May 2021 Client Newsletter

Over 4,100 funds spread across 52 sectors

In April 2021, the Investment Association (IA) announced a major restructuring of the way in which it lists its members' funds. If you ever look at the investment league tables that appear in the weekend press, you need to know what has happened. That means considering two distinct reforms.

The inclusion of exchange traded funds

Until the IA made its change, its sector coverage was limited to UK based funds (unit trusts and open-ended investment companies – OEICs) and a limited number of offshore funds with a similar structure. This approach had become increasingly unrealistic as the popularity of exchange traded funds (ETFs) had grown.

ETFs have been around since 1993, starting life in the USA and first appearing in the UK seven years later. The ETFs included in the IA sectors are very similar to OEICs, and, for regulatory purposes, are classed as such. However, there is one major difference between the typical OEIC fund and an ETF:

- OEIC fund prices are normally fixed once a day by the fund manager, based directly on the value of the underlying investments. All fund dealing goes through the manager and takes place at a single point in the day.
- ETFs are traded on the stock exchange, so the price is determined by the market in real time, with dealing throughout the day. In practice, the way in which ETFs operate mean that normally their trading prices fully reflect the underlying value of the investments.

With few exceptions, ETFs are index-tracking funds. However, that does not mean you are limited to funds linked to the FTSE 100, S&P 500, MSCI World and similar broad market indices. ETFs long ago reached the stage where the index creators design appropriate indices for ETFs to use. Thus, for example, there are a range of equity income ETFs tracking dividend-driven indices.

Another 13 sectors

ETFs were originally purely share-based funds; the first fixed interest ETF did not emerge until 2003. Since then, fixed interest ETFs have proliferated to become an important part of the ETF market. The size of their impact can be seen by the fact that when the IA decided to include ETFs, it found that if it had made no other changes, the Global Bonds sector would have increased in size by 50% through the addition of 129 ETFs.

The IA's solution was to replace its catch-all Global Bonds Sector with 13 new bond sectors covering individual bonds markets, such as Euro High Yield and Global Inflation Linked. The net result is that the total number of IA sectors, including a large Unclassified sector, is now 52 – one for each week of the year.

Knock-on effects

Expanding the number of sectors and adding over 530 ETFs to those sectors means a change to the league table constituents. For example, 79 ETFs joined the Specialist sector and 71 made their way into the Global Sector. As a result, a non-ETF fund's ranking could change because there are more (mostly index-tracking) competitors in its sector, or, in the case of former Global Bond funds, it has moved into a new sector.

Another consequence is that there are changes in historic rankings between sectors. Thus, the newly created USD Government Bond sector now counts as the worst performing sector in 2017… and the best performing sector in the following year. What was that about past performance being no guide to the future?

ACTION

The proliferation of funds and sectors, with assorted changes to rankings, makes it more important than ever that you seek advice before investing.

If your existing fund holdings have not been reviewed for some time, or your investments goals have changed, talk to us now.

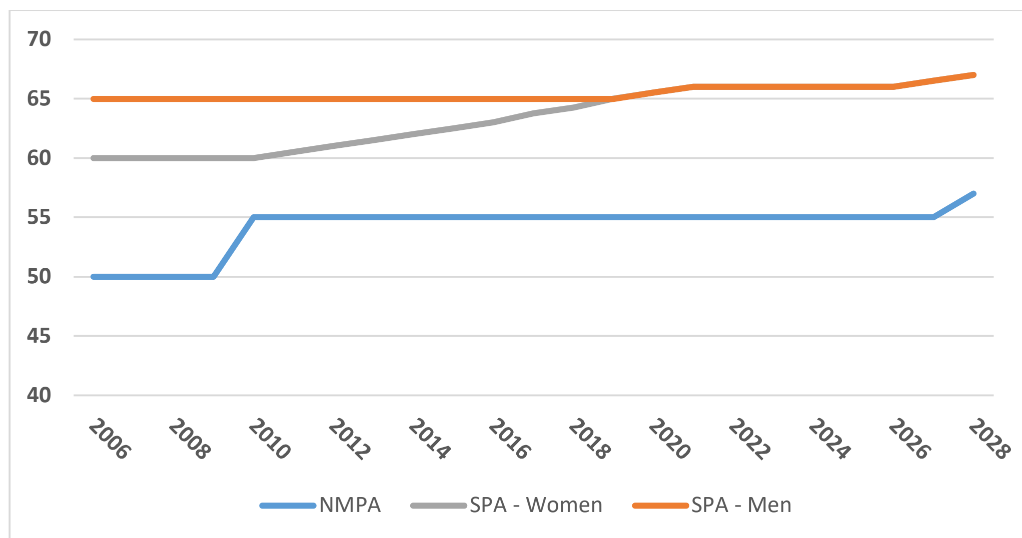
Another pension age change

The start of the next increase to state pension age (SPA) is still nearly five years away, at which point it will be phased up to 67 by April 2028.In the meantime, the Government has confirmed a rise in pension age for private pension provision that was originally suggested in March 2014.

The normal minimum pension age

The increase is to be made to the normal minimum pension age (NMPA). This is the earliest age from which non-state pension benefits can be drawn, subject to very limited exceptions. The current NMPA is 55, set in 2010 as 10 years below the then male SPA of 65. The new NMPA from 2028 will be 57, 10 years below what by then will be the SPA for both sexes.

Changing pension ages



The Government has indicated that there will be exceptions to the higher NMPA covering:

- Members of the armed forces, police and fire services pension schemes, who will have a 'protected pension age' of 55;
- Anyone who has a protected pension age for scheme benefits arising from the last increase in NMPA; and
- Anyone who, on 11 February 2021, had a right under a pension scheme to draw benefits before age 57. In this context, the right has to be unqualified, i.e. there must be no requirement for consent from any other person, such as a trustee or employer. It will also apply on an individual scheme basis, so you might find some benefits can be drawn before 57, while others cannot because consent is required.

It would appear that if you have a personal pension established by the February cut-off date, you will generally meet the 'unqualified right' requirement, giving you a protected pension age of 55. However, some experts believe this could change when the necessary legislation emerges. When the previous NMPA increase was made, there was no such protection for personal pension owners.

Born between April 1971 and April 1973?

If you were born on 6 April 1973, you are potentially the worst hit by the change, unless you have benefits that are subject to a protected pension age. That is because you will reach your 55th birthday on the very day the NMPA increase to 57 takes effect – unlike the changes to SPA, there is no phasing in of the change. If you were born in the preceding two years, you will be in the odd position of being able to draw benefits at age 55 until 5 April 2028, but then need to wait until you reach age 57 before setting up any new drawings from you pension.

A realistic retirement age?

The idea of retiring at 57, yet alone 55 may sound appealing, but is it at all realistic? Consider these two factors for a start:

1. At age 57, the average man has 27 years of retirement ahead of him, while the average woman has 30, according to the Office for National Statistics. 1 in 4 of those men will live until age 92, the corresponding age for 25% of women is 94.
2. From 2028, there will be a gap of at least 10 years before your state pension starts. With the current state pension of £179.60 a week, that means an income hole to fill of at least £93,400 (plus inflationary increases).

A recent report showed that the average age of those 'retiring' in 2021 was 60. However, it also revealed:

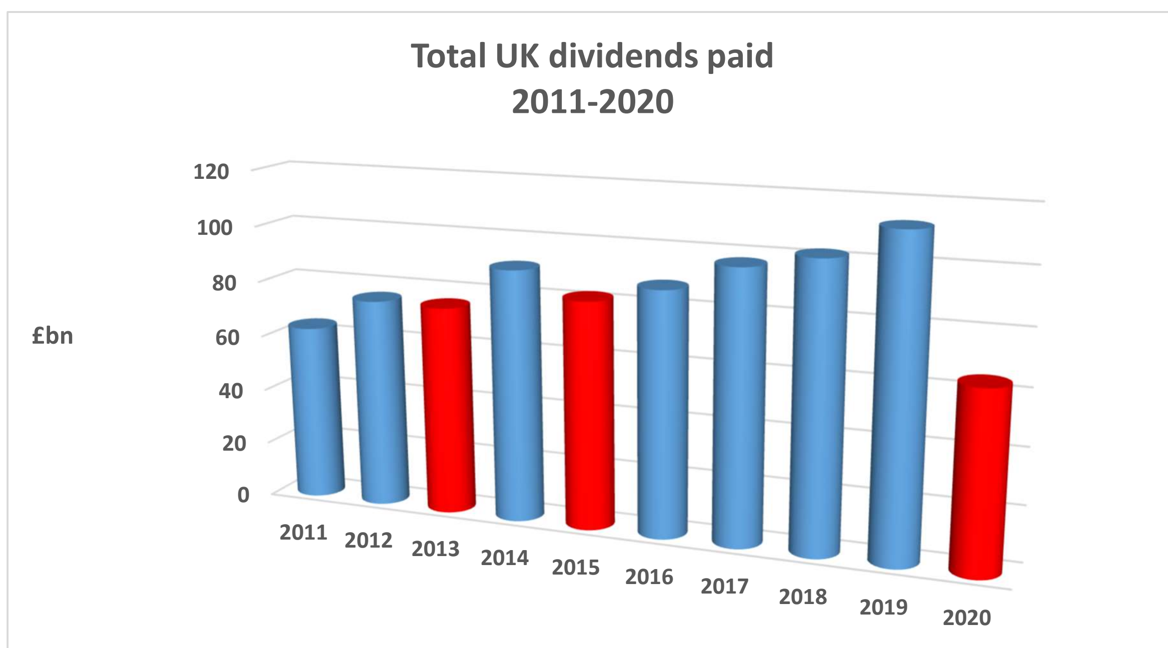
- 37% had brought forward their retirement in the past year, with the three main reasons being pandemic related;
- 27% will work part time to support themselves in retirement;
- 37% were worried about not having enough money to last through retirement;
- Two thirds of retirees risked running out of money in retirement according to calculations by the report's authors, even though the planned average total spend was a modest £21,000 a year.

ACTION

The change to a normal minimum pension age of 57 is largely irrelevant – few people can afford to retire so early – but it might affect you if you plan to draw some benefits early, e.g. to clear a mortgage.

Are you sure your planned retirement age is not going to leave you among those two thirds who might run out of money before they run out of life? Ask us for an impartial assessment now – the sooner you know where you are, the quicker you can, if necessary, make the necessary adjustments.

The dividend picture brightens



If you hold funds designed to provide income from UK shares, you probably do not need reminding that 2020 was a grim year on the dividend front. Indeed, by the final quarter of the year, the IA's worst sector in terms of net retail sales was UK Equity Income.

What happened?

In a word, the pandemic. In 2019, the total amount of UK dividends paid out rose by 10.8% over the previous year, helped by some large special (one-off) dividends. 2020 started off looking as if dividends would grow more slowly, but nobody foresaw the drop that happened.

The pandemic was especially bad news for two sectors which account for a significant slice of dividend payments: banking and oil. In March 2020, the Bank of England told the major banks that it regulates to stop dividend payments immediately in order to preserve cash. That act alone accounted for 30% of the £44.8bn drop in dividend payments for the 12 months ending on 31 March 2021 - the year of Covid-19 – according to Link Group, one of the UK's leading share registrars.

The oil companies were under a different cosh; a collapse in both oil prices and in demand. For some while there had been speculation that the UK's two oil majors, BP and Shell, would have to cut their dividends, but the pandemic gave them a green light to make much larger cuts than anticipated. Shell's quarterly dividend dropped by almost two thirds, while BP's halved. The oil sector accounted for a quarter of that £44.8bn dividend decline.

Across the pandemic year, two thirds of all UK listed companies either cut or stopped dividends. Probably not all the cuts can be blamed on the pandemic. For some companies that had been paying out too much of their profits to shareholders, Covid-19 offered useful justification for surrendering to the inevitable. Others took a super-cautious approach and suspended dividend payments until the picture was clearer.

The UK saw one of the biggest global drop in dividends in 2020, partly because of the types of company it is home to. The european market suffered about three quarters of the UK fall, while North America managed a small increase – a reminder of the benefits of international diversification.

The view ahead

With the roll out of vaccines now well underway, the uncertainties facing UK businesses are much reduced, although they have not disappeared. The Bank of England has given the banks permission to resume dividend payments, but at lower than pre-pandemic levels. All have taken the opportunity. Shell has even started to modestly increase its dividend.

In the first quarter of 2021, total dividend payments were higher than the corresponding quarter of 2020. However, this rosy picture is a distortion created by the unusually large value of special dividends paid in the first three months, £5bn of which came from Tesco alone following the sale of its Asian business. Underlying dividends (i.e. excluding the specials) were down 26.7% year on year, an improvement over the 39.0% drop of the previous quarter.

For the second quarter of 2021, the underlying dividend comparison should change dramatically, if only because the year ago figure will be the quarter in which the pandemic had most impact. In the latest edition of its quarterly dividend monitor, Link Group says that "Companies are increasingly declaring dividends roughly in line with our best-case scenario for the year'. Its best-case forecast for 2021 is that underlying dividends will increase by 5.6%, while best-case total dividends is a rise by 17.2%, again chiefly due to Tesco's Q1 bumper payout.

ACTION

UK shares continue to offer an attractive income return compared to other asset classes – close to a 3% yield at the time of writing.

Selecting an income fund is about much more than simply looking for the highest current yield. For more information on choosing equity income funds – both UK and global – please talk to us.

The incorporation question

The Chancellor's plan to increase the main corporation tax rate from 19% to 25% in April 2023 has once again brought into focus the question of whether it makes sense to incorporate your business if you are currently self-employed. Although tax alone should not be the determinant, it can be a major factor in many instances.

Crunching the numbers

The first point to note is that the 25% rate will generally only apply for companies with profits of at least £250,000. Up to £50,000 of profits, the current corporation tax rate of 19% will continue, albeit labelled a small companies' rate. In between those limits, the tax rate will be 19% on the first £50,000 of profits and 26.5% on the excess. This can mean that if you incorporate when your profits are modest, you may regret the move if your business starts to make more money.

How you draw income from your company will determine your overall tax bill. In the examples below, we have assumed:

- All of the profits will be drawn. This makes the picture consistent with the self-employed alternative under which all profits are taxed.
- You draw a salary of £8,840 a year from your company. At this level neither you nor your company will have any National Insurance Contributions (NICs) to pay.
- All your profit, after deducting your salary, is taxed at corporation tax rates and then paid to you as a dividend.
- The first £2,000 of your dividend is free of tax thanks to the dividend allowance, but still counts as part of your total income for tax purposes.

Let us first look at a profit of £75,000:

	Self-employed	Company	
	£	2021 £	2023 £
Gross profit	75,000	75,000	75,000
Less Salary	-	8,840	8,840
Taxable profit	75,000	66,160	66,160
Less Corporation tax	-	(12,570)	(13,782)
Net profit = Dividend		53,590	52,378
Less NICs	(4,316)	-	-
Less Income tax	(17,432)	(6,629)	(6,235)
Net income	**53,252**	**55,801**	**54,983**
Gain/loss on incorporation		+2,549	+1,731

Now, double the profit to £150,000:

	Self-employed	Company	
	£	2021 £	2023 £
Gross profit	150,000	150,000	150,000
Less Salary	-	8,840	8,840
Taxable profit	150,000	141,160	141,160
Less Corporation tax	-	(26,820)	(33,657)
Net profit = Dividend		114,340	107,503
Less NICs	(5,816)	-	-
Less Income tax	(52,460)	(30,616)	(27,362)
Net income	**91,724**	**92,564**	**88,981**
Gain/loss on incorporation		+840	-2,743

The higher profit level highlights the impact of the corporation tax change: at £75,000 the corporation tax bill increases between 2021 and 2023 by 9.6%, but at £150,000 the bill jumps by 25.5%.

Conclusion

If the corporation tax increase goes ahead – and there are voices suggesting it might be tweaked nearer the time – then on tax grounds the case for incorporation will be weakened, particularly at higher profit levels. However, as mentioned above, tax is not the only consideration.

ACTION

The numbers above are for two specific profit levels. Comparative calculations are complicated by the phasing out of the personal allowance, so there is no straight line between the £75,000 and £150,000 results.

The corporation tax move is another step on the slow path to rationalising the taxation of earnings between employees, the self-employed and owner directors. For a review of your personal situation and the tax saving opportunities available now, please talk to us.

Past performance is not a reliable guide to the future. The value of investments and the income from them can go down as well as up. The value of tax reliefs depend upon individual circumstances and tax rules may change. The FCA does not regulate tax advice. This newsletter is provided strictly for general consideration only and is based on our understanding of law and HM Revenue & Customs practice as at 28 May 2021 and the Finance Bill 2021. No action must be taken or refrained from based on its contents alone. Accordingly, no responsibility can be assumed for any loss occasioned in connection with the content hereof and any such action or inaction. Professional advice is necessary for every case.