



How to protect your pension against inflation

By Lorna Bourke | 00:01:00 | 24 November 2009

The rise in the Consumer Price Index from 1.1% in September to 1.5% in October follows closely on the heels of scary predictions of a shock rise in inflation from some pundits.

Further rises in inflation are expected – particularly if Alistair Darling raises VAT to 20% next year as is widely predicted. So what can we do to protect our savings - particularly pension investments which are a long term commitment - from having their buying power eroded by inflation? If we really do suffer high levels of inflation, will history repeat itself?

In the seventies when inflation in the UK topped 26% the best safe return available was 17% from gilts – so you were still losing out. However, had you invested long term in gilts at 17% you would soon have made a handsome profit because the IMF stepped in to impose tight constraints on the Labour government's spending and inflation and interest rates fell sharply soon after.

Whilst we are not likely to see gilts yielding 17% any time soon, those who keep their savings readily realizable in cash or near cash are well placed to move into government stock if inflation takes off and interest rates move up sharply – as many expect.

In addition, higher interest rates – when they eventually arrive – will prompt a setback in share prices, so profit taking on your equity portfolio, if you have profits to take, could be a sensible move. However, those who have already retired and are investing for dividend income will probably want to sit things out.

'Mervyn King has said that inflation will come back,' says Keith Churchouse, chartered financial planner with Churchouse Financial Planning. He recommends reviewing your portfolio now and looking at asset allocation.

'There is probably still a bit of a way to go for equities but profit taking is well worth considering – and I think we will see some in the next few weeks or by the end of the year at the latest.' Churchouse also recommends inflation-linked gilts for the ultra cautious but the return on these is so low you might as well keep your money available in a notice deposit account where you can get between 3% and 4%.

If the past is any guide to the future those who survived best in the 1970s bout of hyperinflation were property owners. The biggest ever boom in house prices was during the early seventies. In 1970 the average house cost £4,378. By the fourth quarter of 1972 house price inflation had reached an annualised rate of 42.4% and in 1979 the average home cost £21,966 - more than five times their level at the beginning of the decade.

If history does repeat itself, this could account for why house prices are starting to rise again now. Cash rich investors take the view that returns for cash on deposit are negligible and the stockmarket looks very risky, so long term property has to be a good bet.

The trouble is that you can't put residential property – which most people prefer – into a pension scheme so if you decide to take this route to protect your savings from the ravages of inflation, you will have to buy direct – and of course you will need a deposit of at least 25% of the purchase price.

In addition, the flood of property onto the buy-to-let market means that the yields on residential property are falling in many areas and are likely to continue to do so all the time unemployment is rising. There may be a case for investing in buy-to-let in some areas but you will need to take a long term view and check out the local market before you buy.

However, after the 40% plus fall in commercial property prices over the past two years, a good commercial property fund held within a SIPP or ISA might be just as good a bet - and you get tax relief on pension contributions and any profits roll up capital gains tax free in both a SIPP or an ISA.

Laith Khalaf, pensions analyst at Hargreaves Lansdown, says that the firm has recently come back cautiously in favour of commercial property and is recommending the Threadneedle UK Property Fund. 'But don't put more than 5% of your portfolio into property.' He also warns those tempted by buy-to-let, 'there are a lot of costs in buy-to-let which people don't factor in – management fees, insurance, maintenance.'

Meanwhile some investors have already taken refuge in gold, the traditional hedge against inflation when governments debase their currencies. In the 1970s inflation the gold price rose from \$185 to \$850 per ounce in just 18 months – equivalent to \$2,400 an ounce today.

With gold now firmly through the \$1,000 an ounce barrier, we could be at the beginning of another period of rapid price rises. Investors seem to think so anyway. Gold bugs are predicting that the metal could reach \$2,000 an ounce, perhaps within as short a timescale as six months.

Churchouse is recommending a mix of 'gold funds, gold mining funds and gold ETFs.' He also points out that, 'if inflation is going up, then productivity usually rises which means there will be more demand for commodities.'

Khalaf also likes commodities, particularly oil. 'I have personally put some money into oil ETFs and a leveraged oil ETF,' he says (see Citywire's ETF centre here). 'Long term there is certainly a commodity strategy that is playing out,' he says. But be aware, it is all gambling.

But are the predictions of a big inflation rise realistic? The biggest threat on the inflationary front is a weak pound, rising energy prices and the possible revaluation of the Renminbi. This will affect all Asian currencies and will put an end to cheap consumer goods as surely as a strong Euro has forced many families to holiday at home. However, it is a good case for buying Asian funds – in spite of the fact that the sector has already had a good run this year. It could, however, be a bumpy ride.

The only sure way to counter the inflationary effects on savings and pensions is to save more – difficult if you have just suffered a pay cut, as many in the private sector have. Impossible if you are now unemployed. 'Make sure each year that your pension contributions are going up in line with salary,' advises Khalaf. 'You need to save around 15% of gross earnings including any employer contributions.'

He also recommends those at retirement with a big enough SIPP to look at drawdown rather than buying an annuity which offers flexibility on benefits and the chance to leave the fund invested.

But as he points out, 'there are no magic wands if inflation takes off. You can of course buy an inflation linked annuity.' The problem with this is that few can afford to take the lower income this implies. A 65 year old male buying a level annuity would see an income of £7,000 a year on a £100,000 investment. This drops to £4,300 for a fully RPI linked annuity or £5,600 if you opt for inflation linking of 3% a year.

If inflation is going to eat into your pension income in retirement – it pays to think laterally. If you can't significantly increase your income in retirement, you can cut your outgoings. Consider switching to an offset mortgage now and paying off your debt faster, rather than making more pension contributions. 'Offsetting is a good idea because you are getting a return of 5% or 6%,' says Khalaf.

Offsetting effectively allows you to reduce mortgage interest payments out of untaxed income by offsetting one pound of mortgage interest for every pound of cash deposited alongside. It also gives you the flexibility to get at your savings and move back into the bond and equity markets when the time looks right.

Comments (2)

gordon rankin - increase your pension

11:56 | 24 Nov 2009

my recommendation for increasing disposable income in retirement would be to contact the citywire HR department and ask for a job writing financial articles.

It would seem to take only a couple of hours research, a trawling of a few friendly financial advisers and 4 or 5 recycled options all guaranteed to cancel each other out.

oh dear ! Lorna

STB - History

12:04 | 24 Nov 2009

History may try to repeat itself but we have no wage inflation, not much production just a heavily borrowed asset bubble sucking in more imports till it pops.

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