Broken trust?

With the economy in turmoil, should you stick with a child trust fund that's decreasing in value, or find a better way to save for your kids' future?

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Child trust funds were launched by the government in 2005 as a tax-free way of saving money for children, but they may not be the best option. In a new Which? investigation, 80% of the funds we looked at are worth less now than they were when the scheme launched.

Over four million children now have a child trust fund, containing more than £1 billion of public money, and parents and grandparents have topped up the initial £250 provided by the government by an average of £14 a month.

Short-term pain

We looked at the main providers of child trust funds (CTFs) and assessed their performance over the first three full years (2006-09). The results make depressing reading, as this period ended with a major stock market downturn.

The FTSE 100 stood at 5,780 on 30 January 2006 but had dropped to 3,626 by 2 March 2009 – £250 invested in a fund that tracks the FTSE 100 share index would have dropped in value to around £157 as a result.

Many shares-based CTFs have done equally badly, as our table on p18 shows. In contrast, cash CTFs have gained in value, as interest rates for the period were generally high, though these too have started to fall recently – the average annual interest rate in February 2009 was 2.9%, compared to 6.35% in February 2008.

Long-term gain

CTFs are a long-term investment, however, and it's likely that many shares-based CTFs will recover before today's children turn 18. Equities have outperformed cash in the past, and experts believe that, in the long run, they will continue to do so by a considerable margin.

But there is no certainty of this, as interest rate changes and market fluctuations are impossible to predict.

If you'd prefer a low-risk option, you'd do better to stick to a cash CTF. For more on investing and investment choices, see *Which?* April 2009, p18 or go to **www.which.co.uk/investmentchoices**.

Trust fund choices

There are three different types of child trust fund account available.

The simplest option, a cash CTF is a savings account that pays annual interest at a variable rate. There are no charges and no taxes to pay. Of all CTFs, 19% are held in this type of account. For up-to-date Best Buys for Cash CTFs see **www.which.co.uk/childtrustfunds**.

Most CTFs are held in shares-based accounts. These invest money in stock market funds, aiming to accumulate in value as share prices rise and dividends are accrued. There are two types – stakeholder and non-stakeholder.

Stakeholder CTFs are the most popular. They account for 75% of all CTFs. Designed to allow cautious investors to enjoy stock market growth, they have annual fees capped at 1.5%, are obliged to minimise risk by holding a spread of investments and must offer a 'lifestyling' default when the child reaches 13, where funds are moved to less risky investments to lock-in past gains.

Non-stakeholder shares-based CTFs offer a wider range of investments and have the potential for more spectacular growth. They also carry a greater risk. Only 6% of CTFs are held in this sort of account. Our survey takes in only those non-stakeholder CTFs that offer a clear choice of collective funds. There is another group of non-stakeholder providers, typically stockbrokers, that allow inves-

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www.which.co.uk/childtrustfunds

A CAPTIVE INVESTOR

Paula Chatfield *42, housewife*

In 2005, Paula Chatfield was sent a CTF voucher for her son, Michael, who was born in autumn 2003. She intended to open a cash CTF account, but didn't get round to applying before the initial 12-month period had passed.

When she rang the government helpline, she found that the money had already been allocated to a stakeholder account. 'When the paperwork came through, I was totally taken aback to find that it was in a stocks and shares investment. I'd assumed a government investment would automatically be in a low-risk product.'

Paula's latest statement shows that the value of Michael's Family Investments CTF has fallen to less than the government's original contribution. She intends to switch to a less risky cash CTF before considering adding any money to the account.

tors to 'self-select' their investments. These firms normally deal with those investing the maximum £1,200 each year. The bespoke nature of these funds makes them impossible for us to assess, though some could produce impressive results.

High fees handicap

With a few notable exceptions, most stakeholder providers charge the maximum 1.5% fee, even for tracker funds that usually cost far less to invest in. Though this reflects the administrative cost of handling a large number of low-value accounts, it could reduce your long-term gains by as much as 8% compared with a stocks and shares Isa, for example, which enjoys the same tax advantage but might have fees of around 1%.

The issue of stakeholder fees is made sharper still by the fact that these are the default accounts invested in by the government when parents fail to use their £250 voucher (see 'A captive investor', above).

Around a fifth of CTF vouchers issued each year are currently allocated to stakeholder providers in this way. With 779,000 vouchers issued in a 12 month period, this produces an influx of around £39m from allocated vouchers alone, from which providers take around £584,250 in fees.

Switching CTFs

You can have only one CTF at a time, but switching funds is a straightforward process that is very similar to making an Isa transfer. You need to fill in a form from your new provider, who will set up a new account and arrange for your money to be moved. You can also move to another fund offered by your current provider, assuming it offers that choice.

It's also possible to move from a stakeholder CTF to a cash CTF or vice versa without incurring any charges. Non-stakeholder shares-based CTFs may charge a modest fee for switching, which covers stamp duty and fees, but the process is the same. For a full list of CTF providers, see www.childtrustfund.gov.uk.

CTFs and tax saving

Parents can pay up to £1,200 each year into a child trust fund without the interest it makes being taxed in any way. Outside these accounts, parental gifts which generate interest of more than £100 a year are taxed as though it is part of the parents' income. For a 40% taxpayer this can be especially costly.

An alternative is to save for your child within your own tax-free Isa allowance. This has the added advantage of allowing you to keep control of the money when the child turns 18, rather than having to hand it all over at once. For more on children's savings and tax see www.direct.gov.uk/en/moneytaxandbenefits.

Which? says

Child trust funds have given many children who would otherwise miss out a potentially useful savings opportunity. With £250 deposited by the government for every child at birth, and a further £250 at the age of seven, they were meant to ensure that all 18-year-olds have a modest nest egg. Whether they are the best home for additional gifts from parents and grandparents is more debatable.

Cash CTFs have got off to a good start but, with falling interest rates, may not do so well in the long run. Share-based CTFs have been badly hit by a falling market, though they should do better when the economy recovers.

Parents may prefer to hold off investing more money in their CTF until the outlook is more certain, or keep money in an Isa on their child's behalf. Few will be enthused by the figures in our table.

Trust funds ups and downs

Our research

We asked the main child trust fund providers for details of their funds and for the value at 31 January 2009 of £250 invested on 1 February 2006 after charges. Self-select non-stakeholder shares-based providers, such as Killik & Co, Pilling & Co, Redmayne-Bentley and Reyker were excluded. Of 41 surveyed, 23 provided figures for us to use. Those that didn't aren't included in the table.

As child trust funds (CTFs) are a long-term investment, the table is illustrative only, and should not be taken as a prediction of future performance. We intend to repeat the survey at regular intervals, tracing the value of CTFs to maturity.

Cash CTFs come out on top

After three years, the best return on £250 is shown by cash CTF providers, such as **Hanley Economic BS** at £307. These offer a safe haven for cautious savers, though their potential for long-term growth is limited. No annual charge is deducted by these providers, so any interest paid is added directly to your fund.

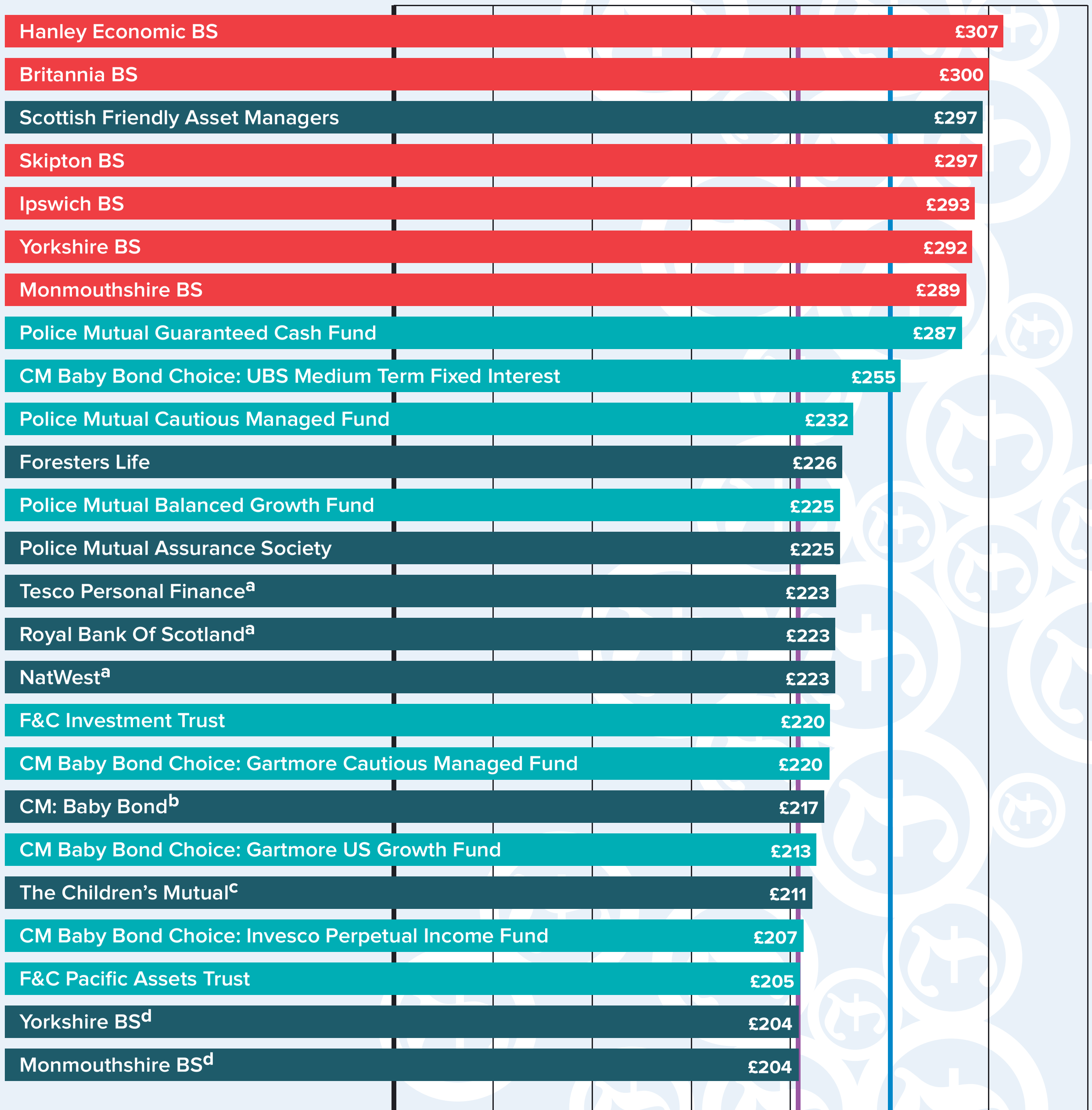
Cautious funds a safe bet

The best performing shares-based CTFs have been those cautiously invested in a mixture of equities, bonds, government stock and cash. Stakeholder provider **Scottish Friendly** tops the chart at £297. More typical is **Children's Mutual's (CM) non-stakeholder Baby Bond Choice**. This is two thirds held in gilts and has maintained its value at £255.

Managed funds outpace trackers

When markets are falling, actively managed funds tend to do better than trackers. By reducing their

How child trust funds have fared since 2006



exposure to equities, they manage to contain their losses and go for more certain gains in the form of bonds and securities. **Police Mutual's Cautious Managed Fund** at £232 is good example of this strategy.

Trackers follow the market

Tracker funds, as their name suggest, follow the market, for better or worse. Many CTFs track the FTSE All Share Index, though some, such as Engage, follow the narrower FTSE 100. Most have shown heavy losses during 2008. **F&C's Asset Management stakeholder CTF**, for example, was worth £281 in January 2007 but two years later had fallen to £196.

Expensive ethics?

Some funds avoid certain types of investment for ethical or religious reasons. **Children's Mutual** offers a **stakeholder Shariah CTF** which tracks the FTSE Global Islamic Index, excluding companies involved with things such as tobacco, pork, and alcohol. Despite this, it is quite high in our chart at £217. Other ethical funds have done less well, such as **Children's Mutual's CIS UK fund** and **Family Investment's Ethical CTF**, which have dropped to £186 and £143 respectively.

Adventurous funds reveal risk

Specialist funds often offer better growth prospects than their more cautious counterparts. Investing in unlisted companies, overseas exchanges or commercial property, they take higher risks in search of high reward. When they succeed, they can do well, such as **F&C's Private Equity Trust**, which climbed to £308 in January 2008, only to fall back to £106 a year later, or their **Active Capital Trust**, which registered just £70 in January 2009 after a high of £265 in 2007. These CTFs are clearly not for the risk-averse.