ETHICAL INVESTORS

ETHICAL FINANCIAL MANAGEMENT

A Guide to Self-Invested Personal Pensions (SIPPs)

2008-9 tax year

Introduction

The private pensions market is now more flexible than ever before. There are a myriad of pension options open for those that do not have access to a company scheme, ranging from the excellent low cost Stakeholder Pension, through Personal Pensions and up to SIPPs. Choosing the right plan depends upon one's current situation, as well as the position of any pension assets that may have already accrued.

This guide is an introduction to the area of SIPPs, and how they fit in to a broad retirement planning strategy. SIPPs are not suitable for everyone, but they can offer benefits to those accumulating sizeable pension pots and who require flexibility and investment choice. This guide should be read in conjunction with our broader Guide to Stakeholder Pensions.

What is a SIPP?

Put simply, a SIPP is a very flexible and adaptable private pension. It offers benefits both before and after retirement, thus providing a more continuous and adaptable retirement plan compared to conventional private pensions.

The 'Self Invested' part of the plan is one of the key differentiating factors between a SIPP and a standard personal pension or stakeholder pension. The latter plans are offered by a pension company and, in most cases, the investments available are those funds managed by the same company (often between 10 and 20 funds, one of which might be an ethical fund). A few external links to other providers may be available, but these are generally very limited. For a SIPP, the pension company provides an Inland Revenue approved pension 'wrapper' and an investment strategy is then drawn up, usually working with a financial adviser, to decide what investments to hold in the SIPP.

These investments can be very varied, generally from any pension or investment company, including individual stocks and shares, or even commercial property. The greater the investment choice, the greater the potential for increasing the value of the pension fund at retirement.

Not just a pre-retirement strategy

As alluded to above, a SIPP offers significantly greater flexibility both before and after retirement. Instead of taking benefits from the pension fund in full, as with conventional private pensions, income can released as it is needed (essentially taking partial benefits). This flexibility will allow many people to phase their retirement more effectively.

For example, one may wish to cut back on the number of hours worked, but may also have ongoing financial commitments for which one needs to maintain a full level of income. It is possible to draw a top up income from the SIPP, allowing one to work less and maintain the same level of income. The income drawn from the SIPP can be increased, decreased or stopped at any time throughout retirement, so as hours reduce and financial commitment reduces, more income can be taken from the SIPP until full retirement is reached. This process of taking of income is known as Pension Fund Withdrawal, or 'drawdown' (described later).

Because a SIPP doesn't cease to exist on a fixed retirement date, the overall investment strategy is completely different to a normal personal pension. In the latter, the nearer one gets to retirement, the more one would move the investment strategy away from growth orientated funds to safer, cash based funds. Then, at retirement, the accumulated pension pot is converted to an annuity (see below). With a SIPP, the investment strategy might be adjusted slightly as one nears retirement, perhaps to reflect reducing hours worked, but the main thrust of the investment strategy would be to continue with a broad investment policy up to the point of retiring and throughout retirement.

The investment strategy is continuously adjusted to meet changing needs over the years; some years a higher level of income is taken and in other years less is taken from the SIPP.

At Ethical Investors, we can easily meet these changing needs by selecting the most appropriate ethical investments to hold in the SIPP. This evolving strategy does not involve clients in any additional work; it simply means that clients meet periodically with their Ethical Investors adviser to look ahead at their income. If an individual's circumstances have not changed, then little or no adjustment is needed to the overall strategy. If new ethical funds come along which might enhance the investment strategy, these can be included very easily by drawing money from existing funds. This is normally transacted at no cost.

Once one starts to draw income from the SIPP, it is likely that the investment strategy will move from being 100% growth orientated to being a balance of growth and income funds. The balance between the two will be dictated by the level of income needed.

Annuities

So, eventually reaching the point where instead of putting money into a pension plan, it is time to start to spend some of the accumulated fund. With a personal or stakeholder pension the main option to generate an income in retirement is buying an annuity (note that one does not have to stop work to buy an annuity). A SIPP can also buy an annuity as a guaranteed income for life, based on the value of the pension fund. Annuities can provide an income on a level basis for life, increasing by inflation or a fixed amount and can also include a spouse's pension if needed.

The biggest factor in deciding to purchase an annuity is the trade-off between accessibility and a guarantee. At the point at which the pension fund is converted to an annuity, access to the pension fund is lost. This now belongs to the annuity company (not necessarily the same company that the pension fund was with). In return for the loss of access to the capital, there is the benefit of a guaranteed income for life. No matter how long one lives, the annuity company will continue payments. It is possible to guarantee the payments of an annuity for up to 10 years, but on death after any guarantee period the income ceases and there is no lump sum payable (unless the option in include a spouse's income has been chosen).

Adding any of the options such as guarantees, annual increases or spouse's pension will reduce the initial starting pension. Therefore, careful consideration of the total income in retirement is needed before an annuity is purchased. It is important to see how a regular annuity might interact with any other pension arrangements that have been accumulated.

It is important to consider what occurs upon the death of the policyholder – if an annuity is in payment then future payments simply cease and there is no other possible payment to other beneficiaries (unless a spouse's annuity is purchased, or death occurs inside any initial guaranteed period).

Income Drawdown

A SIPP provides another option on retirement to stakeholder and personal pensions; it can simply remain as a SIPP, with the funds still invested - the plan does not convert into something else.

Money can then be taken out of the SIPP by a process known as Income Withdrawal or 'Drawdown'. One selects the level of income that is required and this is paid out until circumstances change. The minimum amount that can be drawn is £0 and the maximum amount is roughly the same as the level of income that could be purchased by buying an annuity. It is possible to change the level of income in line with changing circumstances, taking more in some years and less in others. Provided that the level of income drawn does not exceed the growth/income achieved from the underlying investments in the SIPP, the value of the pension fund remains intact.

Drawdown can continue as long as there is a need to retain this income flexibility, although the rules change somewhat at the age of 75. At any time, one can convert some or all of the SIPP pot to a guaranteed lifetime annuity.

Again, addressing the important subject of what happens in the event of death, assuming drawdown is in force, whatever is left in the SIPP fund is payable to the deceased's estate or nominated beneficiary (different rules apply after age 75).

As can be seen, with a personal pension there is far less choice in terms of being able to leave the pension fund to beneficiaries. With a SIPP the full value of the pension fund can be paid out on death, before or after retirement, up to age 75. Specialist advice is needed if drawdown is to continue after age 75.

Tax Free Cash

All private pension plans offer the option to take up to 25% of the accumulated fund as a tax free lump sum on retirement and SIPPs are no different. However, with a personal or stakeholder pension, taking the tax free lump sum also means that one has to take a regular income (annuity) at the same time. In many cases, clients may wish to access the 25% tax free lump sum, but do not immediately need to take any income. In this case, a SIPP offers an ideal solution.

Investing Ethically

Since the introduction of the Stakeholder Pension in 2001 there are now far fewer pension companies. The very low cost of Stakeholder Pensions is great for the investor, but the low costs have led to many pension companies withdrawing from the market; in some cases a pension company will not break even for at least 10 years on a Stakeholder Pension.

This has, therefore, restricted the choice of providers in the market, and thereby the choice for funds. For ethical investors it is pleasing to note that most of the UK's leading Stakeholder Pension companies offer at least one ethical fund. Compared to the broader investment fund market, however, the choice of ethical pension funds is quite limited; there are many more funds available from the long list of investment companies, compared to the considerably smaller number of pension companies.

This increased investment choice allows Ethical Investors to include specialist environmental funds and socially directed funds alongside the long list of mainstream ethical funds within SIPPs. Each client can have a fully tailored investment strategy that meets their financial needs and their ethical values. This investment strategy can be adjusted to meet changing needs and attitudes, and can easily accommodate new and exciting ethical fund launches over the years, as well as specialist environmentally focussed funds.

ETHICAL INVESTORS
ETHICAL FINANCIAL MANAGEMENT

The ethical SIPP specialists

Head Office: Montpellier House, 47 Rodney Road, Cheltenham, GL50 1HX
Tel: 01242 539848 Fax: 01242 539851 info@ethicalinvestors.co.uk
www.ethicalinvestors.co.uk www.ethicalstakeholder.com www.ethicalmortgage.co.uk