NORTH CAPITAL

# Spotlight:

## Portfolio protection whilst maintaining equity exposure

## Pension planning

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# Portfolio protection whilst maintaining equity exposure

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As global equities continued to hit new highs over the summer, investors are understandably becoming nervous about what lies ahead. Preserving capital forms part of growing capital, and if one can avoid significant drawdowns, as part of a long-term growth plan, so much the better. However, calling market peaks and troughs is notoriously hard, so we would never advocate trying to time entry and exit points. That said, there are ways in which investors can still maintain exposure to equities whilst taking a little less risk. Strategies include favouring fund managers that have a defensive style of management; passive funds that screen for lower volatility stocks; or engineering a return from the market through a structured product. Here we will discuss a few of these strategies.

### Defensive fund management

A portion of fund managers believe that a portfolio that suffers fewer and less destructive drawdown will be in a better position to compound returns over the long run. These managers will tend to invest in quality businesses with the following characteristics:

- **Strong pricing power:** Essential products and services.
- **Stable franchise:** Sticky customer relationships; high switching costs; few/no rivals.
- **Barriers to entry:** Unique intellectual property (IP); cost advantages; high regulatory hurdles.

This will likely lead to businesses that have stable and recurring revenues, predictable growth and high free cash flow (a measure of profitability). An example fund that invests in this way is the Troy Trojan Income Fund. The fund invests in predominantly UK equities. Stocks within the fund, which exhibit many of the above characteristics, include: Unilever, Croda, Experian and Intertek. Over the long-term, the fund has provided solid compounding returns to investors and importantly cushioned drawdowns during periods of significant market stress (e.g. COVID stock market fall in 2020, and the financial crisis in 2008).

You might think this is an eminently sensible approach to have for much of your equity investments, but it can mean forgoing strong long-term returns, as investors tend to miss out on high growth companies as well as those companies that present good, shorter term, value for investment.

### Lower volatility stocks

In a similar vein, if you are looking for companies to help reduce risk in your portfolio, screening for low volatility might help you in your quest. Factor investing, which screens for specific types of stocks, such as quality, value and low volatility has become a popular investment approach in recent years.

The low volatility factor has consistently shown to deliver equity market like returns, but at lower levels of volatility than a basket of stocks.

What we see from the data, is that during good times – when equity markets are very buoyant and volatility is low – investors in low volatility stocks still participate in much of the upside. The real value of this investment approach comes in the downside protection that has been shown historically, where screening for low volatility stocks has seen investors suffer far less significant falls during periods of market stress. Accessing this style of investing is predominantly done through a passive (factor driven) approach, through funds such as the iShares MSCI World Minimum Volatility ETF.

### Structured products

Structured products have been available to investors for the last couple of decades under various guises. Essentially, they are investment products, typically sold through banks, that seek to provide a more defined return profile, than investing directly in equities. For example, if an investor had a view that equity returns were going to be relatively flat over the next 3-5 years, a product could be created to generate a return of 6-7% per annum in such an environment. Alongside this, investors can receive a degree of capital protection (up to a 40% fall in the index). Whilst this may seem too good to be true, investors do need to sacrifice a few things as part of this: they forgo dividends on their investments (which, in the case of the FTSE 100, is around 3%); they (in some cases) take on the issuing bank credit risk; and they do not receive upside in excess of this – should the underlying index (FTSE 100, for example) perform better than the product defined return (in this case 6-7% per annum).

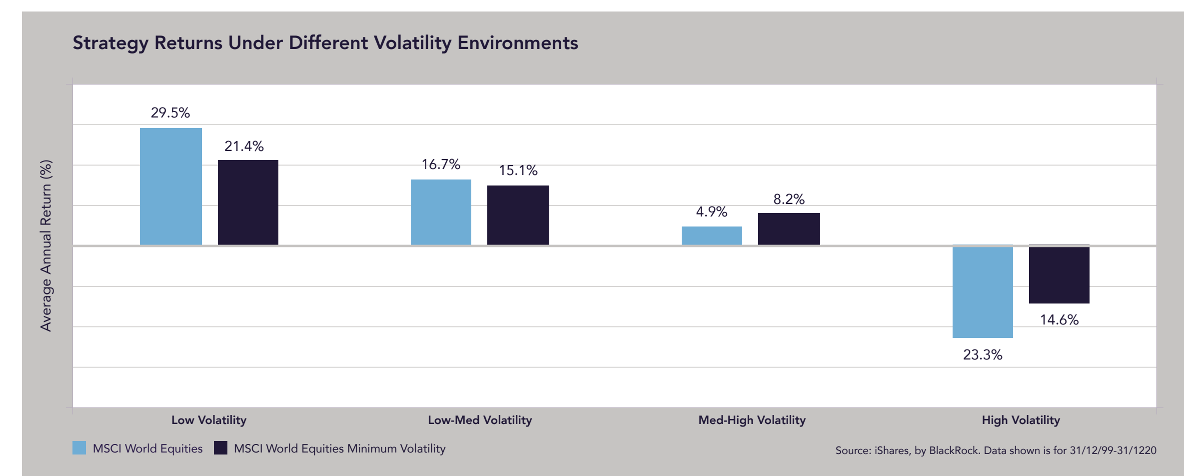
***How do they work?***

Structured products are created using a bond from the issuing bank (e.g. HSBC) and a package of derivatives to create the designed payoff structure. The payoff structure may be an enhanced performance of an equity index (e.g. super tracker); benefiting from a range bound market (e.g. range accrual or autocallable); or generating a return providing an index does not fall below a certain level (e.g. synthetic zero). These would be individual products tailored to a client's specific views.

In recent years, there have also been unitised funds created that are a professionally managed package of structured investments. The most popular being a fund of autocall structured products. An autocall is a structured product that pays a high coupon if the underlying – typically one or more equity indexes – is above a predetermined level at annual observations dates, at which point it automatically matures and the investor's principal is returned, alongside any potential coupon return.

Defensive features can be incorporated into the products, where equity indices may be some way below their initial level and the investors can still receive a return. Two examples of funds in this space are the **AHFM Defined Return Fund** and the **Fortem Progressive Growth Fund**.

We have introduced exposure to these strategies in our discretionary range recently and whilst we are confident that current valuations are underpinned by robust earnings, we feel exposure to these approaches helps to diversify return, particularly through bouts of increased volatility.



# Striking the right balance with your pension planning

It must be said, pensions are definitely not the most exciting topic for a spotlight article. However, pensions are complex, often misunderstood and the relevant pension legislation is nigh-on impossible to decipher. Pensions provide benefits that are worthwhile understanding and perhaps beyond the standard notion of an income stream in one's 'twilight' years.

**Christian Poziemski**
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This article does not attempt to cover every aspect of pension advice, but instead aims to outline the basic concepts of how you might make your pension work best for you. As with most things in life, with pensions there are options. Hopefully, this article will raise questions in your mind about how you wish to treat your pension. For example, you may choose to access your pension savings or alternatively consider preserving these assets as part of a transfer of wealth to the next generation. Inheritance Tax (IHT) planning is a key focus for our clients and the potential use of the pension pot forms an integral part of that discussion and we hope this article will provide food for thought and will aid future planning discussions.

Pensions are a tax-efficient savings vehicle which allows individuals to make annual contributions of up to £40,000. The carrot on HM Revenue and Customs' stick is the incentive of income tax relief on personal contributions and corporation tax relief on employer-sponsored contributions. Personal contributions receive basic rate tax relief with the ability to claim additional tax relief up to your marginal rate of income tax via the self-assessment tax return. Additionally, investment gains on the underlying pension assets are free from capital gains tax (CGT) as well as being ringfenced from inheritance tax (IHT).

You can access your pension during your lifetime and/or bequeath the benefits as part of a wider succession strategy on death. The current statutory minimum age for accessing your pension savings is 55, but this is due to rise to 57 in 2028.

Importantly, it is not necessary to retire to take benefits from your pension savings. Since 6 April 2015 (Taxation of Pensions Act 2014), individuals have been able to take as much or as little from their pension from the time they have reached the minimum age.

There are many different types of pensions but, following pension simplification on 6 April 2006 (referred to as A-day), there are two main types of pension schemes.

Firstly, Defined Benefit (DB), more commonly known as Final Salary pensions. The value of DB savings is based on time served and an applicable salary. DB benefits are sometimes referred to as 'gold plated' as they offer a guaranteed pension income for life regardless of the performance of the underlying investments. This guarantee is expensive and not surprisingly, new schemes are few and far between.

DB schemes are governed by their applicable scheme rules and primarily offer access to a guaranteed income. On the death of the pension member, a proportion of the income can pass to the surviving spouse or a dependant. However, unlike a personal pension, the underlying value of the pension asset cannot be passed to a nominated beneficiary.

The second is the Defined Contribution (DC) pension, also known as money purchase pensions. DC pension values are based on the total contributions and the underlying investment performance.

From a succession planning perspective, a consideration may be to review existing DB benefit to determine the suitability of a possible transfer of the underlying value to a personal pension scheme. By doing so, the DB assets are not 'lost' on the death of the surviving spouse, remain ringfenced for IHT and can be preserved for future beneficiaries.

### Annual Allowance

Pension contributions can be paid by an individual, an employer or by a third party. The maximum contribution that is eligible for tax relief is the greater of £3,600 p.a. or 100% of your employment income.

The annual allowance is the total amount you can contribute during a tax year without incurring a tax charge. The annual allowance is currently set at £40,000.

In addition to receiving tax relief, pension contributions can also help regain some or all of your income tax allowance (£12,570 p.a.). The personal allowance is reduced by £1 for every £2 of income above £100,000 resulting in an effective rate of tax of 60% for income between £100,000 to £125,140.

The example below shows the impact of that a pension contribution of £10,000 (gross) would have for an individual with an income of £110,000:

| | Before | After | Difference |
|---|---|---|---|
| Gross Income | £110,000 | £110,000 | - |
| Tax | £33,432 | £27,432 | £6,000 |
| Balance | £76,568 | £72,568 | £4,000 |
| Pension | £0 | £10,000 | £10,000 |

This means that for £4,000 less net income, the investor has managed to add a further £10,000 to their pension savings. The contribution has the effect of regaining the allowance, thereby increasing the amount of tax-free income as well as increasing the basic rate band. A contribution of £10,000 has saved £4,000 in tax and received tax relief in the pension of £2,000 – an effective rate of tax relief of 60%!

### Lifetime Allowance

The Lifetime Allowance (LTA) was first introduced in 2006 and is the amount of pension savings that can build up in a tax-advantaged environment. The current LTA is £1,073,100 and is measured against the aggregated total of all pension savings. If your pension savings are within the LTA, no tax charge will be levied. Any excess is subject to a 'lifetime allowance excess tax charge' of 55% or 25% depending on how the assets are drawn. Since the introduction of the LTA, it has been possible to protect the LTA at a higher level and therefore your available LTA may be much higher.

The value of your pension assets will be tested against the LTA at one of 13 specific events (typically when the pension comes into payment) known as Benefit Crystallisation Event (BCE). Should you decide to pass on your pension assets to the next generation, the LTA test will take place at age 75.

Pensions that are in drawdown will be re-tested at age 75 on the growth of the fund following the prior LTA test. A member's death will trigger a BCE regardless of age, except where the pension assets have previously been tested at age 75.

### Taxation

| | |
|---|---|
| Capital Gains Tax (CGT) | Not applicable. CGT does not apply on the growth of the underlying pension investments. |
| Inheritance Tax (IHT) | Not applicable. IHT does not apply for assets that remain within your pension. |
| Annual Allowance Tax Charge | Payable on the total contributions you make/receive that are in excess of the applicable annual allowance at your marginal rate of income tax. |
| Lifetime Allowance Tax Charge | Payable on the value of your pension in excess of the (applicable) Lifetime Allowance at the point of accessing your pension or at age 75. |
| Tax-Free Cash | Tax-Free. Typically, 25% of the fund value or the available Lifetime Allowance. Important, once the lump sum has been paid into your estate, it will be subject to IHT. You can access your tax-free cash from age 55 until age 75 after which the option will expire. |

### Pension Drawdown – Income Options

As we said above, the key things to be aware of with your pension are your options. You have an important choice on how the benefits should be taken. The first choice to consider is whether to take advantage of withdrawing tax-free cash. If you also wish to receive a regular income, most registered pension schemes can pay an income in two different ways – as secured pension income or as flexible income. Secured pension payments are guaranteed for life and are available via a scheme pension or an annuity. If you would prefer a more flexible income a flexi-access drawdown pension may be an option to consider.

The table below lists the main income options available during a member's lifetime.

| Payment | Type | Taxation | Expiry |
|---|---|---|---|
| Secured/ Guaranteed | Scheme pension | Income | Lifetime |
| Secured/ Guaranteed | Lifetime Annuity | Income | Lifetime |
| Flexible/not guaranteed | Flexi-access drawdown | Income | Lifetime (subject to available funds) |

Flexi-access drawdown offers flexible income directly from the pension fund. Flexi-access income is not guaranteed insofar as it can only be paid if the pension has sufficient assets to meet the income requirements. Historically, income could also be accessed via capped drawdown which is no longer available as funds needed to be designated into capped drawdown prior to 6 April 2015.

### Tax-free Cash Option

As part of drawing an income from your pension, you would likely consider the withdrawal of your Pension Commencement Lump-sum (PCLS), more commonly known as tax-free cash. The PCLS is typically 25% of your fund value or up to a maximum of 25% your available LTA.

An Uncrystallised Funds Pension Lump Sum (UFPLS) offers access to some or all of your uncrystallised or unused pension as a lump sum.

One common misconception we often observe is how benefits are treated for IHT. The decision to access tax-free cash or draw an income does NOT in fact 'adversely' impact your IHT liability as the pension will remain ringfenced from IHT.

### Uncrystallised/Unused Pensions

Taking benefits from your pension is a crystallisation event. Therefore, a pension is said to be uncrystallised if the savings have not been accessed. Pension savings could also be classed as unused.

Unused (funds) is the term used by HMRC to describe funds that have not been crystallised but where the member has reached age 75. The reason the term changes from uncrystallised to unused is because they have been tested against the member's LTA and therefore, any future beneficiaries will not incur any further LTA tax.

### What happens when I die?

Upon death, your pension can pass to a dependant, a nominee or a successor. Upon death, your pension can be passed on to a dependant, a nominee or a successor. The decision on who this will pass to must be decided upon within two years following the member's passing.

Relevant to long-term inheritance tax planning, pension funds received by the beneficiary can be passed on again on their death to a nominated successor. This makes the pension an effective inter-generational IHT planning tool.

With the payment of death benefits, two factors will determine the tax treatment of the pension assets and the taxation of the benefits in the hand of the recipient.

***The factors are:***

1. Whether the member's death occurred pre or post age 75, and
2. If the pension value is in excess of the LTA.

For an uncrystallised/unused pension, where the member dies BEFORE age 75, the value of assets will be tested against the applicable LTA before the asset can be paid to the beneficiary who will have no further tax liability. If the pension fund is in excess of the LTA, the responsibility to pay the tax lies with the executors.

For an uncrystallised/unused pension, where the member dies AFTER age 75, the assets are not tested against the LTA as this will have happened automatically at age 75. Post age-75 lump-sum payments paid directly to the beneficiary are taxable at the recipient's income.

With a pension already in drawdown (capped or flexi-access), it is again relevant whether the member's death occurred pre or post age 75.

For those in drawdown, where the member's death occurs pre age 75, the payment is not subject to tax and is not tested against the LTA (as this will have already occurred at the point of crystallisation). Conversely, where the member's death occurred post age 75, the payment will be taxable. Where it is payable directly to the beneficiary, it is taxable as the recipient's income.

To draw this article to a close (thankfully I hear you say), pensions have historically been equated by the simple formula of Pensions = Income in retirement. Whilst for many this may still be the case, pensions offer additional benefits which we urge our clients to consider. These benefits are significant and are more akin to a trust. The biggest benefits are tax-free growth, inheritance tax protection and the ability to pass assets to successive generations.

You will perhaps agree with me that it is difficult to describe pensions in a nutshell. It has certainly been a challenge to avoid being overly technical, yet relevant but it is probably impossible to make it captivating.

However, we hope it has triggered your interest in your specific pension objectives and if nothing else, you may wish to consider the following questions:

1. What types of pensions do I have?
2. What is the objective for my pension?
3. Is my pension currently in line with my life ambitions?
4. What are the relative benefits of maximising my pension contributions?
5. Is it sensible to let my pension assets grow beyond the Lifetime Allowance?
6. Should I take tax-free cash if it does not affect my IHT position?
7. Do I benefit from a higher Lifetime Allowance? And if so, have I informed my administrator?
8. Should I draw assets before age 75 in advance of the automatic LTA test?
9. Do I want to leave my pensions assets to the next generation?
10. Have I nominated my beneficiaries and who should I choose in the context of a long-term IHT strategy?

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