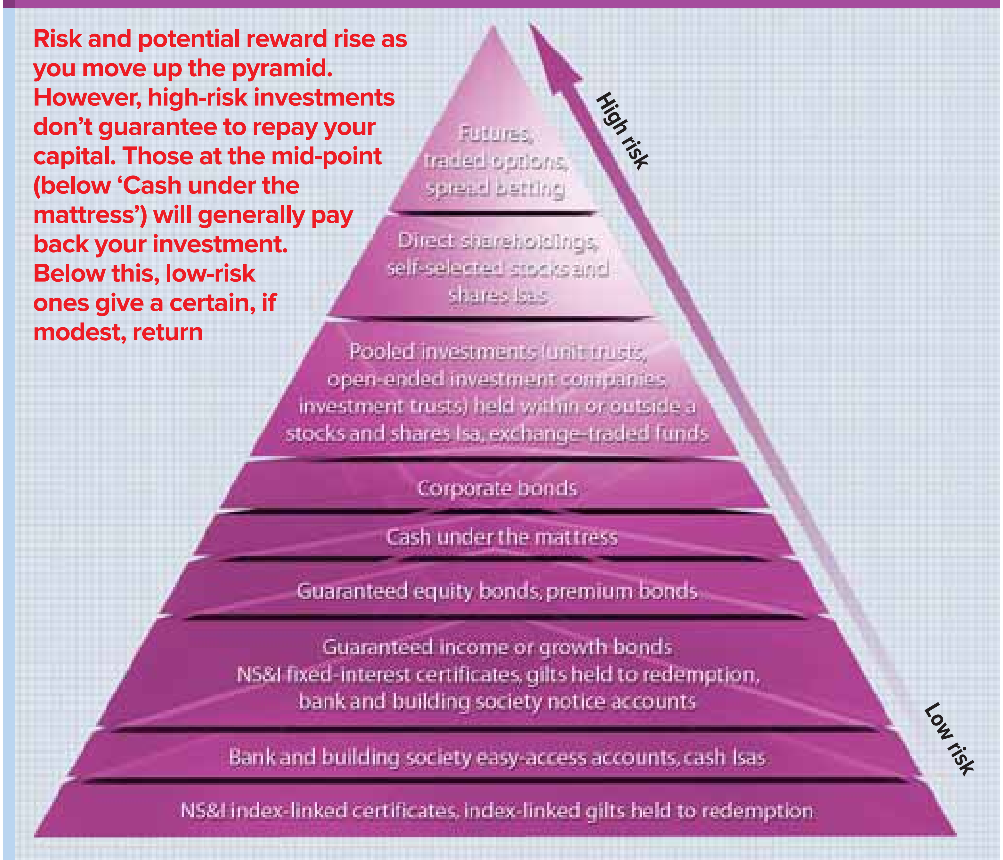
Not such a risky business

With Northern Rock still in the news, how can you minimise the risks to your money?

Investing is all about assessing risk against reward. And for many people, particularly in light of recent events with Northern Rock, reducing risk to a minimum is all important.

The pyramid, right, rises towards the most risky – but possibly the most rewarding – investments with the least perilous at the bottom of the pyramid. We examine these less risky options and the significant differences between the investments.

THE PYRAMID OF RISK



Three key factors to take into account when considering risk-free savings are interest, tax and inflation. The interest you earn on savings varies considerably, depending on: the type and size of investment; the length of time you are prepared to see your money tied up; and how often you need access to it. For purposes of comparison, savers should always look at the annual equivalent rate (AER), which is the true rate of return. It assumes that you reinvest any interest you are paid monthly.

Headline interest rates tend to ignore tax and risk-free savers need to be very aware of this. Banks and building societies usually pay interest with tax deducted at the standard rate of 20 per cent. Higher-rate taxpayers pay 40 per cent tax.

As a risk-averse saver, the interest you earn needs to keep pace with inflation; otherwise, your capital's purchasing power will be eroded. For a basic-rate taxpayer, with current RPI at 4.1 per cent, this requires a minimum rate of 5.12 per cent gross, and for a higher-rate taxpayer 6.83 per cent gross. Your savings will grow only by the amount you beat this and only then if you reinvest the interest you receive.

National savings and gilts

At the base of the pyramid are National Savings and Investments (NS&I) tax-free saving certificates, particularly index-linked certificates, which guarantee to outstrip inflation. Available from post offices and online (see 'Contacts', p23), a number of issues are offered each year, and you can invest up to £15,000 in each one. The most recent pays interest at 1.35 per cent plus inflation. Based on the latest figure, this gives a rate of 5.45 per cent, equivalent to 6.81 per cent gross for a basic-rate or 9.08 per cent for higher-rate taxpayers.

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Alongside these are British government stocks or gilts, which can be bought through a stockbroker. These usually pay interest twice a year, plus the stock's nominal value when it reaches its redemption date, which may be ten or more years later. They can be sold before this for a less certain return.

Cash Isas

A good way of boosting your savings is to hold them in a cash Isa. The interest from these accounts is tax-free. You can pay in up to £3,000 a year (£3,600 from April 2008) and top up your Isa holdings annually. A Best Buy such as Kent Reliance's Direct account offers 6.21 per cent. Grossed up this is the equivalent of 7.76 per cent. (For more, see 'A brand new Isa age', *Which?*, March 2007, p20). Most savers can benefit by using their annual Isa allowance before putting any funds remaining funds into ordinary taxed accounts.

Savings accounts

You may use a current account for everyday spending, but it makes sense to move any surplus funds into a savings account. In choosing one, you need to look carefully at its features as well as the interest rate it pays.

Instant or easy-access accounts suit those who may need to withdraw money at short notice. They are suitable accounts for rainy-day funds but don't offer much growth above inflation. The best rates are currently

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SAFE BUT ACTIVE SAVING

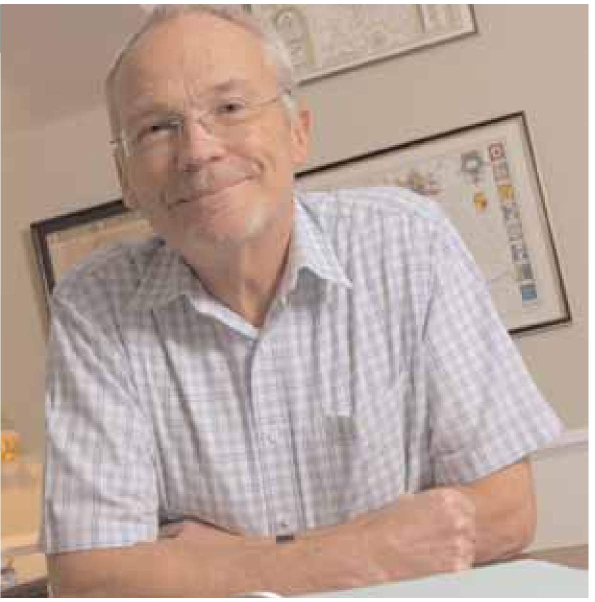
Robert Thornberry *57, accountant*

Robert has long-term holdings in a stocks and shares Isa, but his most active investments are risk-free. His strategy is to 'keep a close eye on what's on offer and move my money when necessary'. For example, he ditched ING when it failed to pass on interest rises. 'I look for accounts with the highest rates guaranteed for about 18-24 months,' he said.

He has a cash Isa with Which? Best Buy Kent Reliance (see 'Money monitor', p24), paying 6.21 per cent tax-free, equivalent to 7.76 per cent gross for basic-rate taxpayers and 10.35 per cent for top-rate payers.

Robert also has savings accounts with Icesave, ICICI and Nottingham Building Society. Icesave pays 6.20 per cent. ICICI pays 6.30 per cent but is excluded from our tables because it is not a member of the Banking Code – a voluntary code agreed by the banking sector to provide a minimum level of performance.

One investment where Robert accepts a small element of chance is premium bonds. He enjoys the fun of unexpected prizes – and recently won £5,000.



around 6.4 per cent gross (see 'Money monitor', p24, for Best Buys), which offers 5.12 per cent net to basic-rate taxpayers. If you invested £10,000, the gross interest you would get at 6.4 per cent is £640. Tax at 20 per cent on this is £128, which leaves £512 net. For higher-rate taxpayers the net rate is 3.84, which means their money lags 0.26 per cent behind inflation.

Higher rates of interest are often offered to savers when they open a new account. These bonus rates commonly last for six months or a year, reverting to a lower rate thereafter, so it is worth making regular checks to confirm the rate you will receive.

Some savings accounts offer higher rates of interest to those who can give 30, 60 or even 90 days' notice before making withdrawals, although the best easy-access accounts increasingly tend to match these.

Others limit the number of withdrawals you can make to three or four a year – deducting interest if you need to make more. Another common feature is tiered interest rates, where those who can afford to deposit a large sum are paid a higher rate.

Regular deposits can also earn you higher rates with some accounts, such as Yorkshire Building Society's Regular Saver, which currently offers 7.10 per cent. Accounts of this kind do not normally allow withdrawals during the year and are often capped in terms of the total amount you can save.

Higher rates still can be earned by combining your savings and current account, or saving with your mortgage provider. For example, Alliance & Leicester's Premier Regular Saver account offers 12 per cent for the first year to new customers.

Bonds, bonds and more bonds

As we move up the pyramid, we find riskier bonds. Guaranteed income or growth bonds are sold by insurance companies and guarantee to repay your original investment, plus interest, provided you hold them for the full term – typically up to five years. As with any fixed-rate product, you may lose out if the base rate rises.

Guaranteed equity bonds are risk-free only in that you should get back your original investment, but interest paid is linked to stock-market performance. There is a risk of a poor return if equities fall over the period you hold the bond.

NS&I also pays premium bond prizes tax-free. These are not the same as guaranteed interest, as you may not win, but your original investment is never at risk, except from inflation if you don't win anything.

Cash under the mattress

Finally, worried savers may be tempted to put their cash under the mattress, but, surprisingly, this is a fairly risky strategy. As it is not earning interest, your capital will be seriously eroded by inflation. For example, at current rates, after ten years, £100 would be worth only £65.80.

So, while greater risk may bring greater reward, there are numerous alternatives for risk-averse savers to get solid returns on their money and to keep their savings secure (see 'In case of emergency', right).

In case of emergency

The government has stretched the safety net

For many, the Northern Rock situation has shaken confidence that there is any such thing as risk-free saving. Thankfully, there's no need to panic and the government has also stepped in to allay fears further.

Strictly speaking, saving with government-backed institutions such as National Savings & Investments (NS&I) is safer than if you save with building societies and banks, though in the UK, banks are authorised by the Financial Services Authority (FSA) and covered by the Financial Services Compensation Scheme (FSCS).

Recently, the Chancellor announced that the FSA has increased the limit of the FSCS so that it covers the first £35,000 of an individual's savings.

Sums above this are not covered by the scheme, so risk-averse savers with more to invest should consider using different institutions to limit their exposure. However, the overall level of cover may rise in the new year depending on the outcome of government consultation.

Contacts

Alliance & Leicester
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Bradford & Bingley
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Financial Services Authority
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Icesave
www.icesave.co.uk

Kent Reliance BS 0845 122 0022; www.krbs.co.uk

National Savings & Investments 0845 964 5000
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Nottingham BS
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