MILSTED LANGDON

A GUIDE TO

TAKING ON FINANCIAL RESPONSIBILITY AFTER DIVORCE

INTRODUCTION

Many couples divide their domestic chores between them. One may have primary responsibility for emptying the rubbish bins and the other for changing light bulbs or doing the ironing. Of course, some chores will be shared but often, the primary responsibility for looking after the family finances will be borne more by one party than the other.

For those who have left the management of the domestic finances to their spouses, a divorce can mean having suddenly to “take over the reins”. This may seem at first to be a daunting prospect but this guide is intended to help demystify what you need to know to become a competent and confident investor, secure in the knowledge that you are living within your means and saving enough for your retirement.

BUDGETING – THE BASICS

Any consideration of family finances should start with a domestic budget by which we mean an estimate of how your wealth is likely to change over the course of a year.

There are essentially six factors that need to be taken into account, namely:

1

Your net wealth at the beginning of the year, being the value of all your assets (including your home, savings, investments and pensions) less the value of all your liabilities (including mortgages, credit card debts and student debts and bank overdrafts or loans).

2

How much you are likely to earn during the next 12 months from maintenance payments, from employment or from self-employment, after tax.

3

The amount by which your investments, if you have any, may increase in value including any income they may generate for you. Of course, there's always a risk that investments fall in value but one would hope that would be a rare event and certainly not the norm.

4

How much you are going to spend. This guide will help you work out what you are likely to spend during the year ahead on day to day living expenses.

5

How much debt you are going to repay or how much you are likely to borrow. If you have a mortgage, student debts, bank loans, credit card debts or hire purchase liabilities, you need to understand whether they are likely to increase or decrease and by how much.

6

How much you can afford to save, perhaps by contributing to a pension or, conversely, how much you have eaten in to your savings to make ends meet.

We shall consider each of these aspects of personal finance in the succeeding sections of this guide but the overriding principal is that you should start each year with a good understanding of whether, if all goes to plan, you should be able to afford to put money away for the future. Conversely, if your budget suggests that you are going to have to dip into your savings, you need to be able to understand if that is something temporary or, if not, whether it is sustainable.

> *If you would like some help to put together a cash flow budget so you can plan for the future with confidence get in touch now.*

It is important to recognise that as you go through life the dynamics of your finances change. When you are young, you ought to be saving for later life. Financial advisers call this the "accumulation phase" when you are accumulating wealth.

Later, perhaps in retirement, is the time to start to spend what you have saved and draw down on any pensions. Financial advisers call this the "decumulation phase" and, for those who have more than they are ever likely to spend it can involve the passing of wealth to the next generation.

The role of a financial adviser is to help you identify how much you should be aiming to save during the accumulation phase and how much you can afford to spend during the decumulation phase, as well as advising you about how to invest your savings and what protection policies (such as life insurance) might be appropriate for you.

WORKING OUT YOUR NET WORTH

A good starting point for anyone who is trying to get to grips with their finances is to work out what they're worth.

The more complex your financial affairs the more difficult this will be but the checklist below is intended to help you to identify everything that should be included in your calculation:

ASSETS	
Property:	
My home	☐
Investment properties	☐
Holiday homes	☐
Investments:	
Individual Savings Accounts	☐
Other bank accounts	☐
Premium Bonds	☐
National Savings	☐
Building Society savings	☐
Investment bonds	☐
Share portfolios	☐
Shares in family businesses	☐
Overseas assets	☐
Pensions	☐

ASSETS	
Other assets:	
Cars	☐
Jewellery, artwork and antiques	☐
Amounts owed to you	☐
Private aircraft, boats etc	☐

LIABILITIES	
Mortgages	☐
Bank loans	☐
Other loans	☐
Overdrafts	☐
Hire purchase liabilities	☐
Money you owe anyone	☐
Student debts	☐
Credit card debts	☐
Tax liabilities	☐

TYPES OF INVESTMENT

There are literally thousands of different ways to invest your savings ranging from a deposit into a building society savings account to the acquisition of a collection of vintage wine. Whether you decide to invest in gold or Bitcoin or the stock market, there are some basic principles that always apply of which the most fundament is the concept of risk and return.

What is risk?

A risky investment is one that can go down in value. Typically the greater the chance that the value of an investment might fall the more risky it will be considered to be.

Conversely, in order to attract investors, high risk investments usually offer the prospect of high rates of return. A good example of a high risk investment might be shares in a start up Tech company. Anyone buying shares will know that there is a good chance that the company might fail and the shares might become worthless but there will also be a possibility that the company will become the next Apple or Amazon and the shares could become worth a fortune.

Before making an investment it is important to think about your appetite for risk. Some people are risk-averse because they cannot afford to lose money but others are naturally cautious. By contrast, some people enjoy taking financial risks and get a “buzz” from the thrill of the possibility of achieving a big win without being too troubled by the thought of suffering a financial loss.

> *One of the most common misconceptions is that depositing money in a bank account is a risk-free investment. It is true that £100 in the bank today will still be £100 in 10 years’ time but the value of £100 in 10 years’ time in terms of what it can buy will be much less than its value today because of the effect of inflation.*

That is why investors often talk about “real returns”. The “real return” of an investment is the return over and above inflation.

We currently live at a time when bank interest rates are at an historically low level which means that investors need to take some risk even if all they want to do is to ensure that their savings aren’t eroded by inflation.

One way to reduce risk is to invest in assets that are very unlikely to fall in value but the safer an asset is, the lower the likely level of investment return that it provides.

A better way to reduce risk is therefore to apply the principle of “diversification”. This means investing in a broad range of investments so that, even if some fall in value, the chances are that others will increase in value to compensate.

In the context of the stock market, it is possible to have a diversified portfolio by investing in the shares of a large number of different companies operating in different sectors and perhaps even in different countries.

A good way to acquire an interest in a wide range of companies is to buy units in investment funds. These funds are run by investment experts who buy and sell shares all the time on behalf of their investors in an attempt to maximise the return for them within the constraints of their stated risk profiles. Some funds also operate with particular ethical policies or focus on specific geographical regions or sectors of the economy.

It is also possible to achieve diversification by investing across different classes of asset, perhaps not only buying shares but also, cryptocurrency, property, precious metals, artwork, premium bonds or any of the myriad of other options that are available.

By investing in a range of different investments, some high risk and some low risk, it is possible to achieve a blended overall risk profile that is suitable for you.

Income and capital returns

If you are considering what investments to make, it is important that you appreciate the two different types of investment return, namely income and capital.

Some investments, like money deposited in a bank, only provide an income return which, for a bank account is represented by the interest that the bank pays you.

Other investments, like vintage cars, wines or artwork for example, only provide a capital return. They may increase in value (and of course than can also go down in value) but they will never generate an income.

Finally, there are investments like shares in companies that provide both an income and capital return. The income return arises because owning shares in a company gives you an entitlement to receive dividends by which a proportion of the profit that the company may have generated in the year is distributed to its shareholders. By contrast, the value of a share in a company will itself fluctuate depending on how well the company is performing and how well it is expected to perform in the future. You might buy a share for £1 which you later sell for £1.50 giving you a capital return of 50p. However if, during the period you held the share, you received dividends of say a further 2p per year for say five years, your total return would be 60p.

It is important to consider whether you have a preference for income or capital returns because this can have a significant impact on the choice of investments that will be appropriate for you. Essentially, if you need your investments to provide an income for you, it may well be worth focussing on income-producing assets. By contrast, if you are content for any income to be reinvested, then the level of income may be less relevant.

Tax incentives

It is in the interests of the Government to encourage all of us to save for our retirement which is why some investments come with tax incentives.

The most common of these is the pension. In order to incentivise us to put money in our pensions, the government gives us tax relief on qualifying pension contributions. However, the quid pro quo is that once you have put money into your pension it is tied up until you reach retirement age.

A more flexible investment that comes with a tax incentive is the Individual Savings Account (“ISA”). Although the tax-breaks for an ISA aren’t as generous as for a pension, any returns from ISA investments are tax-free but there are limits to the amount you can invest in an ISA in any given year.

If you decide to put money into a pension or an ISA, it may then still be possible for you to choose how it is invested and how much risk you want those investments to carry.

PENSIONS

There are three types of pension, each of which are considered below.

State pensions

Anyone in the UK who has paid sufficient National Insurance contributions during their working life will be entitled to a state pension. They are payable from your retirement age which will itself depend on when you were born.

The basic state pension is £134.25 per week so many people augment it by contributing to other pension schemes.

Defined-benefit pensions

Defined-benefit (which are sometimes called final salary pensions) are only available to those who work for employers who offer this type of benefit. Defined-benefit pensions are far less common today than they used to be and they are now relatively rare outside the public sector.

If you have a defined benefit pension, your employer will tell you how much you have to contribute to it and a formula will determine what pension you will be entitled to when you retire. Essentially the longer you have worked for your employer and the greater your salary (either at retirement or averaged over the course of your career) the greater your pension will be.

Once you are in receipt of a defined-benefit pension it will be guaranteed to be payable to you for the rest of your life and may well include a provision that means that, if you are married when you die, your spouse can continue to receive a reduced pension until he or she dies. Most defined-benefit pensions are also "index-linked" which means that the amount of the pension goes up each year with inflation.

In addition to an annual pension, you will also be entitled to a one-off so-called lump sum payment when your retire.

The fact that they are guaranteed for life makes a defined benefit pension a very valuable commodity.

Defined-contribution pensions

Defined-contribution pensions typically have no guarantees associated with them. If you have a defined-contribution pension you and perhaps your employer will pay money into a fund that is ear-marked as being yours and yours alone. That money will be invested and hopefully increase in value by at least the amount of inflation if not more.

The value of the fund when you retire will reflect how much you and your employer have contributed to the scheme and how well the investments performed.

Some defined-contribution schemes are more flexible than others. The most flexible allow you to draw unlimited amounts from your pension as soon as your retire or to pass funds on to the next generation after you die. However, others are much more restrictive.

If you have a defined-contribution pension, it is really important to get professional advice about it so you understand what you are likely to get when you retire and whether your scheme has the flexibility you need. Furthermore, if you contribute to a scheme in which you are able to have a say in how the pension funds are invested, you should seek advice about this too to make sure that the investments are appropriately matched to your risk profile and also to any ethical objectives that you want to impose.

Swapping from one type of pension to another

If you have a defined-contribution pension you are unlikely to be able to convert it to a defined benefit pension. However, once you get to retirement age, you can use the fund that you have accumulated to buy an annuity which will pay you a guaranteed, and possibly index-linked, income for a fixed period or even for life.

In recent years annuities have become increasingly expensive and they are always somewhat of a gamble. If you are in poor health you may be able to buy a annuity relatively cheaply because the insurance company that sells it to you will bank on you not surviving long enough to enjoy many years of annuity income. Essentially the longer you live, the greater will be the value you get from an annuity.

The alternative to an annuity is simply to "draw down" or use your pension fund each year to supplement your income and hope that it lasts your lifetime.

Making decisions about your pension can be difficult and professional advice should always be sought to help you understand the pros and cons of each of your options.

One of the biggest decisions that you can face can arise if you have a defined benefit pension and your employer offers you a lump sum to convert it to a defined contribution scheme. If you accept the offer you will lose the cast-iron guarantees that come with a defined benefit scheme but there can be good reasons for making the swap, including the fact that benefits under a defined benefit scheme cannot be passed to the next generation whereas some defined contribution scheme benefits can be inherited.

Transferring from a defined benefit scheme can often be the biggest financial decision you'll ever make so getting the right advice is really important.

PROTECTION

Most of us insure our cars and our houses against fire, theft and damage but relatively few of us insure against financial risk. Such insurance can provide protection not only for yourself but also for those who are financially dependent on you.

It is almost impossible to insure against everything but it is sensible to give consideration to what insurance is available and to make a conscious decision about what policies might be right for you. Here are some examples of the types of policies that are worth considering:

- Life assurance – which pays a lump sum to you or your dependants in the event of your death. It can either be for a fixed amount or, for those who want to use it to pay of a mortgage, it can be linked to the amount outstanding on the mortgage itself.

- Term assurance – which is cheaper than general life assurance because the policy only pays out if you die within a given period or "term".

- Critical illness insurance – which pays a lump sum in the event that you are diagnosed with certain terminal or critical illnesses.

- Income protection insurance – which pays you an annual income if you are unable to work due to ill-health.

Deciding what protection to buy, if any, is a very personal decision but getting quotations for suitable policies costs nothing. You might decide you cannot afford insurance or are content to live with the risks but equally, you may conclude that a modest monthly cost is a price worth paying for peace of mind.

KNOWING WHAT YOU SPEND

An important part of any financial plan is to have a realistic view about how much you spend so that you can work out if you are living within your means. It's all too easy to think about regular expenditure on rent, groceries, utilities and so on while forgetting the vast number of less frequent costs that we all inevitably incur and which should be included in any annual domestic budget.

If you want to work out what you spend each year, here's a list which, though not exhaustive, should cover most of the most common expenses:

Housing
- Rent
- Rates
- Water rates
- Waste/garden waste
- Mortgage
- House insurance
- Repairs
- Cleaning
- Gardening
- Swimming pool
- Second home

Groceries
- Food
- Household products

Leisure
- Eating out/take-aways
- Books/music/film/TV
- Gifts
- Cinema/days out
- Holidays
- Short breaks

Personal care
- Clothes
- Haircuts
- Make up and toiletries
- Manicures/pedicures etc

Pets
- Pet food
- Veterinary bills
- Insurance

Healthcare
- Dental costs
- Prescriptions
- Medication
- Complementary medicine
- Health insurance
- Opticians

Children
- School/tuition fees
- Clothes/shoes
- Gifts
- Parties
- Healthcare

Finance costs
- Credit card interest/ repayments
- Loan interest/repayments
- HP/lease payments

Utilities
- Telephone
- Broadband
- Mobile phones
- Electricity/gas/water

Transportation
- Rail/bus/taxi fares
- Motor costs:
  - Lease costs
  - Fuel
  - Insurance
  - Repairs
  - Replacement vehicles

Protection
- Life assurance
- Critical illness
- Income protection

Savings
- Pensions
- ISA's
- Other savings

MANAGING DEBTS

If you have any significant liabilities it is important that you understand how quickly they need to be repaid and what interest you are being charged.

> *Some debts can be much more expensive that others and moving liabilities so as to minimise the level of interest you pay can save you a very considerable amount.*

Typically mortgages and long-term loans are much cheaper than overdrafts and credit card debts but sometimes low or even zero rate interest “deals” are available that can make even short term borrowing very cost-effective.

If you have any debts, you should find out whether they are subject to repayment terms. Most importantly, if you have a mortgage that is “interest only” (as opposed to being a repayment mortgage) your monthly mortgage payments will only be meeting the ongoing interest and will not be reducing the overall amount you owe. That means that, at the end of the mortgage term, you will have to find the money from somewhere to repay the capital balance.

If the mortgage is secured on your home and if you don’t have any other savings, that could mean having to sell your home to repay the mortgage. If you want to avoid this, you may need to consider converting your interest only mortgage to a repayment mortgage or building up savings elsewhere that can be used to repay the mortgage at the end of its term.

For the purposes of long-term financial planning it is important to decide whether you are comfortable living with debt and, if so, that it remains at a manageable and affordable level. If you are uncomfortable about being in debt, you need to put together a long-term strategy to repay what you owe. Once again this is where a professional financial planner can help.

> *If you would like more information about anything discussed in this guide, please get in touch:*
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