Millions excluded from home loans

NEW affordability criteria established by the Financial Services Authority (FSA), the City watchdog, seem likely to exclude millions from the possibility of remortgaging their home loan.

This conclusion is reached by a report for the Council of Mortgage Lenders which suggests that about 5.6m borrowers could be affected.

The FSA's new rules are to be introduced next year but lenders have pre-empted them by imposing several of the measures it is proposing.

The CML report warns that 2.2m home owners will be refused a new mortgage because they fail to meet the new lending rules adopted by many banks.

Another 3.4m will not be able to borrow as much as they could have done before the credit crunch.

This situation arises from fears that interest rates could be raised next year as the economy continues to strengthen.

About a third of borrowers are on standard variable rates (SVRs) and thousands more are reverting to their lenders' SVR every month rather than remortgaging to a new fixed rate or tracker deal.

Experts have encouraged borrowers on variable rate loans to "stress-test" their finances to ensure that they can afford a rise in repayments.

Borrowers on a £200,000 mortgage paying an SVR of 2.5pc will see their monthly repayments rise by more than £100 a month if the bank rate climbs to 1.5pc, as some expect at the beginning of 2012.

Those on a 5.5pc SVR would see repayments on the same loan increase by £120 a month.

Tax friendly pension saving

NEW restrictions on pension tax relief for high earners are expected to prompt wealthy individuals to seek alternatives to save for retirement.

From next April the maximum that can be saved in a pension with tax relief in a year will be £50,000 compared with £255,000 at present.

Alternatives to be considered will include:

ISAs Currently £10,200 a year can be invested in a self-select equity ISA. Although there is no tax-relief on such savings, the income is tax-free and it does not count towards higher age-related personal allowances.

The annual £10,200 ISA allowance will rise with inflation from next year.

Maximum Investment Plans are again catching the attention of wealthy investors.

These policies are essentially short-term endowments which have fallen out of favour due to their high front end charges.

But as providers come back into the market it is expected that the charges will be lower.

The attraction for higher rate taxpayers is that, if set up for a minimum of ten years and held for at least seven-and-a-half years, these plans will not be subject to higher rate tax on returns.

The returns are taxed at basic rate at source and there is no further tax to pay.

VCTs (Venture Capital Trusts) offer worthwhile tax breaks. Investors receive 30pc income tax relief on annual contributions of up to £200,000, provided the VCT is held for at least five years and there is no tax on gains or dividend income.

EISs (Enterprise Investment Schemes) like VCTs typically invest in early stage companies although they receive only 20pc income tax relief.

The main benefits are that there is no liability to capital gains tax and investors can put in up to £500,000 a year. EIS shares are also exempt from Inheritance Tax when held for two years.

Investor's Notebook

FUNDSMITH, the low-cost fund developed by City *enfant terrible* Terry Smith *(please see our leader column on the front page)* was launched on November 2 and retail and institutional clients are offered a long-term, buy-and-hold strategy using a portfolio of about 20 shares.

It will avoid companies that need leverage, looking instead for businesses that have unique assets, have a long record of resilience and are attractively valued.

★★★★★

BRITONS selling holiday homes in Europe could have seen almost £13,000 wiped off the value of a typical property in November after the euro plummeted on fears that the Irish debt crisis could spread.

★★★★★

UK's MUNICIPAL BOND market could be revived following the government's decision to raise the interest rate at which local authorities can borrow from the PWLB from 0.2pc to 1pc above gilt yields and the reduction of councils' capital funding by 45pc

The UK muni-bond market fell out of favour in the 1980s when it was undercut by the Public Works Loan Board, which lent £5bn in the last financial year.

★★★★★

TAX-FREE savings plan "The Junior ISA" will replace the Child Trust Fund and will become available in August 2011.

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Focus on fund costs

EXCESS charges levelled on investors by fund managers are attracting growing criticism and the government's proposed Retail Distribution Review (RDR) which will banish commission payments, is drawing more attention to the problem.

In response, the gathering popularity of Exchange Traded Funds, whose annual charges typically average less then 0.5pc compared with about 1.5pc is already demonstrating investors' readiness to switch.

More positive action has been the establishment in the UK of low-cost index funds of which the most recent has been that of Vanguard, an offshoot of the American fund group of that name, which was set up last year.

Now Mr Terry Smith, well known in the City as author of Accounting for Growth, the ground breaking exposure of dodgy accounting practices, has relinquished his position as deputy chairmen of Collins Stewart, Britain's biggest stockbroker, to launch his own low-cost index fund.

We support the campaign for low-cost investing but its success is likely to depend more on investors' awareness and initiatives than on any other factors.

We survey the battleground in this issue.

Mortgages:

NEW rules are to be introduced by the Financial Services Authority next year which will make it harder to obtain a house mortgage.

The strict new regime could mean that a significant number of borrowers will have few options to move their existing loan.

Low-cost pensions at work for millions to start in 2012

NEW workplace pensions reform to be introduced by the Department of Work & Pensions (DWP) in 2012 is designed to encourage employees to acquire the savings habit.

The DWP estimates that about seven million workers are not saving enough to deliver the retirement pension they will require.

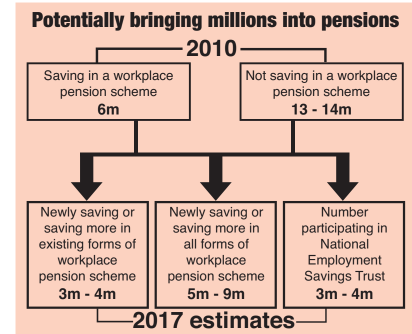
The reform will bring to fruition NEST, the National Employment Savings Trust, which was mapped out in 2005 by the Turner commission.

Starting with the biggest companies in 2012 all employers will be required by 2016 to enrol the majority of their workers into a pension scheme.

Companies and employees will be required to contribute a combined minimum of 8pc of earnings within a given pay band.

Employees will retain the right to opt out. But depending on how many do so, between 4m and 8m people could be saving in a pension for the first time.

Employees will be enrolled in NEST once they earn about £7,500 a year – though they will pay contributions on earnings above about £5,700.



They will put in a minimum of 4pc of pay up to a maximum salary - £33,500 in 2006 prices.

Tax relief will add 1pc and employers will add a minimum of 3pc.

Success, would mean that some 13m private sector employees could then be saving in a workplace pension for the first time.

Employers will be required to offer a pension at least as good as NEST.

About 750,000 employers who do not already offer their workers a pension scheme will now have to do so.

While the original proposal was that employees should be enrolled once their earnings topped the £5,700 threshold at which NIC starts to be paid, automatic enrolment will not start until the income tax threshold of about £7,500 is passed – although contributions will be paid on earnings above the £5,700 threshold.

US second print good for equities

FED Chairman Ben Bernanke's second attempt at restoring the US economy with a relatively modest extra $600bn of asset purchases (known as "quantitative easing" or QE2) was greeted by near universal condemnation as being inflationary and unnecessary.

The UK's decision on whether to follow with its own QE2 was postponed but it could be influenced by the crisis over the euro and especially by Ireland's difficulties.

With exports to Ireland accounting for 7pc of UK overseas trade those difficulties could have a direct impact on the UK's continued economic recovery which saw a GDP increase of 0.8pc in the third quarter, twice as fast as expected.

Despite the criticism of Mr Bernanke some commentators conceded that he was, at least, honest.

"Higher stock prices, "he wrote in the Washington Post, will boost consumer wealth and help increase confidence, which can also spur spending."

More cynical commentators described the move as the "Bernanke Put", so called because it encourages speculators to take out put options on shares to enable them to sell at higher prices later.

But despite the criticism most economists recognised that the decision could have some merit if only that it forced down the value of the dollar to help American exports.

All accepted, however, that the printing of an extra $75bn each month to July 2011 on top of the $1.7tr already in the system is building up a huge inflation problem for the future – not just in the USA and the western world but also, and especially, for the emerging markets.

In this issue

"Mutual funds were meant for folks with a small pool of money. But at a price. A big one."

THESE words by billionaire Ken Fisher, fund manager, author and columnist for Forbes Magazine for over 30 years, summarise the gathering contention in the UK concerning mutual funds and their charges.

In that magazine column Fisher concluded: "Everyone knows that the average fund hasn't kept pace with the market. Here's why.

"Funds tend to be overweight in small companies, underweight in large ones. There could be a lot of reasons for this but a big one is probably just that it's bad for the portfolio manager to justify a fat money management fee if he owns only big, obvious stocks".

Fisher and others, notably John Bogle, another American billionaire and founder of the Vanguard Fund, have pioneered the agitation in the US for lower fund charges which has earned the acclamation of investors who have readily switched into low-cost index funds.

It seems probable that one of the reasons why UK funds have been able to impose their charges for so long without challenge from investors is that there is widespread confusion about their significance and impact.

Annual charges in funds are commonly expressed in percentage terms and a typical annual charge is 1.5pc. That is, 1.5pc of the annual increment expressed as the fund's performance.

That, to the mathematically challenged, seems to be quite a small, almost negligible figure. In fact, on a return of 6pc a 1.5pc charge is actually 25pc.

Investors might also be surprised to learn that one of the biggest expenses incurred by funds each year is the cost of the annual turnover of the portfolio.

It has been demonstrated beyond argument by John Bogle of the Vanguard Fund and many others that stock turnover is always counter-productive and that funds as well as individual investors would achieve a more satisfactory performance by simply holding the shares.

A study by Morningstar found that few managers were able to improve returns significantly through portfolio turnover, but that on balance, the tiny increases in return that turnover may have engendered were gained only by buying riskier stocks.

Even so many UK funds routinely have an annual stock turnover as high as 80pc in their efforts to beat other funds rather than to benefit their investors.

The cost of that rate of turnover adds another 1.5pc a year to the charges which are not included in the total expense ratio.

Equity review

Dividends not growth are the rational aim

BY restricting their portfolio selections to FTSE 100 companies with dividends yielding 5-6pc independent investors have enjoyed a sound income stream this year which seems to have a very good chance of continuing.

Global earnings are, of course, the key to most of them and all essential information concerning yield and, if necessary price/earnings ratios, can easily be obtained through any broadsheet newspaper or even The Times.

Although **BP** fell out of the picture but might soon be restored, others like **Vodafone, Aviva, National Grid, United Utilities, GSK,** and **Royal Dutch Shell "B"** have performed as expected.

All of these shares are worth buying at current prices and they could make a sound basis to a self-invested pension.

Most of them are to be found among the core portfolio holdings of many equity income funds which charge investors an entry fee of 5pc plus an annual fee of 1.5pc.

Fees charged by high street brokers are modest in comparison. On-line brokers charge even less.

Display advertising frequently recommends funds for growth and thereby points investors in that direction to their eventual disadvantage.

Income is the rational target for equity investors at present - reinvested over the long term it should provide adequate growth.

Pension shock for top earners

AN estimated 100,000 top earners will face big tax bills on a part of their pension savings in a Treasury move that will also hit some long serving members of defined benefit schemes on more modest salaries.

Most of those affected earn more than £100,000 a year but about 20,000 people earning less than that will also suffer from the measures designed to help close the country's huge budget deficit.

Under the new rules, which become effective next April, the annual limit on tax-advantaged contributions to a pension plan will be £50,000 - sharply lower than the current £255,000 annual cap.

The maximum amount that can grow tax-free in a pension fund has been lowered from £1.8m to £1.5m and there are no plans to allow either ceiling to rise in line with inflation.

But HMRC also introduced a rule allowing people to carry forward any unused pension allowances from the previous three years.

This leaves many high earners sitting on unused allowances that could be carried forward to next year, resulting in a one-off pensions windfall.

Defined benefit

The new rules for defined benefit scheme members are less onerous than many feared.

Each additional £1 of pension benefit will be subjected to a multiple of 16 to arrive at a notional capital value for the new benefit earned in any tax year.

Where the new rules will bite the not-so-rich is at the point at which a long-serving employee with a DB pension gets a pay rise that is significantly higher than the consumer price index of inflation.

Future inflation or deflation?

ECONOMISTS are warning that the outcome of the UK's economic recovery could be either inflation or deflation.

Few people have any clear idea of which to fear most but those over a certain age and resident in the UK remember the inflation of the 1960s and 1970s.

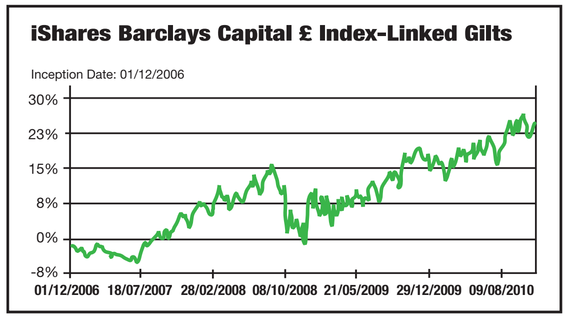
At least, they survived. So maybe it is deflation that we should fear and deflationist economists see parallels with Japan, where it has gripped the economy for the last twenty years.

The cost of living there remains static and the elderly and retired can get by on their pensions and savings.

But Japan's handling of its economic problems in the 1990s was more desultory and much less effective than the reaction of the US and UK in 2008.

So Japan's economy stagnates without sign of recovery and survives largely on the savings of its thrifty population.

Inflation in the UK is already causing alarm to the Bank of England's Monetary Policy Committee (MPC) with the Consumer Prices



Index continuing to exceed expectations at 3.1pc compared with its target of 2pc.

In spite of this there are already MPC members calling for a renewal of QE, following the US lead, in the hope of speeding the UK's economic recovery.

With $65bn of extra money each month now flooding into the world's markets, in addition to the $1.7tr and the £200bn already poised to make their effect, there can be no room for doubting that inflation will be the problem for much of the world for several years to come.

Inflation protection of savings through index-linked National Savings (NS&I) products is no longer possible but index-linked Gilts (government stocks) remain a popular method of mitigating inflation.

Our graphic shows how the market value of I/L Gilts has grown since they were first issued.

Holders of I/L gilts should ponder the likely effect on their holdings when, if ever, interest rates begin to rise.

Many people are likely to find that equities will provide a more satisfactory protection against inflation.

Women gain most in pension reform

MERGER of the basic state pension with state second pension will ensure that everyone will receive a single pension of about £140 a week.

Currently pensioners can receive a basic state pension of up to £97.65 for a single person and £156.15 for a couple, state second pension (S2P, formerly Serps) and extras such as the winter fuel allowance.

People with small private pensions and low level of savings are also entitled to receive pension credit, bringing their income up to at least £132.60 for a single person or £202.40 for a couple.

Women

Under the new regime women, receiving a basic £140, will be the biggest group of winners, particularly for home mothers.

At present, broken work records through bringing up children mean the average basic state pension for women stands at just £70.26 compared with £83.74 for a man.

Women's average S2P/Serps payment is just £15.50 a week, almost half the £28.71 paid to men.

Self-employed

They receive no state second pension at all. Their income would increase from a maximum basic state pension of £96.75 to £140 a week.

As they currently pay lower NIC than PAYE employees, they could see their contributions increased to reflect the extra benefit they will receive.

Money Digest

RECENT personal finance pages have featured:

INVESTORS are urged to challenge fund managers to justify fees that wipe nearly 40pc off the returns of the average investment.

The investment industry is expected to grab as much as £10bn in charges this year.

– David Budworth, The Times

★ ★ ★ ★ ★

THE average mutual fund manager has an annual turnover of 80pc a year, costing the investor a further 1.5pc that is not included in the total expense ratio.

Yet Vanguard funds cost as little as 0.2pc a year, SCM Private funds are 0.75pc and 7IM charges 0.6pc a year.

- Alice Ross, Financial Times

★ ★ ★ ★ ★

A WHIFF of inflation is one thing – the best of times if kept in the 2pc range. Let it hit double digits and we will feel as if we are living in the worst of times.

– Irwin Stelzer, Sunday Times

★ ★ ★ ★ ★

THE Fed now estimates that in early 2008 shadow banking was $20,000bn in size dwarfing the $11,000bn traditional banking system. And though this shadow system has now shrunk to a "mere" $16,000bn, this remains bigger than traditional banking at some $13,000bn.

- Gillian Tett, Financial Times

★ ★ ★ ★ ★

BEHIND the fog of misinformation about deflation the authorities in London and Washington are presiding over a cynical attempt to reduce state debt by stealth: they are betting on "controlled" inflation because it's more agreeable than austerity and less humiliating than default.

– Jeff Randle, Daily Telegraph