NEWS & VIEWS

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ALLOCATING YOUR WEALTH

For many people, the prospect of retirement can seem almost unreal. Nevertheless, it is important to plan ahead and time is your most valuable weapon. Building sufficient assets to fund your retirement will take a long time, and the earlier you start, the better. Even putting a small amount away on a regular basis can make a difference over the long term.

Investors receive income tax relief on their contributions to an occupational and personal pension schemes, subject to certain limits. You can contribute up to £3,600 or 100% of your net relevant earnings, whichever is the greater (subject to an overall maximum of £50,000 in the tax year 2012/13). Your contributions to company pension schemes are deducted before income tax is calculated. For contributions to personal pension schemes, your pension provider will reclaim any tax that you paid before you made your pension contributions.

It is also worth considering individual savings accounts which are tax-efficient 'wrappers': all income and profits generated by the investments held within are paid out free of further tax. The amount of money you can invest in an ISA is also subject to limits (currently £11,280 during the tax year 2012/13, £5,640 of which can be saved in cash), but it is worth getting into the savings habit.

PLANNING YOUR INHERITANCE

Soaring property prices have pushed many people above the Inheritance Tax (IHT) limit. For the 2012/2013 tax year , the individual allowance is £325,000 (or £650,000 for married couples and civil partners). However, a little bit of planning can help you access the annual exemptions and allowances that are available to you, in advance. For example, regular gifts can be made from income without liability, and small gifts can be made annually from capital to children and for weddings . Larger sums can become exempt if the donor survives seven years. Alternatively, you can set up the funding for beneficiaries to pay the IHT bill via some form of insurance policy, so they don't have to sell items of sentimental value.

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ON YOUR BEST BEHAVIOUR

Investors are strange creatures: they wait until the market has risen before they put money in and then sell out when the market has plunged - or worse, hold on to a floundering stock, waiting for it to get back to the value they paid for it.

Why do we behave irrationally? We would not wait for the price of our morning coffee to go up 20% before buying it, so why do we do this with investments? Why do we panic when markets drop, even though we knew it would happen? And why do we become attached to lame ducks when selling them and moving on would get our money back quicker? Many theories abound: go back as far as the 18th century and economists such as Adam Smith were seeking an explanation of why markets behave as they do. One that has gathered force of late is behavioural finance.

Behavioural finance suggests people often make decisions based on so-called rules of thumb, rather than after rational analysis. Technically referred to as heuristics, it involves understanding that the way a problem is presented can affect the outcome (a process called framing). Therefore, market inefficiencies are not the only way to explain outcomes that go against rational expectation.

Two of the most influential psychologists in the field are Daniel Kahneman and Amos Tversky who, in 1979, published a paper comparing models of rational economic behaviour with decision-making during times of risk and uncertainty. Their theories sought to explain anomalies in the way investors and financial markets react.

These theories help explain how we all got pulled into phenomena such as the technology boom (mostly too late to make any real money), despite the irrational theories that tend to support them. They also help explain why we sell out of a falling market, just when our loss is at its greatest, and why we hold on to 'loved' investments long after they have started to go wrong. And it is why we shy away from markets that have underperformed, despite indications of great potential.

Increasingly, asset managers are using pricing models to take behavioural biases into account, as they believe it gives them an advantage. If you understand these theories, you could have that advantage too.

REACHING YOUR INVESTMENT GOALS

Investors are generally either income-seekers or growth-seekers but, whatever your aims, it is important to set them out and understand your attitude to risk as these decisions will form the basis of the investments you make. There is a relationship between the amount of risk taken and the amount of potential return but, to ride out short-term ups and downs, you need to take a long-term view. So the decisions you make about a pension – which might have a 35-year lifespan – will be different to those of, say, an inheritance which you want to spend in less than five years. Put the latter in the wrong place and you risk losing a lot of what you have been given.