

Investment freedom & borrowing opportunities

Our eighth Survival Guide looks at the changes in investment rules that give many pension schemes more investment freedom.

As well as traditional investments such as equities and bonds, many pension funds will soon be able to invest in residential property, works of art, vintage cars, fine wines and even racehorses. We anticipate that residential property and the more esoteric investments will only be of interest to those who have a small self-administered scheme (SSAS) or a self-invested personal pension (SIPP). There remain certain restrictions on the way that the trustees of occupational pension schemes can invest their assets.

In addition, A-Day will bring about a number of changes in relation to borrowing opportunities. Under the new rules borrowing within the SIPP market will be much more flexible.

Investment freedom post A-Day

On A-Day, the concept of permitted and non-permitted investments for SIPPs will disappear. Previously, SIPPs could only invest in a range of permitted investments which included quoted shares, futures and options, unit trusts, investment trusts and deposits. Investments in unquoted shares, most residential property, works of art and other esoteric investments were not permitted. SSASs were also unable to invest in residential property or in works of art.

Under the new regime, non-occupational pension schemes will be able to invest in what they like. Perhaps understandably, attention has been largely focused on the ability to invest in residential property (which we covered in our June Survival Guide). This has been driven by the potential tax savings available to a higher rate tax payer who owns his buy-to-let property or his holiday villa within his SIPP or SSAS.

However, it is important that investment into residential property – or any investment for that matter – is not made just for tax reasons, but is assessed for its merits as an economic asset that can grow or produce an income stream. It's worth remembering that the pension scheme may be required to pay out retirement or death benefits in the future and that this might not be possible if the funds are tied up in illiquid assets.

Important note

It should be noted that this guide is provided for general information only and should not be relied upon to take action nor should it be seen as attempting to provide you with any advice. The issues covered are most likely to be of interest to individuals with a SSAS or SIPP. A-Day will present a large number of complicated opportunities and you will need to seek advice specific to your individual circumstances, needs and objectives.

It is important to note that the provisions of the Finance Act have not yet come into force, and may be amended before A-Day. A package of supplementary measures was included in the 2005 Finance Act and further amendments are likely.

The views and opinions expressed here are those of the author, Matthew Sharp, given his understanding of the issues at the time of publication. The favourable tax treatment of pension scheme investments may not continue in the future. The value of investments and the income from them may go down as well as up and is not guaranteed.

Unquoted investments

Investment freedom opens the door to a whole raft of other opportunities. High on the list is the ability to invest in unquoted shares. This not only provides an interesting new investment option as part of a well-thought-out asset allocation strategy, but also offers some great planning opportunities for small businesses.

Shares in sponsoring employer

Holdings of shares in the sponsoring company (whether quoted or unquoted) are restricted to 5% of the fund value. Any purchase of shares in excess of this value would be classed as unauthorised and taxed at 40%.

Esoteric investments

Investments in assets such as works of art, fine wines, vintage cars, stamp collections, and even racehorses will no doubt be attractive to the specialist investor or those with experience.

However, although the tax breaks may seem very attractive, it should be noted that, with all investments from which personal enjoyment can be derived, the benefit-in-kind rules will be all-important in weighing up the overall tax benefit. It is expected that benefits in kind will be taxed at 40%.

Occupational pension schemes

The Department for Work and Pensions has issued draft regulations on the investments permitted within an occupational pension scheme. Trustees are required to invest prudently with regard to the security, quality, liquidity and profitability of the portfolio as a whole. They must invest predominantly in regulated markets and ensure that the portfolio is properly diversified. Investment in derivatives is only allowed in limited circumstances.

Investments & asset allocation

With much of the press comment centred on investment flexibility, some commentators have failed to mention that all permitted investments under the current regime will continue to be allowed post A-Day. Over the past 20 years pension funds have tended to invest in the following asset classes:

- Cash
- Gilts (conventional & index-linked)
- Corporate Bonds
- Equities (UK & overseas)
- Commercial Property
- Alternative Investments (Hedge Funds & Private Equity Vehicles)

In developing a suitable investment strategy the focus must remain on the allocation of funds to different asset classes. Even though there will soon be more asset classes, with the inclusion of residential property and esoteric investments, asset allocation remains the crucial decision. It is important to balance several (sometimes conflicting) features when deciding how to efficiently apportion the assets. These are:

- The desire to achieve the required return (within the appropriate risk tolerances)
- The obvious investment merits of diversification
- The diseconomies of scale that can arise from excessive diversification leading to uneconomically small pools of assets within a given asset class.

Since the performance of different asset types and markets can vary over time, often with little correlation between each other, spreading your pension across a range of asset types and markets can protect you from excessive volatility. Sensible asset allocation should remain the bedrock when deciding upon the investment strategy of your pension.

This is also true of an individual's non-pension assets. Most people have 2 main assets; their home or primary residence, and their pension fund. If one were to consider the efficient allocation of an individual's entire asset pool, then additional property investment within their pension scheme could be seen as having too many eggs in one basket.

Page two

Whatever the decision, there is now even more need for professional advice, not only in regard to the underlying investments, but also in terms of pension fund wrapper.

Borrowing rules pre A-Day

Under current rules, it is possible for a SIPP to borrow money to buy commercial property. Prior to A-Day your SIPP can borrow up to a maximum of 75% of the purchase price of the intended property. This requires you to have the remaining 25% as asset in your pension fund.

Example

Mr Jones has £200,000 within a SIPP and is considering a commercial property purchase of £800,000. Under the current legislation he would be able to purchase this property by using the £200,000 within the SIPP and borrowing £600,000 (75% of £800,000). However, the new rules reduce this maximum borrowing to 50% of the value of your pension assets. It will mean a maximum borrowing of £100,000 (50% of £200,000). As such, Mr Jones would not be able to fund his property purchase post A-Day. He would be well advised to complete the purchase ahead of 6th April 2006.

Borrowing rules post A-Day

As mentioned above, a pension fund can only borrow 50% of the market value of the fund post A-Day (not 50% of the value of the asset to be purchased). Nevertheless, whereas currently a SIPP can only borrow to fund a commercial property, under the new regime gearing will be much more flexible and an individual or scheme will be able to borrow to purchase any asset. In addition, the more a scheme borrows, the more it will be able to borrow.

Example

Mr Peters has a SIPP with assets of £400,000 and is looking to build his fund quickly. Post A-Day he can borrow £200,000 (50% of the assets), which would mean that his SIPP would be worth £600,000. He would then be entitled to borrow total assets of £300,000 (50% of £600,000), which means he can borrow a further £100,000 (£300,000 less £200,000 already borrowed). In theory Mr Peters could borrow up to £400,000 to give him assets of £800,000, although in practice it would become uneconomical to go beyond 2 or 3 borrowing cycles.

Where can I get further information?

For independent financial advice, please contact Richard Meek on 0121 213 1800 or your usual PSFM Consultant. For an overview of the new pensions tax regime, please get in touch with your usual Punter Southall contact. If you wish to discuss investment opportunities please contact Matthew Sharp of PSigma Investment Management on 020 7747 6999.

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