Make your money grow

Whether you've got £10 or £1,000 a month to spare, we help you weigh up your investment options

Like many people, if you've had some money to invest over the past five years, chances are you've been tempted to shove it in a savings account and hope for the best. Sales of cash Isas have rocketed since they were launched in 1999, while stocks and shares Isas haven't been nearly so popular. 'People are opting for security,' says a spokesman for Halifax, the UK's largest savings provider. 'They've seen the stockmarket fall sharply between 2000 and early 2003 and decided that cash is king. But it's worth remembering that, in the long term, equities have tended to outperform cash.'

GET PERSONAL

You can see from the graphs on p22 how the fall in the stockmarket from 2001 to 2003 means that cash savings have outdone shares over five years, but over ten years shares have outperformed cash. So how you invest your money depends on how much you have to spare, what you're hoping to achieve with it and your attitude to risk.

It's always best to let an independent financial adviser (IFA) assess your finances and talk you through the options. We've given tips on finding an adviser on p23. But it's a good idea to be clued up about your choices before you see an adviser.

To help you understand all the things you need to consider, we've asked two IFAs to make recommendations for four fictional cases with typical investment dilemmas. All four are in a strong position to save: they have no debts other than a mortgage and they have all addressed their basic financial needs.

SORT OUT THE BASICS FIRST

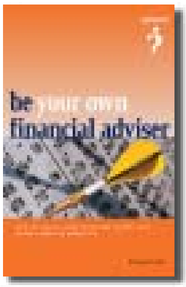
Before you start thinking about investing your money, you must sort out the basics. Debts (other than your mortgage) need to be tackled as a priority because you're always likely to pay more interest on your borrowings than you'll earn on your savings. After they're cleared, the most important thing is to ensure that you have an emergency fund to cover the unexpected. This should be between three and six months' salary in an easy-access cash Isa or high-interest savings account. You should also make sure that your pension arrangements are sufficient and that you have enough life, house and protection insurance. For more on how to sort out these basics, see our report on basic financial planning, March 2004, p46.

If you've still got money to play with once these essentials are covered, you can start planning a savings and investment strategy.

ESTABLISH YOUR GOALS

There are some key questions you need to answer before planning what to do with your cash. What are you saving for? Are you happy for your money

WHICH? BOOKS



Be Your Own Financial Adviser (£11.99) gives tips on planning your finances. The new edition is out on 26 May. Order by phone on **0800 252 100** (quote code FINAD) or online at **www.which.co.uk/bookshop**

to be out of reach for a few years or do you want to be able to get at it easily? Are you saving to create a lump sum or do you want a regular income?

You also need to decide how much risk you are willing to take with your money. There's no such thing as a no-risk strategy. If you don't make your money work for you, you risk it being eroded by inflation. For example, £1,000 might be worth only £781 in ten years' time if prices rise at 2.5 per cent a year. But there are varying levels of risk. You need to decide whether you are prepared for your investment to go down as well as up and by how much. You should discuss with your IFA what level of risk you are willing to take .

PAYING OFF YOUR MORTGAGE EARLY

A less traditional method of saving is to make overpayments on your mortgage, which can significantly reduce the time it takes to pay it off. The graph on p20 shows that overpaying by £50 a month on a 25-year £80,000 mortgage could save you over £11,700. Bear in mind that not all lenders will let you overpay, but you can always switch to a more flexible deal if yours doesn't allow overpayments.

If you're not sure whether to put your spare money into a savings account or to overpay your mortgage, look at the interest rates on both. If the rate you could get on a savings account is higher than the rate you're paying on your mortgage, it makes more sense to save your money. But unless your savings are in a tax-free account, such as a cash Isa, don't forget to take account of tax. If the interest rate on your mortgage is 5 per cent, then, as a basic-rate taxpayer, you'll need a savings account that pays 6.25 per cent to match it. A higher-rate taxpayer would need 8.33 per cent to make it worth opting for the savings account.

SWITCH WITH WHICH?

If you want to switch mortgage, our mortgage calculator at **www.which.co.uk/switch/mortgage** allows you to search more than 8,000 mortgages and is packed with useful information.

Investment basics

As the chart below shows, the higher the risk, the higher the potential return on your investment.

Cash This includes savings accounts, cash Isas and National Savings & Investments (NS&I) products.

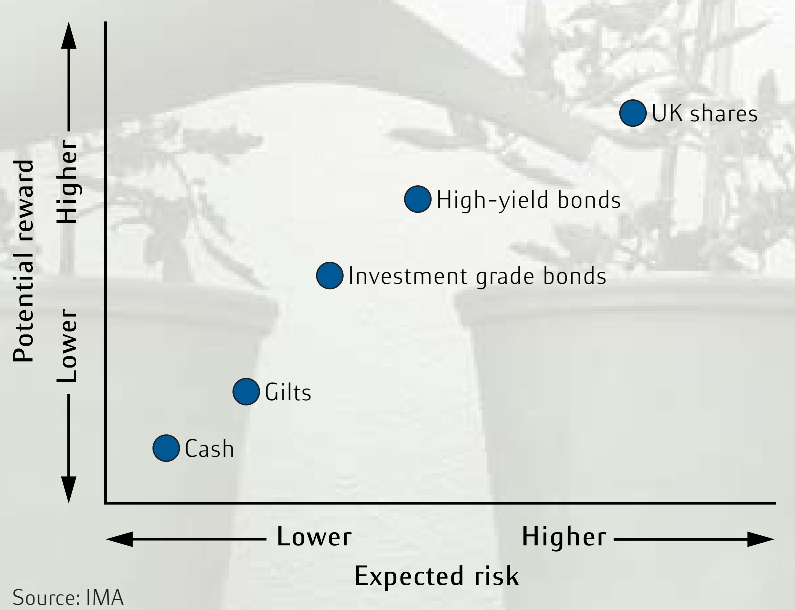
Gilts When you buy a gilt, you're essentially lending money to the government. Most gilts have a fixed life so, if you hold a gilt until it's repaid (the redemption date), you know exactly what return you'll get from it.

Bonds These are like gilts, except that you are lending to a private company. Bonds are less risky than shares, but different types of bond have different risks. **Investment grade bonds** are issued by companies that are unlikely to go bust. **High yield bonds** are issued by less secure companies and carry more risk. They usually offer a higher return, but if the company runs into problems you may not get your money back.

Shares Also known as equities, shares are the riskiest type of investment. When you buy a share in a company, you own a small part of it. The amount of money you make or lose depends on how the company's share price changes and the dividends (your share of the company's profits) you receive.

Expected risk vs potential reward

This chart shows roughly how much risk and return you can expect from various types of investment.



Source: IMA

SPREADING RISK

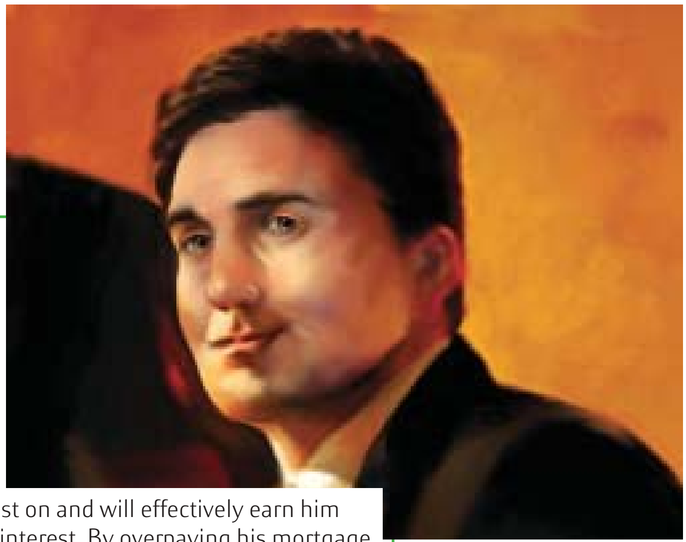
Unit trusts and open-ended investment companies (Oeics) allow you to pool your money with that of other investors. So instead of buying shares in lots of companies, you invest in a fund where a fund manager buys and sells shares on your behalf.

Because you're pooling your money with other people's, you're investing in a wider range of shares than if you were investing alone, and thus spreading your risk. There are different sorts of fund, with levels of risk ranging from very low to very high. You can also choose to invest for income or growth. **Income funds** aim to produce a good income while protecting against inflation. **Growth funds** invest mainly in expanding companies. As the companies become more profitable, the value of your shares increases.

SAVING TAX

All the investments mentioned here can be put in an Isa (individual savings account). Isas enjoy favourable tax treatment, although stocks and shares Isas are not completely free of tax. There are limits on the amount you can save each tax year.

Keeping savings accessible



CURRENT SITUATION

Mark (33) is a marketing executive earning £28,000 a year. He has a £50,000 mortgage on his flat with a fixed-rate mortgage deal, which expires in August 2006.

SAVINGS GOALS

Mark isn't sure what he wants to save for. He has £7,000 sitting in a cash Isa and, after paying all his outgoings, he has £60 a month left to play with. He wants his money to grow steadily and doesn't want to take much risk.

IFAs' SUGGESTIONS

As Mark has a relatively cautious attitude to investing and wants to be able to get at his money easily, he should keep his savings in cash. The two best ways for Mark to do this are to continue paying into a cash Isa, which means all the interest he earns will be tax free, or to overpay his mortgage.

Mark's mortgage currently charges 4.79 per cent interest. So any amount he overpays he won't be charged interest on and will effectively earn him 4.79 per cent interest. By overpaying his mortgage by £60 a month, Mark will be able to pay it off five years early and save an impressive £8,650.

However, at the moment Mark could earn more by putting his £60 a month into a Best Buy cash Isa. At the time of going to press the best rate he could get was 5.5 per cent. He could also transfer the £7,000 from his existing Isa to the Best Buy so that this would also benefit from the higher interest rate.

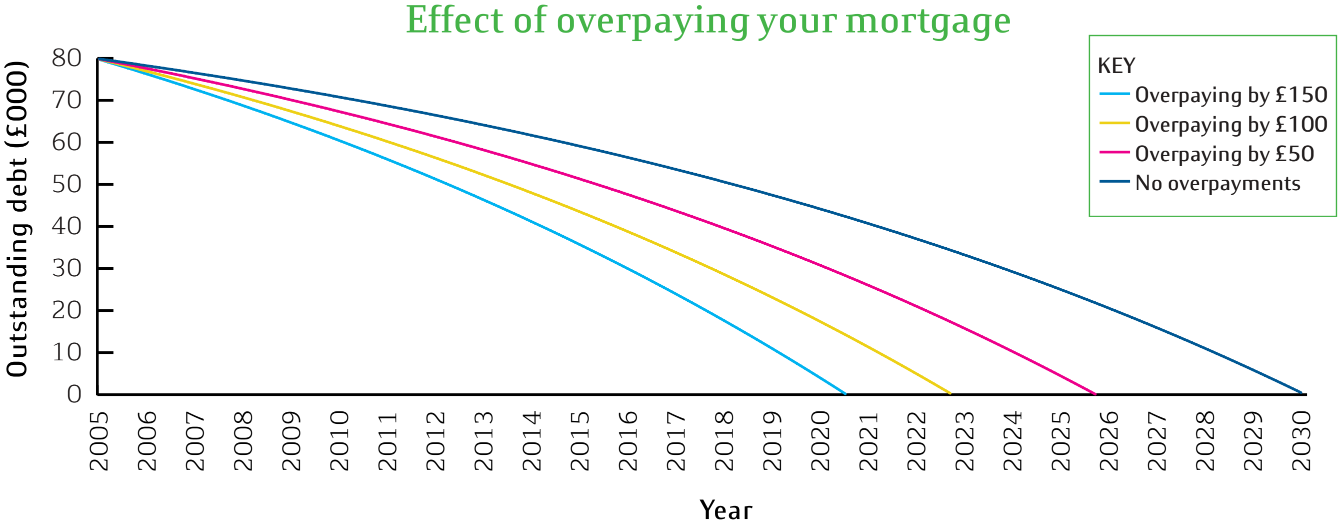
By overpaying his mortgage by £60 a month, Mark will pay it off five years early and save an impressive £8,650

Mark needs to keep an eye on mortgage and Isa rates. He's on a fixed-rate mortgage deal, and when that finishes he'll probably find himself paying more and may want to switch to another mortgage. He could consider a flexible mortgage, which lets you make overpayments and underpayments, and allows you to 'drawdown' (borrow extra money) up to an agreed limit. Mark could then consider overpaying regularly or using a lump sum from his cash Isa to knock a good chunk off his mortgage. We'll be covering flexible mortgages in detail in July.

TOP TIP

You'll get the most from overpaying your mortgage if your lender calculates interest daily because it will take account of everything you pay off immediately and charge you interest on only the outstanding balance. If your lender calculates interest monthly or annually, you'll be paying interest on money you no longer owe until it recalculates your debt each month or year.

Effect of overpaying your mortgage



The graph shows how quickly you would reduce your mortgage if you overpaid it by £50, £100 or £150 a month. It is based on a 25-year repayment mortgage of £80,000 with an interest rate of 5 per cent.

Overpaying by £50 a month would save you £11,723 and will pay it off four years early. An extra £100 a month would save you £19,469 and pay it off seven years early. And if you could afford to overpay by £150 a month, you'd save £25,003 and pay it off nine years early.

Source: Halifax

PHOTOGRAPHY GETTY IMAGES ILLUSTRATION BERNARD CHAU

Investing for the family

CURRENT SITUATION

Sue (39) is a self-employed osteopath who earns around £40,000 and Tom (42) is a GP on a salary of £58,000. They are married with two children, Anna (7) and Gareth (5). They have a mortgage of £300,000.

SAVINGS GOALS

Sue and Tom currently pay £250 a month into a cash Isa but can afford another £275 a month. They want to save for the children, and Sue's parents have donated £6,000 towards this, but they also want to provide for their own future. They don't want to take any risk with their money and would like it to grow steadily.

IFAs' SUGGESTIONS: THE CHILDREN

A good bet for the money from Sue's parents is a Best Buy children's saving account paying 5.35 per cent. Alternatively, Children's Bonus Bonds from NS&I are low risk and tax free, and Sue and Tom could put up to £3,000 in bonds for each child. This would earn interest and, every five years, would also receive a bonus (£122 after the first five years). The amount of interest they'd get depends on which issue they buy. NS&I issues new bonds at regular intervals, each with its own interest rate. The current issue would earn them 4 per cent AER, so in 13 years' time, when Gareth turns 18, both children will have £4,852 in their bonds.

Sue and Tom want to save more than this for their children's future, and one of the IFAs suggested that they use their child benefit, currently £113.60 for two children every four weeks, for this.

Although Sue and Tom don't want to take any risk with the money they save for their children, their savings are in danger of being eroded by inflation. So they may want to consider taking some risk in the hope of a better return. A good way of doing this would be to invest in a low-risk fund within an Oeic or unit trust. They would need to consult their IFA about the best fund for them and they should look for funds with low initial charges. They should also watch out for tax. Even if they put the investment in their children's names, any interest over £200 (£100 for each parent) the savings earn each year will be taxed at 40 per cent, as if it's their money and not the children's.

IFAs' SUGGESTIONS: SUE AND TOM

Once they've used their child benefit for the children, Sue and Tom will have £525 a month left to save for themselves. There are two things they should be doing with this money. First, they should think about overpaying their mortgage or saving in a cash Isa and using whatever they save to pay a lump sum off the mortgage later. Second, they should look at their retirement provision. Sue is currently putting £120 a month into a stakeholder pension. Although Tom's also got a pension through work, they need to think carefully about whether this is enough. They should look at their annual pension statements to see how much they're projected to get. They can also get a state pension forecast, either from their IFA, online at www.thepensionservice.gov.uk or by calling 0845 3000168.

If they think that their current arrangements aren't going to give them enough, they could top up Sue's pension. This is a particularly good idea because Sue is a higher-rate taxpayer. She will get higher-rate tax relief (40 per cent) on any contributions that she makes. But by the time she comes to take her pension, she's likely to be a basic-rate taxpayer, so the pension she receives will be taxed at only 22 per cent, meaning she'll have effectively saved 18 per cent.

Sue and Tom don't want to put their children's money at risk, but savings are in danger of being eroded by inflation

TOP TIP

If a parent invests in their child's name, any interest above £100 the savings earn each year is treated as belonging to the parent and is taxable at whatever rate of tax the parent pays. To avoid this, parents should look for tax-free investments, such as NS&I Children's Bonus Bonds, or keep the investments in their own names and put them in an Isa or other tax-free product. Alternatively, they can consider a growth fund instead of one that generates an income.

Investing to retire early

CURRENT SITUATION

Henry (56) is a teacher and earns £39,000 a year. Alison (55) works part time for the local council and earns £17,000 a year. They no longer have a mortgage and their grown-up sons are now financially independent.

SAVINGS GOALS

Henry has recently inherited £235,000 and he and Alison want to know whether this, along with another £10,000 they have saved, will allow them to retire early. They're willing to take some risk if necessary, but they want to make sure they don't lose their lump sum. They also have £100 a month disposable income to save.

IFAs' SUGGESTIONS: RETIRING AT 60

If Henry and Alison work until they turn 60, they should have no problems getting the money they want in retirement. Their work and state pensions will give them a good income, which can be supplemented by leaving Henry's inheritance in cash Isas and high-interest savings accounts. If, on the other hand, they're concerned about keeping pace with inflation, they could buy NS&I Index-Linked Certificates, where the return is set at a rate higher than inflation. They're tax free, and Henry and Alison would be able to invest up to £15,000 each per issue for up to five years at a time.

IFAs' SUGGESTIONS: RETIRING EARLY

Ideally Henry and Alison want to give up work as soon as possible. To do this comfortably they need to make Henry's inheritance work harder. If they give up work now, aged 56 and 55, one of our IFAs estimates that Henry will lose about 20 per cent of his pension income and Alison about 25 per cent. But they will both still get lump sums from their pension. This will increase the amount they have to invest from £235,000 to roughly £300,000.

For the first few years of their retirement, before their state pension kicks in, Henry and Alison will need an extra £9,000 a year to bring them up to the level of income they want. This means that their investments need to earn at least 3.1 per cent initially. To get this they could keep around £50,000 in cash savings – they already have £10,000 in a cash Isa and could put another £40,000 in high-interest savings accounts.

This leaves about £250,000. One of our experts recommends investing half in UK shares and half in UK bonds. This provides a good mixture of risk, will help their savings to keep pace with inflation and should generate the income they need.

The usual way of investing in shares and bonds is through Oeics, unit trusts and investment trusts. But, given the size of their investment, one of our IFAs recommends that Henry and Alison use a stockbroker to manage their portfolio. This means they will be able to invest directly in shares and bonds, which the stockbroker will buy and sell on their behalf. This should be cheaper than Oeics and unit trusts, which typically have initial charges of between 3 and 5 per cent and annual charges of 1.5 to 2 per cent. If they shop around, Henry and Alison should be able to find a stockbroker with annual charges of 1 to 1.25 per cent.

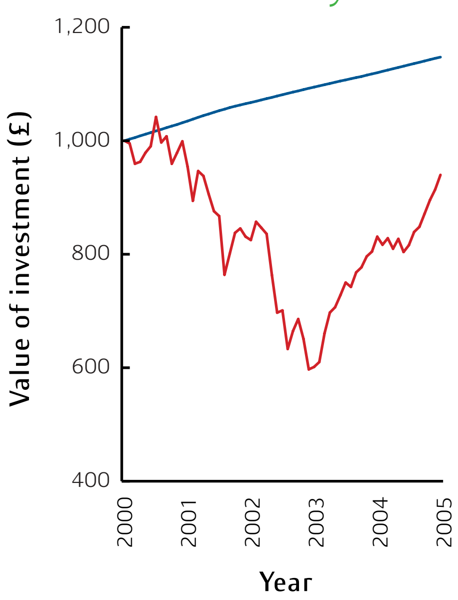
TOP TIP

Stockbrokers buy and sell shares on your behalf, and they charge each time they do this. Keep an eye on how much of your portfolio your stockbroker is selling each year. If it's more than 20 per cent, you're likely to be incurring excessive charges, so think about changing stockbroker.

Over ten years

KEY
— **Cash** (90-day savings account)
— **Shares** (UK All Companies sector)

Over five years



These graphs compare the progress of £1,000 invested in shares on the stockmarket with £1,000 invested in a savings account over the last five and ten years. The figures for shares are after initial charges have been paid.

Over the longer term (ten years) the stockmarket has given a better return than cash invested in savings accounts. But over the short term (five years) cash savings accounts have been a better bet.

Source: Lipper

Willing to take some risk

CURRENT SITUATION

Thea (28) earns £31,000 working as an assistant account manager for a PR firm. She owns her own house with her boyfriend Brian.

SAVINGS GOALS

Thea has inherited £50,000 and she has £70 a month of her own to put away. She's not sure what she's saving for – perhaps a wedding or retirement – and she's willing to take some risk as long as £10,000 is left easily accessible.

IFAs' SUGGESTIONS

Thea currently wants to keep her finances separate from Brian's, so our IFAs don't suggest that she overpays her mortgage, as this would benefit Brian too. Instead, she should pay her £70 a month into her work pension. She currently pays in 4 per cent of her earnings directly from her salary. But she's entitled to make additional voluntary contributions (AVCs) of up to 11 per cent of her total taxable earnings each year. Any AVCs benefit from tax relief at Thea's top rate – currently 22 per cent, as she's a basic-rate taxpayer.

As Thea wants £10,000 readily available, she should use part of her inheritance to boost her cash savings. Her best bet is to put £7,000 in a high-interest savings account and pay regular amounts from there into her mini cash Isa each tax year. She already has £3,000 in her Isa, so this will bring her savings up to £10,000.

Thea will then be left with £43,000 of her windfall. One of our experts recommends that she puts around £13,000 into a unit trust fund that invests in gilts and corporate bonds, which are lower-risk investments that pay interest. So that Thea isn't taxed on this interest, she should move lump sums from her investment into a mini stocks and shares Isa each tax year. She should be careful, though, as she could have to pay an initial charge (typically 3 to 5 per cent of the investment) twice – once when she opens her investment and again when she moves it into an Isa. She should go for funds with low initial charges.

For the rest of her inheritance, our expert recommends putting £30,000 in a unit trust or Oeic that invests in UK equities. This reflects the fact that she's willing to take some risk over a reasonably long period. To spread the risk, our IFA says that Thea should consider investing £15,000 in a tracker fund and £15,000 in an income fund. Tracker funds have low initial costs and track indices such as the FTSE (Financial Times Stock Exchange) 100 Index. The index can go up or down, affecting her investment's value. Income from income funds can be reinvested to help the fund grow. Although her money won't technically be tied up, Thea should think of it as unavailable for at least ten years to get the best returns.

TOP TIP

There's no point in Thea moving her equity-based investments into an Isa if she remains a basic-rate taxpayer. A rule change in April 2004 means that basic-rate taxpayers get no income tax benefit from saving in a shares-based Isa. However, once all of her bond investments are in an Isa, and if Thea then becomes a higher-rate taxpayer, she should consider moving her equity funds into an Isa.

FURTHER INFORMATION

If you're looking for a financial adviser, try one of the following organisations.

IFA Promotion
www.unbiased.co.uk

Institute of Financial Planning
www.financialplanning.org.uk

The Personal Finance Society
www.thepfs.org

Independent financial advice

Unless you just want a cash account (in which case our Best Buys are all you need), always speak to an independent financial adviser (IFA) before investing. Finding an adviser can be a minefield, so here are our helpful tips.

- Speak to friends and family to get an IFA recommendation, but always check that they're authorised on the FSA's register – see www.fsa.gov.uk/register. Also, you could contact the organisations listed in 'Further information', above, for help.
- Choose an IFA specialising in the area you want advice on – for example, investments or pensions. Ask what qualifications the adviser has and how long they've been advising in this area.
- Be clear about what is information and what is advice. Information is useful as background, but if you pay for financial advice, that's what you should get. You need to get reasons in writing why the adviser has chosen the type of product and the product provider. This is to protect you if you're given bad advice.
- By 1 June 2005 all advisers who call themselves 'independent' will have to offer you the choice of paying by commission or fees. Typical fees for an investment adviser are between £75 and £150 an hour.
- For more detailed information on financial advice, see 'Puppets on a string', November 2004, p26.