Guide to investing for children

CHARLES STANLEY *Direct*

Introduction

Whether it is saving for school or university education, or to provide a deposit on a first home, giving your children or grandchildren a good start in life is among most people's top priorities. As with all investing, the earlier you start the better and even saving a relatively modest sum each month can be very effective over the long term – especially if it is well invested.

First steps

The first decision to make is what you are saving for, and the likely timeframe. This will, to some extent, dictate the type of investment you choose. Investments for children generally have time on their side, so taking on the risk and volatility of the stock market in pursuit of higher returns is worth considering.

Leaving money in cash is the lowest risk approach. It provides very little return but it does have the important advantage of keeping capital secure. However, even in the short term cash is unlikely to grow fast enough to keep up with inflation - the increase in the cost of living.

The main other types of asset – equities, bonds, property, commodities – each have different characteristics, but unlike cash all can fall as well as rise in value to a greater or lesser extent. History shows that over the long term equities (representing shares in individual companies) are the most volatile asset class but have also provided the best returns. In the final section of this guide we offer some fund ideas which are predominantly equity-based.

Tax benefits

Once you have considered which asset class is appropriate for your needs it is time to look at which investment vehicle to use. One option that is notable for its tax-efficiency and flexibility is a Junior ISA.

Junior ISAs are a popular way for family and friends to build up tax-efficient savings and investments for a child. The tax benefits are the same as an adult ISA – no capital gains tax, and no further tax to pay on income. Withdrawals are possible from the age of 18 when it automatically converts to an adult ISA, meaning the pot can be useful to help with the cost of university or a deposit for a house.

A parent or legal guardian of an eligible child can open a Charles Stanley Direct Junior Stocks & Shares ISA online, manage the account and make the investment decisions. Grandparents, relatives or family friends can then also contribute at any time up to the annual investment limit.

Any child resident in the UK is eligible for a Junior ISA, although those who hold a Child Trust Fund or Junior ISA elsewhere will need to transfer it in order to open a Charles Stanley Direct Junior ISA.

Junior ISAs are easy to manage and flexible. With the Charles Stanley Direct Junior ISA you can contribute ad-hoc lump sums or a monthly amount via direct debit of at least £50. There is also a wide investment choice of thousands of funds.

Child Trust Funds

Child Trust Funds (CTFs) are tax-free savings products that have been replaced by Junior ISAs. Although it is still possible to contribute to existing CTFs, only a small number of providers offer them and it is now possible to transfer a CTF into a Junior ISA.

SIPPs

Parents and grandparents can also contribute to pensions for their children. Under current rules the earliest they will be able to access the money will be at 55 (though this is set to rise), but it could provide an excellent foundation for their retirement plans. Indeed, investors wary of handing large investments over to children on their 18th birthday could consider the pension route.

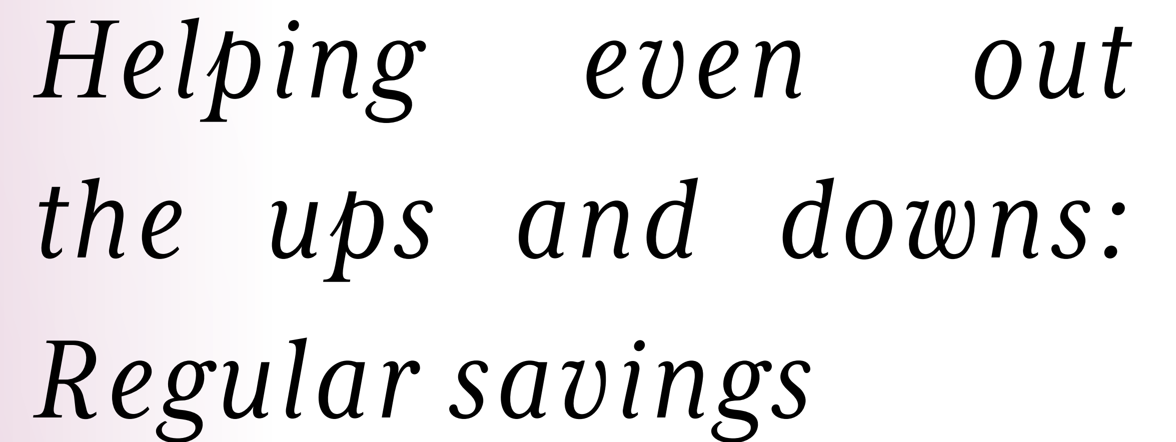
The other advantage is tax relief. Most people, including children, can contribute up to £2,880 a year to a personal pension, which the government will boost to £3,600 irrespective of whether they pay tax or not. Remember tax rules and state benefits for pensions could change substantially between now and the child's retirement, and this adds some uncertainty as to how benefits might be taken.

A self-invested personal pension (SIPP) is a flexible type of personal pension. Like all pensions, it is designed to grow your money to provide a retirement pot from which an income can be drawn. Other types of personal pensions often restrict your investment choice to a range of funds run by the pension providers own fund managers, though they can have lower charges. With a Charles Stanley Direct SIPP you are have given access to the same wider range of investments as a Stocks and Shares ISA or investment account.

Account designation

Although tax efficient, Junior ISAs and SIPPs have annual investment limits. For larger sums it is possible to open an investment account in a parents name but “designated” to a child. If set up as a “bare trust” it will belong to the child for tax purposes.

Bare Trusts are simple trusts created when you make a gift into a designated investment account with the intention of creating a trust. The child is the beneficiary of the trust and becomes automatically entitled to the investments at 18. However, acting as trustee, a parent may be able to distribute money earlier so long it is for the benefit of the child, for example to pay school fees.



Helping even out the ups and downs: Regular savings

Your child doesn’t need a large amount of money to begin with to become a wealthy investor. Almost anyone can build a sizeable sum by investing small amounts regularly. The key is getting started. The earlier you do the more time your chosen investments have to grow - and time can be an exceptionally powerful ally for an investor.

For long term investing children have time on their side, and can allow their investments to ride out the peaks and troughs of any stock market fluctuations, providing time for compound returns to take effect. Albert Einstein once referred to compound interest as the eighth wonder of the world, and even if you don’t have a multi-decade time horizon it is still possible to build up a significant sum.

Regular savings are also flexible, so you can stop and start them as you wish, or change the amount if you need to. They can have the advantage of helping smooth out the effect of stock market volatility too. By investing a given amount monthly in equally-sized chunks, rather than a larger lump sum in one go, an investor ends up buying more shares or units when prices become cheaper, and fewer when they become more expensive. This systematic approach takes away any decision of market timing and helps conquer bad habits such as only buying shares when markets are buoyant.

You can start a regular savings plan for a child in a Junior ISA or Investment Account from just £50 per month.

Investment ideas

Income and capital gains tax

Using a Junior ISA or SIPP is likely to be the simplest way to minimise tax for a child's investment. They are free of capital gains tax and there is no further tax to pay on any income. Designated accounts, however, are liable for tax and the tax position of both the child and the donor needs to be considered.

Children have the same personal income tax allowance and capital gains tax allowance as adults. So while deposit savings accounts and other investments, such as unit trusts and shares are taxable, the sums involved usually fall within their allowances meaning no tax is payable.

However, the rules are slightly different in respect of income from investments given to children by their parents. Up to £100 each year is tax free (or £200 if both parents have contributed). Any more and the parents must pay tax on all interest or dividends at their highest rate. For investments made on the child's behalf by any other relative or family friend, there are no such issues and only interest or income over the child's personal allowance would be taxable.

Inheritance tax and gifting

Parents and grandparents are often keen to make gifts to children as a way of potentially reducing inheritance tax (IHT). Each person is allowed to give away up to £3,000 each year free from IHT and, in addition, £250 each to any number of recipients who have not also benefitted from part of the £3,000 exemption.

It is also possible to make gifts out of "excess" income free from IHT. These regular payments are IHT free provided they do not have a detrimental effect on standard of living. This exemption can be useful when contributing to regular savings investments for children.

Sums which don't qualify for any of these exemptions are usually treated as potentially exempt transfers (PETs). Providing the donor survives seven years following the gift, they will also be IHT free. If not they will be added to the donor's estate for the purposes of calculating IHT.

A 'hands off' approach – Charles Stanley Multi Asset Funds

These funds represent 'ready-made' portfolios designed to meet different, broad investment needs and risk profiles. Managed by Charles Stanley's investment team each fund is spread among various underlying investments in different areas. Not having all your eggs in one basket means you are not reliant on specific investments performing well.

Our experts choose from different asset classes, mixing shares and bonds as well as alternative investments such as absolute return or infrastructure funds. If you don't want the hassle of putting together, monitoring and rebalancing a broad portfolio yourself the Charles Stanley Multi Asset Funds could be worth considering.

Dividend growth – River and Mercantile UK Equity Income

With constant news about market developments and geopolitical events it is easy to lose sight of the power of reinvesting dividends. Yet it is an important trend that is always on your side as a long term investor. Reinvesting dividends "compounds" returns: Your income is used to buy more shares, which means you receive greater quantities of dividends in the future. Repeat the process over a long period and the compounding becomes even more powerful.

Equity income is the mainstay of many investors' portfolios, and an excellent area to keep adding to for the long term. Companies that can consistently grow their dividends can provide investors with a growing income and long term capital growth on top. Many investors choose the big names in the sector, but one unheralded fund we like is River and Mercantile UK Equity Income. The modest size allows the manager, Daniel Hanbury, more scope to consider smaller companies where other funds might struggle to build meaningful positions. This flexibility could lead to outperformance over the long term if the manager gets his selections right.

An adventurous option – Lazard Global Emerging Markets

Emerging markets have had well-publicised troubles over the last few years but they are more important than ever to world growth. With large populations that are getting wealthier they could offer a valuable source of returns for more adventurous investors happy with the risks.

A broad emerging markets fund like this one can cover all areas including China, India, South East Asia, Latin America, Eastern Europe and even Africa, aiming to seek out the best opportunities wherever they lie. Valuations now look cheap compared to many developed markets, and for a long term investment in nations that are likely to be the growth engines of the future this fund is worth considering as a high risk children's investment.

Alternatives

Investors can also choose from all the collective investments available on the Charles Stanley Direct platform, comprising over 3,000 funds and investment trusts, and our Foundation Fundlist and Foundation Portfolios could provide you with a starting point for your own research.

For further information

Remember: take advice when you need it

If you have a more complex situation that needs expert attention we can introduce you to a Charles Stanley Investment Manager or Financial Planner at any time, whether on the telephone or at one of our local branches.

If you have any further questions on investing for children or on investing via Charles Stanley Direct please contact our Helpdesk on 0131 5501234.

Important information

This document is a marketing communication. The information does not constitute advice or a personal recommendation or take into account the particular investment objectives, financial situations or needs of individual investors. If you are unsure as to whether an investment or a pension is suitable for you, please seek professional financial advice.

Investors should be aware that past performance is not a reliable indicator of future results and that the value of investments and the income from them may fall as well as rise. The capital invested is therefore at risk and the amount realised may be less than the original sum invested. Investments should be considered for the medium/long term (5 years or longer).

Before you invest and for your own protection, please ensure you have read the available product literature carefully.

For funds that invest overseas, exchange rate variations may cause the value of your investment to rise or fall. Investments in certain funds, including emerging markets, specialist geographical areas, smaller companies and specialist sectors (such as technology & ethical stocks) tend to be more volatile. Where a fund's objective is to provide income and the income is paid out, there can be reduced potential for capital growth, especially over the medium to long term. The level of income payments can vary and where a bond fund's running yield is greater than the redemption yield, this may erode capital.

Some funds invest in higher risk fixed interest securities, known as sub-investment grade bonds. These bonds have a low credit rating and higher risk of default than investment grade bonds. This means that there is an increased risk that the value of your investment could fall.

The tax treatment of investments and pensions depends on individual circumstances and may be subject to change in future.

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