bases of and reliefs from taxation are subject to change and their value depends on the individual circumstances of the investor.

The value of your investment can go down as well as up and you may not get back the full amount invested.

## State Pension Reform

### Basic state pension and pension credit increases

From April 2011 there is a ‘triple guarantee’ that the basic state pension will rise by the highest of:

- National average earnings
- Prices - the percentage increase in the cost of living that year; and
- 2.5%

In 2011/12, the highest of these 3 measures is the retail price index (RPI) and as a result the Basic State Pension will increase by £4.50 to £102.15.

It should be noted though that from 6 April 2012, the consumer price index (CPI) will replace the retail price index (RPI) for increases thereafter, and CPI historically has nearly always been lower than RPI.

If you qualify for a basic state pension, you may also be eligible for pension credit to top up your

pension income, and from April 2011 the annual increase in pension credit will be at least the same cash increase as the basic state pension.

Pensioners on a low income who receive pension credit will therefore receive a £4.75 increase in their guarantee credit this year.

### What do you need to do?

You do not need to do anything. If you are receiving a state pension, this will be increased automatically and the Department of Work and Pensions should write to you about this.

### State pension age increases

The age from which the basic state pension and the additional state pension can currently be taken is 65 for



men and 60 for women.

Between 2010 and 2018, however, the State Pension Age (SPA) for women is increased on a sliding scale so that Women's SPA will be 65 from November 2018.

Following the equalisation of the SPA in 2018, the SPA for both men and women will then increase to 66 between December 2018 and April 2020.

Furthermore, the government is also now considering the timetable for future increases to the SPA from 66 to 68, and indicated in the March 2011 Budget that it intends to bring forward proposals to manage future changes in the SPA more automatically by increasing it in line with life expectancy.

Based on Office for National Statistics data, the increase in male life expectancy at age 65 over the last 30 years (between 1981 and 2011), was 5.3 years.

So, if life expectancy continues to rise at this rate over the next 30 years as well, SPA could rise by another 5 years on top of the 1 year increase to 66 already due to take effect from 2010, in which case the SPA for someone born in 1970 would be 71 and young people leaving school today would have a SPA of over 75 (!)

#### What do you need to do?

You do not need to do anything. If you are reaching State Pension age, you should receive a pension claim pack.

#### The £140-a-week flat rate state pension

As you will have no doubt heard on the news and read in the newspapers, the Government have recently proposed a £140 a week flat rate state pension, which is above the current pension credit minimum guarantee, payable to everyone with a sufficient national insurance record.

Such a move, which would spell the end of the additional state pension and pension savings credit 'mean-testing' should significantly simplify matters and also encourage more low earners in particular to save more.

As Iain Duncan-Smith put it "Too many people on low incomes who do the right thing in saving for their retirement find those savings clawed back through means-testing. We have to change this and send out a clear message across both the welfare and pension systems that you will be better off in work than on benefits, and you will be better off in retirement if you save."

#### When will the changes happen?

If the plans go ahead as proposed, they are likely to come into force during the next Parliament - which is likely to mean 2015 at the earliest.

It is estimated that the £140-a-week pension will actually be worth around £155 a week if it is introduced in 2015.

#### I'm already retired. Will this affect me?

If you're one of the 12 million people already drawing your state pension, it will not change, so you'll miss out on the new £140 flat rate. Critics say this will create a cliff edge between current and future pensioners.

#### Who will benefit?

Anyone who reaches their state pension age after the new system is introduced and has paid (or been credited) with at least 30 years of national insurance contributions will receive at least the full weekly flat rate.

Women and the UK's 3 million self-employed, who lose out under the current system, will be the main winners.

#### Who will lose out?

Higher earners with long working lives will be worse off as they will no longer be able to build up an additional entitlement over and above the 30 qualifying years.

#### Will I lose any additional state pension I've already built up?

No. Those people who have built up an entitlement to an additional state pension (SERPS and/or S2P) which takes them over the £140 threshold before these changes take effect will keep these benefits. So, if the additional state pension and new full state pension combined was £160 a week, this is what you will receive.

#### What if I won't have 30 years' contributions?

The amount you get will be linked to how many years of national insurance contributions you have built up, although the minimum to qualify for any state pension will be 7 years' contributions, which is worth £32.70 a week in today's terms.

So, someone with 15 years of national insurance contributions would receive half of £140 in today's terms i.e. £70 a week.

#### Will the self-employed get the same state pension?

Yes. Self-employed people who do not currently build up any entitlement to the additional state pension should therefore benefit from the proposed change.

#### If I have been contracted out of the additional state pension, will this affect my state pension?

In order to ensure that people who have built up 'contracted-out' rights don't benefit unfairly, the Government have said that any income they receive from those pensions as a result of being contracted-out will be deducted from their weekly state pension.

So, if someone who would otherwise be entitled to a state pension of £140 a week builds up a pension of £30 a week as a result of being contracted-out, they would receive £110 a week from their state pension instead.

## A Difficult Balancing Act

How best to invest is always a difficult decision to make, but once you have your strategy, the next decision to make is how best to maintain it. This article will look at this maintenance and in particular the relative merits of rebalancing in conjunction with the asset allocation method of investing. It should be remembered that this is merely one type of investment and maintenance strategy and is not necessarily the one most suited to your needs/desire.

#### Allocating assets

The key point of an asset allocation strategy is to achieve the best possible relationship between risk and return by investing in several different asset classes such as cash, fixed interest securities, property and equities. This exploits the fact that, due to their

divergent behaviour patterns then there is usually a low correlation between the returns produced by these different asset classes (i.e. the behaviour of one should not be overly copied by another). By combining them selectively, it should be possible to either increase your return based on your risk appetite or to reduce

the risk you are taking to achieve a specific return when compared to investing in a single asset. This is sometimes referred to as the 'efficient frontier.'

Consequently, this strategy allows you to manage risk - which is why it is extremely important that you do not stray too far from the

recommended asset allocation. If that happens, your portfolio will change in shape over time and will move away from your original risk appetite (either increasing or decreasing in risk dependent upon how the various asset classes perform) that laid the foundation for the recommended allocation in the first place.

### Beneficial rebalancing?

Rebalancing can help to maximise the returns received from your portfolio based on your specific appetite for risk, but it is very important to remember that if you rebalance too often, the trading costs (the cost of buying and selling investments) will reduce the positive returns (or increase losses) and potentially damage your long-term returns. This leads to the almost impossible to answer question of once the asset allocation strategy has been determined, when and how often should a portfolio be rebalanced?

The technical answer is: rebalance when the expected benefit (i.e. the increase in returns for the risk adjusted portfolio) is greater than the trading costs involved. In other words, the more often it is done the more costly it is but does this produce sufficient extra growth to offset the costs?

Rebalancing can be quite a complex matter which has been the subject of many academic studies. However, assuming that rebalancing is suitable and fits in with your investment profile and that your asset allocation has been implemented, you can basically choose between the following rebalancing strategies:

- 1) No rebalancing
- 2) Dynamic programming with cost function minimisation
- 3) Fixed frequency (monthly, quarterly or annually)
- 4) Fixed tolerance band for maximum deviations

Most professional investors opt either for a 'tolerance' strategy (which means that when the portfolio has changed beyond a set percentage it is then rebalanced back to its original position) or a 'frequency' strategy, where this rebalancing is performed over a set period such as annually. Despite the fact that both are quite close in terms of benefit, however, neither of these strategies offers the optimal solution.

According to leading academic researchers, the best solution is optimal dynamic programming. This is a very complex strategy and not many – even institutional investors – use this method. Luckily though, a much simpler 'tolerance' or 'frequency' strategy will produce comparably good results.

Many economists have examined



### Summary of the empirical findings of Sun et al. (2006)

Source: Sun, W., A. Fan, L. Chen, T. Schouwenars and M. Albota, 2006, "Optimal Rebalancing for Institutional Portfolios", Journal of Portfolio Management, 32, 33-43

Rebalancing strategy	Trading costs (bps per year)	Reduction in growth compared to optimal strategy (bps per year)	Total costs (bps per year)
No rebalancing	0.00	30.18	30.18
5% tolerance band	7.29	0.70	7.99
Monthly	23.67	0.00	23.67
Quarterly	13.69	0.28	13.96
Yearly	6.84	1.55	8.39

\* BPS are basis points and represent 100th of 1% so 30 bps = 0.3%

which rebalancing strategies produce the best results and in 2006, in the Journal of Portfolio Management, Walter Sun and his colleagues at M.I.T. in Boston concluded that significant excess returns can be generated by rebalancing your portfolio.

Amongst other things, they tested a portfolio comprising five different asset classes and examined the performance generated after 20 years when adopting four different rebalancing techniques. The trading costs (of buying and selling assets) were assumed to be between 0.4% and 0.6% for the different asset classes – although an important aspect is that the costs did not necessarily include the cost of the individual who had to instigate the changes.

In the table above, from the research, several rebalancing

strategies were considered and the cost of each compared. The tolerance band strategy works on the basis of rebalancing once the portfolio has moved more than 5% from the original allocation.

Whilst this suggests that rebalancing is advantageous it is still dependent upon the costs involved in the whole process, although as mentioned previously, it also helps to maintain the risk of your portfolio within its original intended level.

A key benefit of asset allocation and automatic rebalancing is that it creates a disciplined approach at all times (including when rebalancing), although it is also possible to counter a common and unfortunate weakness of human nature - the desire to invest more in an asset class performing well and less in an asset class that is underperforming. Asset allocation

and rebalancing strategies create a non- emotional buying and selling process and therefore the removal of this human emotion which can create the 'buy high and sell low' failure of many.

It should be remembered, however, that these are not the only investment methods that can be utilised. And, despite the benefits, they do counter the investment expertise of a financial adviser/investment manager and the potentially difficult to ascertain aspect of market timing, such as disinvesting before the credit crunch where asset allocation and most other strategies failed to avoid falls in values due to the market wide nature of the issues.

The value of your investment can go down as well as up and you may not get back the full amount invested.