How Much Should I Save Towards My Retirement?

These notes apply to an individual who is looking to establish a personal pension or stakeholder. This may be because you are self-employed, in employment where your employer does not offer a pension arrangement, or perhaps where the employer has agreed to invest a certain amount and you are considering how much to add

Despite the general confusion created by insurance companies and other pension providers, the fundamentals of a pension plan are very simple. You put money into a savings fund, it hopefully grows in value and at retirement you convert the fund into a regular income payment, which will replace part, or all, of your earnings from employment.

1. PAYMENTS IN

Saving in pension plans is typically done in the following ways:

1.1 Regular Instalments

Regular instalments (usually monthly) are popular because they provide discipline. Once a direct debit is established no further decisions have to be made and the money reduces net funds to spend automatically. There are, however, a number of drawbacks to this approach:

It is very easy to forget to review regular investments to make sure they are at the right level in relation to your salary (and, therefore, your standard of living in retirement).

Regular payments go to one institution. It may not always be a good idea to have "all your eggs in one basket" and the original choice may end up a poor performing pension provider.

1.2 One-Off Investments

Many people prefer not to be committed to small regular contributions and instead make larger one-off investments. This can be particularly useful for self-employed people or those paying higher rate tax. In this case, the amount invested can be set at a level, which will achieve tax relief at the individual's highest rate. It is possible to choose a different provider each time an investment is made and in this way a balanced portfolio of pension investments can be built up over a period of years.

Again, there are disadvantages to this method:

The responsibility is yours to make sure that an investment is made. The pension provider will not automatically remind you that a payment is due and it is easy to find other things to spend the money on.

Regular investment plans usually offer"pension contribution insurance" (PCI), which can ensure investments continue even if you are unable to work through illness. This is not normally available for one-off investments.

If you are investing into equities, you are taking a higher risk by purchasing investments only once per year rather than in 12 installments.

1.3 A Combination Of Regular And One-Off Investments

To achieve the "best of both worlds" investors might undertake a combination of investment periods. This provides both the discipline of regular investments and enables one-off investments with other pension providers to be made so that a balanced portfolio of investments may be built up.

2. TAX CONSIDERATIONS

2.1 Tax Relief

Tax relief is obtained in different ways depending on whether you pay only basic rate tax or whether some of your income is charged at higher rates. Currently, the basic rate of tax is 20% and higher rate is 40%. Thus, the marginal rate is 20%.

For employees (and all stakeholder plans), basic rate tax is obtained by deduction. This simply means that if you invest £80 in a pension fund, the pension provider will claim back from the tax office £20 on your behalf. Claiming this tax relief back can take a pension provider 4-8 weeks, but most assume that it is received immediately. Therefore, when you pay £80, £100 is invested.

If the investor pays any tax at higher rates it is possible to claim back the marginal rate when they complete their tax return. In the example above, you declare on your self-assessment tax return that you have paid £100. The tax office will then credit you with £20 of tax and this will usually be reflected on your PAYE code or schedule D assessment. The overall effect of this is that an investment of £100 will actually cost you £60.

The change to current year taxation for the self-employed has created a complex system of claiming back pension tax relief based in part on what you have paid and in part on an assumption that further payments equal to past payments will be made in the future. Whilst this has the affect of possibly deferring tax, it can cause a nasty shock in the January, 2 years hence! Care should, therefore, be taken to understand the effect on self-employed tax assessments when a large single contribution is made or regular premiums are stopped.

2.2 Restrictions On Payments

The government lay down limits as to how much can be invested in a pension plan. With effect from April 2006 these limits are 100% of salary in 2008/09 subject to an overall maximum of £235,000. This is a radical change from the past which means that pension planning for many can be left until much later in their working lives.

It is possible to invest up to £3,600 per year irrespective of your earnings.

3. INVESTMENTS

Having established a pension fund and started to make investments into it, you will have to decide on the type of fund into which your money will be invested. Most pension providers have a wide range of funds available, indeed, some have literally hundreds available. Essentially, funds break down into three categories: unit linked, with profit and self invested.

3.1 Unit Linked Funds

The principle of unit linked funds is that they are linked to the performance of the underlying investments. These underlying investments are usually equities, ie stocks and shares, but can

also be property, gilts etc. Every time money is invested in the fund units are purchased at the prevailing price. The price goes up and down in line with the investments it holds. For example, if these investments are UK equities and the market crashes, the price will fall. When this happens this is very good news for people investing with a long time to go until retirement. The price is low and so a cash investment will buy more units than would be the case when the price is high. On the other hand, a market crash is bad news for people about to use their fund to provide retirement benefits. The value of their pension fund will have reduced.

3.2 With Profit Funds

With profit funds also invest in stocks and shares and other assets, but the fund manager tries to smooth out the peaks and troughs of unit linked funds by holding back some of the growth as a reserve. This can provide a smooth increase in value in your investments but arguably, as with all investments that contain guarantees; the growth will be less than a unit linked fund over a longer term.

Investors have to decide which route they are more comfortable with. This will probably depend on how long you have until retirement and what other assets you have to provide you with a retirement income.

With profit funds have taken huge “hits” over recent years due to the fall in world equity prices. This means that perhaps, their returns over the next few years will be held back whilst insurers rebuild their smoothing returns once more. Our general view is that unless you have particular reasons to want the security of with profits then now is not a good time to invest.

3.3 Self Investment

For those who can invest perhaps £15,000 or more a year, or who have a particular area of investment expertise, it is possible to establish a personal pension where you decide upon the investments. Clearly, there are restrictions on the type of investments a pension plan can hold, but for the more sophisticated investor a self invested personal pension (SIPP) is an attractive proposition.

3.4 Tax

The capital growth within a pension fund is almost tax free. This means that it should grow faster than a fund which is taxable such as a share portfolio. ISAs and some National Savings accounts have a similar tax treatment and are, therefore, worthy of consideration when long term savings are proposed.

Indeed there is now a very good argument to suggest that an investor with limited funds should place money into an ISA during their younger years and then transfer the accumulated funds to a pension if appropriate as they approach retirement.

4. PROJECTIONS

4.1 Growth Assumptions

When looking at projecting pensions certain growth assumptions are made by pension providers, these are currently 5%, 7% and 9%.

A better way to predict growth is to try to link inflation in and establish “real growth”. In other words, if a fund achieves 5% per annum growth but inflation has been 3% per annum, the real

growth is 2%. With effect from April 2003 this more realistic real growth assumption became the norm.

Over a long period of time it has been shown that good with profit pension funds have grown by between 2% and 4% above the rate of inflation. You can apply this cautious approach to your own retirement fund and the answer will be far more realistic.

4.2 Pension Options

Most individuals want a pension in retirement which will rise by inflation, is paid for their lifetime and which continues to their dependant. This is the most expensive form of annuity, which will generate perhaps half the level of income from the same pot as a pension paid for the annuitant's life alone on a level basis. It is, therefore, essential that you consider the pension you want so that your estimate will be as accurate as possible.

Likewise, post April 2006, annuitants will have a much wider range of pension options including the opportunity to pass on pension funds to their heirs.

5. HOW MUCH SHOULD I INVEST?

You should invest as much as you can comfortably afford, as soon as you can. You should not over-stretch yourself and you should make certain that if you make a commitment to a monthly investment this will be continued for a long time.

The actual amount will be different for each individual and once you have arrived at a figure it is useful to try to link that to salary. For example, if you have decided that you can afford £100 per month and you earn £20,000, a quick calculation will show this amounts to around 6% of salary. Try to maintain that link in future years.

Many investors "target fund", in other words they ask us to confirm the level of savings necessary to achieve a certain level of income at their chosen retirement date in today's terms. This target funding is then reviewed on a regular basis to take into account revised objectives, investment performance and changing annuity and investment conditions.

Perhaps the biggest mistake everyone makes is to under fund their retirement. Most people aged 50 and below will not be able to afford to retire before they are 70 in any event and virtually all non government and final salary employees and the self employed will see a dramatic drop in their living standards when they are too old or infirm to continue working.

6. WHAT ABOUT STATE BENEFITS?

State benefits for most of us form a major part of our retirement income. The introduction of the minimum income guarantee (MIG) (or more politically correct pension credit guarantee) has also greatly complicated retirement funding due to it being means tested and hence taking into account personal pensions. It is easily possible to end up in a position whereby 40% of your pension income is lost to subsidising the MIG, hence meaning your long term savings have been poor value for money.

If you are serious about your retirement you should get a state pension forecast. Application forms are available from us, your local DWP (formerly DSS) or the DWP website.

7. WHAT ABOUT OTHER FORMS OF SAVINGS?

Obviously if you are serious about retirement planning you should not necessarily concentrate all your savings into the one area of personal pensions, but personal pensions will certainly form part of your overall strategy.

The changes to pension funding levels mean that for many, ISAs are an equally good option (and far more flexible) in earlier years.

8. CHANGES TO PENSIONS LEGISLATION

The much vaunted “simplification” of pensions legislation came into effect in April 2006. This radical legislation swept away all the previous rules and replaced them with a new regime. Some protection was given to accrued benefits under the previous formats, however, there will inevitably be winners and losers from the changes proposed.

9. SUMMARY

In summary, if you are considering starting retirement savings:

- First of all consider whether the level of savings you are proposing is realistic from a retirement or State pension perspective.

- Decide whether you want the discipline of a monthly investment or prefer to make lump sum payments from time to time, or both.

- If you prefer, work out how much you need to live on if you had retired today. We can then confirm how much it will cost to achieve your objective.

- Concentrate on building up a fund at retirement and apply the same principles as any investment. Find a balance between risk and reward and security. Do not put all your eggs in one basket and consider different savings vehicles to supplement straight pensions savings.

For assistance in developing your retirement strategy please contact us to arrange a without obligation, confidential appointment.