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STEVE WEBB
DON'T SLATE THE NEW STATE PENSION

INVISIBLE ENEMY
BEWARE THE RETURN OF INFLATION

FIRST FORUM
ALL THE NEWS FROM OUR READERS' EVENT

TAKE NO CHANCES

GRAEME MITCHELL OF LOWLAND FINANCIAL HAS BUILT IN A COMFORTABLE MARGIN OF ERROR WITH CLIENTS' CASHFLOWS

GRAEME MITCHELL
PORTFOLIO PICKS
22

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EDITOR'S COMMENT

PUNITIVE PENSION POLICY IS ALL ABOUT THE TAX TAKE

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After the honeymoon, pension freedoms are starting to attract critics. News that £1 billion has been cashed in already raised questions over whether the whole policy is just one big tax grab.

The short answer is yes. Well, as much as any piece of pension policy is, as it turns out. Talking at our first *Income+* Forum for readers, former pensions minister Steve Webb recalled how a major policy change came about.

Ever wondered why the coalition government immediately cut the annual and lifetime allowance in 2010? It turns out Labour had already 'banked' the tax saving from its own plans, to introduce a taper on tax relief, so it successors needed a way to keep the money.

This could mean other proposals with the potential to raise tax revenue are more than likely to get the green light, for example, second-hand annuities. See pages eight and 11 for details.

Regardless of tax revenue, pensions policy is almost always complicated, especially for consumers.

One major challenge the government, and advisers, face is explaining the changes to state pension entitlements as we move to a flat rate in 2016. Some people will find they are due less pension than they expected.

On page 16, Webb defends the transitional arrangements, highlighting a little understood way the changes could deliver very generous rates for some. But the method costs the government and, given what we now know about pension policy, it might not be around too long.

THE LONGER-LIFE INCOME PLAN

LOWLAND FINANCIAL'S GRAEME MITCHELL DETAILS A RETIRING COUPLE'S INCOME NEEDS AND AVAILABLE CAPITAL, REVEALING THE LEVEL OF CAUTION BUILT INTO THEIR CASHFLOW PLAN

TIM COOPER

MEET THE CLIENT

The clients are John, who previously had a building business, and Pat who was a stay-at-home mum. They are both 68 and John retired three years ago – before seeking advice from Lowland.

Pat and John have a variety of income producing vehicles:

- a pre-existing annuity for Pat, producing an annual income of £3,800;
- three pre-existing jointly owned rental properties in Edinburgh, Kelso and Melrose yielding £17,760 a year;
- a drawdown for John's pension producing £6,000 a year, recommended by Lowland;
- £65,000 each in ISA investments, which Lowland put into an in-house portfolio and which generate £2,000 a year each.

The clients also have £20,000 in premium bonds, £50,000 in savings and deposit accounts and a loan trust bond, valued at £63,400. They also have a whole of life insurance policy.

Pat and John have three children, two of which took over John's business. The couple wanted Lowland to make sure they had enough income to meet their needs while minimising any potential tax liabilities, including inheritance tax.

THE PLAN

Two years ago, Mitchell set up a Voyant cashflow model [see chart] to demonstrate that the couple had the assets to provide their target income of £40,000 a year.

Mitchell also decided to keep hold of the properties. 'In the past, some people were put off pensions and tended towards property but they don't always understand the risks,' says Mitchell. 'For example, tenants default or cause damage or periods with no occupants. But this client was involved in the building trade so it made more sense to keep the properties because he could repair and maintain them.'

For the cashflow forecast, Mitchell set an initial timeline showing assumed death at 100, which Lowland varies from Voyant's default of 90. 'It's better to prepare for "the worst" in terms of running out of money,' explains Mitchell.

He broke their spending down into £20,000 per annum for basic needs, £10,000 for leisure and £10,000 for luxury. The timeline assumes that their need for luxury spending will stop around age 80.

ADJUSTED FOR AGE

The cashflow model expects their income need to grow with inflation at 3% a year and shows how it may need to rise slightly more if John dies at 90, as Pat's tax situation would become less efficient.

Mitchell says: 'In that situation, income needs don't necessarily change a lot. Bills are roughly the same, food and clothes go down a bit, but then Pat might have to employ someone to cut the grass and fix the home and other properties. If the expenditure did change, we can model that, but I would rather be more cautious.'

The model shows how Mitchell anticipates the

various income vehicles contributing to meet that target. He planned in regular withdrawals from the drawdown (light yellow) and ISA investments (in pink).

Mitchell says: 'Once you get [the income and expenditure] to balance, you can start playing with scenarios, if clients are interested. In this case, they wanted to know what would happen if John died say at age 90, so we also modelled that scenario, which this cashflow plan reflects.

'At about 87, they might need to start dipping into other pots. I have set the plan so that if John dies at 90, Pat then increases her income from the drawdown pension to 5%. This makes up for the loss in John's state pension. They might at that point also take less from the bond and more from other things.'

Mitchell has not built in a potential equity market crash to the cashflow forecast because he feels Pat and John have sufficient slack to cope in that event.

He has also not modelled long-term care needs. They vary so much, it is better to remodel when the need arises, he says. 'These are all part of the ongoing review conversations,' he adds.

Mitchell has visited Voyant in the United States and done some work with consultant Andrew Hart, a financial planner at IFA firm Serenity and founder of the Voyant training programme The Voyantist, to help him get the best from the tool. 'Hart shows how important it is to avoid your plan falling short – people are more likely to live to 100 than ever before,' says Mitchell. 'That is why I always make assumptions as cautious as I can.

'Other good things that I got from Andy were reassurance that the default assumptions I use are similar to what others use. Andy also produced a fact find for me linked to Voyant. We talked about how to use the various functions, such as Word, Excel or PDF versions; and gave some parts our own names instead of the Voyant defaults – for example, we call the base plan the "master plan".'

CASHFLOW FOR JOHN AND PAT BY AGE AND THOUSANDS OF POUNDS PER YEAR

MEDIUM RISK OUTLOOK

Mitchell measured the couple's risk outlook as medium. He takes a total return approach to income. Since the couple's assets can meet their spending needs comfortably, he set very cautious return goals that should leave plenty of room for growth and income. 'On the two ISAs, we set up withdrawals of £2,000 a year each, which is a cautious 3% of the total,' says Mitchell. 'Looking at the long-term performance of the asset allocation in that portfolio, it is well capable of earning that in most periods.

'The drawdown target of £6,000 is 2.5% of the total. I have not reviewed this couple since April, but [the recent changes] may change my advice and affect the split of the income they are taking at next review in November. They have an inheritance tax issue and the changes to the way HM Revenue & Customs treat pensions on death mean we might take a bit more from the ISAs and a bit less from the pension.'

Because the pension was the biggest of the individual pots, the client wanted to take less risk with that, so Mitchell selected a low-medium risk portfolio for that and a medium risk category for the ISA and the bond portfolios.

Lowland uses a blend of investment approaches. For amounts below £100,000, it tends to use passive portfolios provided by Parmenion. For larger amounts, it tends to build in-house portfolios that are more active, using research and recommendations from Financial Express.

'For smaller portfolios, costs are more important. But for larger sums, it is good to have a foot in both camps,' says Mitchell.

He therefore put the smaller ISA and bond investments into passive Parmenion portfolios and the drawdown into an in-house portfolio.

Lowland relies on Parmenion and Financial Express to set the asset allocation of the portfolios in line with risk needs. He looks at the previous returns from those allocations to make sure they match client needs.

In client reports, Lowland benchmarks against the FTSE 100. 'It is not a close comparison, but people know and understand it,' says Mitchell. 'I explain that the FTSE is more volatile. It has gone up more than the portfolio recently, but it is also dropping and the portfolio will not drop by as much. FE and Parmenion also benchmark against their relevant sectors to aid a more accurate comparison.'

One of the most highly weighted holdings in the active portfolio is Citywire Selection fund AXA Framlington UK Select Opportunities, managed by Nigel Thomas. According to Citywire Discovery, Thomas is in the second decile for five- and 10-year and third for seven-year risk-adjusted returns in the UK all companies sector.

Another highly weighted fund that has performed well recently is Schroder US Mid Cap, managed by Jenny Jones. In the equity US small and medium companies sector, Jones' risk-adjusted return record has jumped from eighth decile over seven years to third decile over one year. ✦

MEDIUM ASSET ALLOCATION