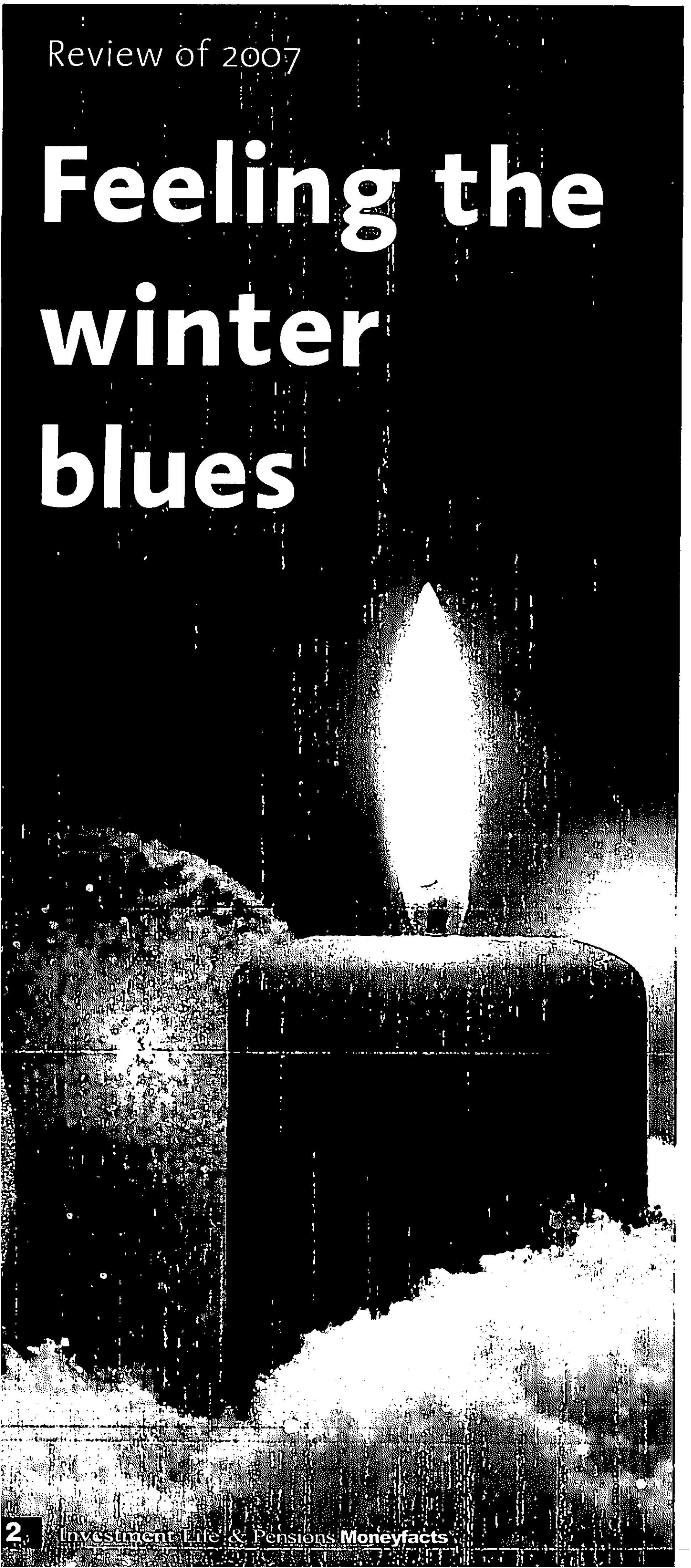
Feeling the winter blues



As another challenging year draws to a close, financial advisers could be forgiven for feeling a touch of the winter blues. Richard Eagling reflects on what 2007 has meant for financial advisers

It may be the season to be jolly, but for many financial advisers and their clients, events over the past few months have brought precious little in the way of Christmas cheer. Instead, the prevailing sense of uncertainty created by the ongoing credit crunch and stock market volatility is in danger of serving up a large dose of the winter blues.

There can be little doubt that 2007 has been a particularly testing time for financial advisers. As *Gillian Cardy, Principal at Professional Partnerships Independent Financial Planning*, is quick to point out: "We have seen very challenging investment markets, falling investor confidence, rising interest rates and the Northern Rock and sub prime crisis. We have also had the Retail Distribution Review on top of the Markets in Financial Instruments Directive (MiFID), in case we needed some regulation to keep us on our toes!"

The good news is that these difficult conditions have presented some excellent opportunities for advisers. Indeed, as figures from unbiased.co.uk testify, the market turbulence has encouraged consumers to seek advice in greater numbers. It claims that requests for advice on savings and investments rose substantially as the credit crunch started to hit financial stocks, with requests during quarter three of 2007 up over 20% on the same period last year. *Jason Hemmings, Director of Albannach Financial Management*, comments: "There has been a lot of media coverage on consumers taking financial advice which I believe has resulted in the number of new clients increasing substantially for most IFA firms. For the first nine months of 2007, the equity markets certainly helped those firms specialising in investments and pensions."

So what have been the major developments over the last 12 months and how have the different products fared?

Investments: a roller coaster ride

Investing has certainly not been for the faint hearted during 2007, with world stock markets experiencing high volatility as a result of the problems in the US sub prime mortgage market and the subsequent credit crunch. *Martin Brookes, Director of Portfolio Management at Prudential,* comments: "The third quarter of 2007 was a roller coaster ride for investors across the world as equity markets suffered their biggest declines since the bull market began in early 2003. Government bonds became a safe haven amid the financial market turmoil. Investor confidence eventually improved but remained jittery due to a cut in US interest rates."

Nowhere was the devastating impact of the credit crunch more visible than at Northern Rock. In September the beleaguered mortgage lender was forced to seek £20 billion in emergency funds from the Bank of England, triggering the first run on a UK bank in 150 years. With its high weighting in financials, the UK equity market has proved particularly vulnerable to the credit crunch. In mid August the FTSE 100 plummeted as low as 5,858 after suffering a 4.1% fall in just one day. However, it has bounced back strongly since and at the time of writing stands at a more comfortable 6,432, a rise of 3.4% for the year (see **Chart 1**).

In contrast to the last few years, where most of the top UK funds delivered impressive double digit returns, this year's performance has been more disappointing. The average UK All Companies fund has fallen 2.7% over the year to date, whilst the average UK Smaller Companies fund has posted an even bigger loss of 9.6%.

Whilst the UK has been amongst those hit hardest by the credit crunch, Asia has emerged relatively unscathed, with China in particular enjoying a phenomenal 2007. Lipper figures show that the Asia Pacific Excluding Japan sector was the biggest success story of the year, with the average fund posting growth of 27.8%. As Martin Brookes explains: "The turmoil in Western markets only had a mild ripple effect on Asia. Stocks in China, the region's powerhouse, rose to record highs as the economy showed no signs of slowing. Hong Kong was another strong performer, as was Korea, riding on the back of China's economic expansion. While growth prospects in the region are accelerating, only Japan remained in the doldrums."

Top performers

Not surprisingly, as **Table 1** reveals, the top ten performing unit trust/OEIC funds over the last 12 months are almost exclusively to be found within the Asia Pacific Excluding Japan sector. **Gartmore China Opportunities** has produced the strongest performance over the last 12 months, returning £1,781 on the initial £1K investment, followed by **Jupiter China** (£1,676) and **Invesco Perpetual Hong Kong and China** (£1,641). Disappointingly, the average unit trust fund posted growth of just 1.6% during the latest 12-month period, down significantly on the 6.1% average growth enjoyed in 2006.

Investor confidence has certainly been dented by this year's market jitters. Recent IMA figures revealed net retail sales of £2,572 million for quarter three of 2007, the worst quarterly figures for two years. On a more positive note, 2007 has been a successful year for ISAs. The 2006/2007 tax year witnessed record ISA subscriptions at over £33 billion, whilst the Government confirmed a package of reforms which will raise the annual allowance from April 2008 and make ISAs even more attractive. Meanwhile, there are signs that the Child Trust Fund initiative is beginning to embed itself in the nation's psyche, with around three million CTF accounts now open.

With profits bonds: out of the rough

With profits investors also received some better news in 2007. After years of waiting patiently, those individuals who kept faith with their with profits bonds through the turbulent investment conditions at the start of the decade are finally reaping the rewards. During the last 12 months our with profits bond surveys have highlighted how payouts are starting to rise, terminal bonuses are back on the menu whilst menacing market value reductions have all but disappeared.

However, the with profits industry found itself back under the FSA microscope for much of the year. In its Quality of Post Sales Communications report of May 2007, the FSA argued that some advisers are still being deterred from offering with profits reviews, whilst September saw the regulator send letters to the chief executives of all with profits providers, reminding them of their duty to ensure they treat policyholders fairly.

Pensions: Not out of the woods yet

The credit crunch may have knocked the pensions crisis off newspaper front pages in recent months, but there have still been plenty of talking points within the pensions industry.

On the plus side, pension business has continued to boom in the post A-Day landscape. As *John Lawson, Head of Pensions Policy at Standard Life*, points out: "In terms of new business, 2007 is likely to be a record year, driven by a strong SIPP market that could generate as much as £10 billion. Recent tax relief figures released by HM Revenue & Customs also show record amounts of tax relief being granted and implied total contributions of £100 billion in 2006/07. This is around £1 in every £13 earned by individuals and companies in the UK."

Meanwhile, the Government's new system of personal accounts has started to take shape. The Personal Accounts Delivery Authority has now been set up with Paul Myners appointed as Chair and Tim Jones as Chief Executive. Thanks to the 2007 Pensions Act we have also seen some of the most important reforms to the state pension system in generations. Besides providing a boost for women and carers, the Act re-links the Basic State Pension with earnings from 2012, or by the end of the next Parliament, and provides for a simpler flat rate State Second Pension.

The year of the hybrids

2007 has also been a remarkable year for product innovation in the pensions market, with third way hybrid pensions exploding onto the financial services landscape. *John Enos, Managing Director, Marketing and Distribution at The Hartford,* comments: "The most encouraging trend in the last 12 months has

Chart 1: How the FTSE 100 changed month by month during 2007

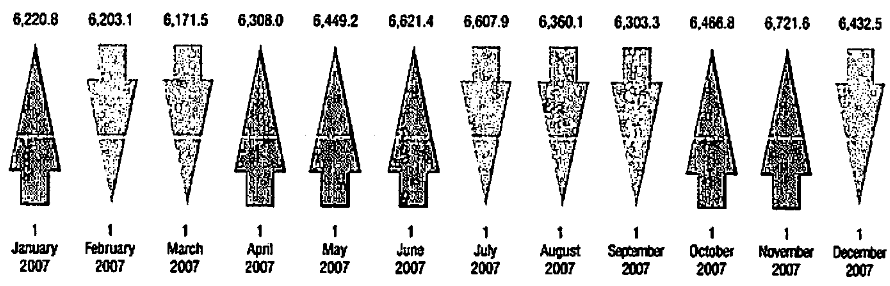


Table 1: Top 10 Unit Trust/OEIC funds over 1 year

Fund Name	1 year value as at 1.12.07	Sector
Gartmore China Opportunities Acc	£1,781.48	Asia Pacific Excluding Japan
Jupiter China Acc	£1,676.06	Asia Pacific Excluding Japan
Invesco Perpetual Hong Kong & China Acc	£1,641.38	Asia Pacific Excluding Japan
Old Mutual Asian Select Acc	£1,614.10	Asia Pacific Excluding Japan
Allianz RCM BRIC Stars A	£1,554.85	Global Emerging Markets
Fidelity South East Asia Acc	£1,544.16	Asia Pacific Excluding Japan
Neptune China A Acc	£1,504.67	Asia Pacific Excluding Japan
F&C South East Asian Equity 2 Inc	£1,499.15	Asia Pacific Excluding Japan
CF Canlife Far East Acc	£1,497.80	Asia Pacific Excluding Japan
Inscape Pacific Basin ex-Japan Equities A	£1,476.42	Asia Pacific Excluding Japan
Total Average of all funds	£1,016.40	

Source: Lipper Hindsight. Figures based on £1K lump sum as at 1 December 2007, total return, UK net, initial charges applied.

been innovation in the pensions market, largely driven by new providers. 2007 has seen the move into the mainstream of third way products, which now provide a recognised alternative to annuities and traditional income drawdown."

Despite some encouraging developments, the UK pension crisis refuses to go away. Indeed, there have been worrying reports that the pension crisis actually deepened in 2007. The annual retirement confidence index produced by Alliance Trust has shown that the number of British adults failing to make any provision for retirement has jumped from 20% to 26% over the last 12 months. Similarly, faced with mounting running costs, many company pension schemes have continued to struggle. Earlier this year a survey from the Association of Consulting Actuaries confirmed a further wave of defined benefit scheme (DB) closures, with 81% of DB schemes closed to new entrants compared with 68% two years ago.

Not surprisingly, John Lawson believes that there are still plenty of unresolved issues hanging over the pensions industry: "The pace of regulatory reform is not as quick as we would like. The Government did announce in the House of Lords that it was planning to reform protected rights next year but, so far, no detailed regulations have been produced. Means testing is still a major issue for advisers in the corporate market and also the fear that personal accounts may result in employers closing group pension schemes. In the individual pensions market, the FSA has been looking closely at SIPP sales whilst contracting-out is also under the microscope again, with new five-year rebates agreed."

Annuities: pleasant surprise

Arguably the biggest surprise of the year has come in the annuity market, where rates halted their historical decline and actually increased. At the time of writing the average level without guaranteed standard annuity rate for a 65-year-old male has risen by 4.9% over the last 12 months, whilst female rates have increased by 5.7%. Unfortunately, there are signs that annuity rates may have peaked, with a number of reductions beginning to creep in over the last month.

Protection: same old story

2007 has proved to be another tough year for the protection market, with providers facing an uphill struggle to rebuild consumer confidence and revive flagging sales. Gordon Brown's final budget as Chancellor failed to bring the last minute reprieve for Pension Term Assurance that many in the industry had hoped for, whilst term assurance sales continued to disappoint despite further premium reductions.

Indeed, there has been no let up in the price war that has engulfed the term assurance market in recent years, with the cost of cover falling throughout 2007. The most competitive £100K sum assured level term assurance premium for a non-smoking male aged 30 over a 25 year term has decreased 7% from £6.61 December last year to £6.13 now (see **Table 2**).

Sadly the industry's obsession with price continues to prove counter productive. Figures published in July by Swiss Re suggest that the Life Assurance Protection Gap remains unchanged at £2,300 billion sum assured, whilst the Income Protection Gap has now widened to £175 billion of annual benefit. The price war also claimed its first major life office casualty, with Standard Life deciding to pull out of the UK protection market in December.

Although many of the old frustrations still haunt the protection market, there have been some notable success stories this year. For instance, there are welcome signs that providers are getting to grips with non-disclosure, with figures recently published by LifeSearch indicating that the average number of paid critical illness claims has risen by 3% within the last 12 months. Similarly, there are high hopes that the new Statement of Best Practice for Critical Illness, which providers were forced to implement back in April, will inject fresh life into the market and will further reduce the number of disputed claims. Finally, there have been encouraging signs that some providers are beginning to improve their product offering on the basis of quality rather than price.

Peter Chadborn, Principal at CBK, believes that 2007 overall has been a mixed year for the UK protection industry: "Apart from the first signs of some welcome product innovation, headlines have been dominated by re-branding and merger talks. Such activity offers little inspiration for advisers. As the price war continues, many advisers sense that protection business is getting harder to transact. One of the major factors has been the increased prominence of direct and so-called non-advice providers. This year has proven more than ever that in order to survive, advisers need to offer more than just a broking service."

Yet more regulation

Although volatile stock markets have preoccupied advisers for much of the year, there have also been plenty of regulatory changes for advisers to keep up with. April saw the advent of regulation for both the SIPP and home reversion markets, whilst the FSA launched its controversial Retail Distribution Review (RDR) in June.

Under the FSA's proposals the regulated investment market would be split into two parts. Professional financial planning and advisory services would be available for consumers looking for the full range of advice and a system of primary advice introduced for those with more straightforward needs. Jason Hemmings comments: "Within the industry, RDR has been a hot topic this year. Whilst there have been many concerns voiced, most firms can see some of the benefits. IFAs have never been treated as equals to fellow professionals such as lawyers and accountants. Although this is still the case, RDR gives individuals and firms the opportunity to become an equal if they are prepared to sit a whole host of exams and expand their knowledge base. However, RDR and the requirement for further study may see more advisers leaving the industry and this could well be the start of consolidation within the industry." ILP

Table 2: The difference a year makes - 2006 versus 2007

Product/Indicator	2006	2007
FTSE 100 [1]	6,048.8	6,432.5
FTSE 250 [1]	10,673.9	10,748.8
FTSE All-Share [1]	3,119.8	3,280.8
Bank Base Rate	5%	5.75%
Cheapest Level Term Assurance - Non-smoker over 25 year term		
£100K LTA - Male aged 30	£6.61	£6.13
£100K LTA - Female aged 30	£5.76	£4.98
Compulsory Purchase Annuities - £10K purchase price, level without guarantee		
Average CPA rate - Male aged 65	£667	£700
Average CPA rate - Female aged 65	£611	£646
Endowments - Gross premium £500 pa, male, non-smoker, aged 29 years, 11 months at outset over 15 years		
Average Low Cost Endowment [2]	£11,464	£11,505
Average Full Cost Endowment [2]	£12,657	£12,426
Pensions - Gross premium £1K pa over 15 years		
Average With Profits Pension [3]	£25,026	£25,159
Average Unit-Linked Pension [3]	£24,895	£24,861
With Profits Bonds - Based on £25K investment over 5 years		
Average with profits bond surrender value [4]	£29,540	£34,815
Unit trusts - Based on £1K investment over 10 years, total return, UK net, apply initial charges		
Average unit trust fund value [1]	£1,926	£1,933
Average investment trust fund value [1]	£3,159	£2,899

Notes: 1 = Source: Lipper Hindsight. Figures as at 1 December. 2 = Figures as at 1 September. 3 = Figures as at 1 October. 4 = Figures as at 1 August.