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SAVING

Saving and investing are about making your money work harder so you don't have to. Before anyone even thinks about saving or investing – and why they are different and which they should do – there is one key question to ask: **do you have debts?**

If the answer is 'yes', you must, before you even think about putting a penny into a savings account or an investment, **pay off your debts**.

The one exception might be – only *might* be – your mortgage (see pages 175–9). But if you have a credit card that you do not pay off in full each month, an overdraft, a personal loan, debts on catalogue purchases or any other debt at all, don't save and don't invest.

Here's why. The average interest charged on a credit card debt or overdrafts is about 16 per cent. The average paid out on savings is about 3 per cent. The difference is 13 per cent. So if you have £1,000 worth of debt it will cost you about £160 a year just to pay the interest due. At the end of the year you will have spent £160 and still owe £1,000. If you have another £1,000 in a savings account, even if it earns 3 per cent, you will get back £30 less £6 tax so that means you end up with £24 (and a nice warm glow, of course, knowing that you have given the government a tenner). Knock that £24 off your £160 cost and you have spent £136.

AUTHOR'S CONFESSION

When I was first self-employed I carefully put a third of everything I earned into a separate savings account so I knew it was there to pay my tax at the end of the year. I did that even though it meant sometimes my current account went overdrawn (I had an overdraft arrangement, of course, which kept down the cost of going overdrawn). But even if I was overdrawn I knew I had the money to pay my tax. I knew it cost me over the year. But I called that expense my 'sleep at night' money. So like all rules, the one about not saving if you have debt can be broken for a good reason.

But if you use your £1,000 to pay off your debt you spend nothing during the year – saving £136. So before you save, pay off debt.

If you have debts, turn now to chapter 9, which tells you about good debt and bad debt, how the banks make money out of you, and how to pay debts off. If you do not have debts, carry on with this chapter and see how to make your money work for you as hard as you worked for it in the first place.

SAVE OR INVEST?

So you have no debts. You have some money to spare. You want it to earn money.

First, understand that saving and investing are different – very different. But they are often confused, even by the government. The Treasury confuses them by using calling its tax-free deal an 'individual savings account' or ISA. Some ISAs are savings accounts. But many others are in fact investments. National Savings & Investments – which should surely know as it has both words in its name – uses the terms interchangeably. It calls its 'passbook savings account' an investment account and says its savings certificates offer a 'range of investment terms'. But the difference is vital.

If you save, your money remains yours. If you invest, your money belongs to someone else. It is that simple – and that important.

Here is how the difference works. Let us assume that you have £1,000 to spare. You go online and open a savings account. You transfer the money into it. The £1,000 remains yours. You have lent it to the online bank. A year later, you need the money back. You go online and transfer the money back to your current account, visit a cash machine and take it out. And the bank has added £50. It takes off £10 tax which leaves you with a **profit** of £40 – for no work. Magic!

For the whole year that money was yours and it was not at risk. You could always get it back.

Alternatively, let us imagine that you have heard that wine is a very good investment. So you go along to a wine merchant and speak to Justin Oenophile, who recommends a case of 12 bottles of a fine Bordeaux, from a chateau called Bonterroir. It costs £1,000, which works out at more than £80 a bottle. But you have heard that the price of fine wine has doubled in the last year or so. You take the wine home and put it in the cellar, or more likely the cupboard under the stairs. A year later, you need the money back. You have resisted drinking even one bottle of the Bonterroir but you cannot take the wine to the bank and cash it in. You have to sell it. But when you go back to Mr Oenophile, who warmly recommended that particular chateau, told you how well it had done and said that if he was investing in one case of wine that would be his choice, he now says that for some reason there is a bit of a glut of wine from that particular part of Bordeaux ('It's left bank, you know, and right bank is much more in demand this year'). Eventually, muttering something about grape varieties and soil conditions, he reluctantly offers you a take-it-or-leave-it £450 – and that is cutting his own throat. **Loss:** £550.

That is the difference between saving and investing. And just because most investments involve money rather than wine that does not mean that the money you use to buy them is still yours. It is not. Just as when you buy wine, the money becomes someone else's. The investment is yours. To get your money back depends on their honesty when they sell you the investment, and whether someone – anyone! – will want to buy it when you want to sell it – and at what price.

So if you have money to spare or you want something in the future and you are 'saving up' for it, should you save or invest? The answer you will get from most financial advisers is 'How much you are prepared to risk?'. Often they use the word 'appetite', as in 'your risk appetite', or even ask you 'What is your appetite for risk?'. Most people have not got a clue, nor do they really understand what is being asked. In fact most financial advisers do not fully understand risk.

Risk will be further discussed later, but for now it is the wrong question. When you consider whether to save or invest the only question you should ask yourself is 'When will I need this money?'. If the answer is within one year, you should save. If it is in 40 years' time, you

should invest. If it is somewhere in between, it depends. Up to about five years, saving is always the answer, and even up to ten it can be the right thing to do. Over that and you might think of investing.

That is where the difficult choices begin.

SAVING ESSENTIALS

Saving should be simple. You lend your money to the bank or building society, it pays you for the loan by adding a certain percentage to the money you lent. It is like rent for using your money and it can be paid every month or every year or, sometimes, when you take back the money you have lent it.

Because interest is expressed simply as a percentage, comparing one savings deal with another should be easy. Interest at 4.5 per cent should always be better than interest at 3.9 per cent but worse than interest at 5.6 per cent (if you are saving, of course: if you are borrowing the opposite is true). And so it used to be. But over the last 20 years the banks have tried out every means they can devise to make it complicated, difficult and confusing – 'complexification', we might call it. Others have described it in shorter and less sympathetic terms – 'deceit' being about the simplest.

It sometimes seems as if the banks have teams of people devoted to working out ways to take money off us in such a way that we will not really notice. Some of the cleverest tricks are reserved for when they lend us money. But they are pretty sharp when it comes to borrowing money off us – in other words, persuading us to deposit our money with them.

Generally it is better to ignore all the trickery and go for a simple, instant access, cash savings account that offers the best rate of interest. Now let's look at what all those words mean, starting at the end.

Interest rate This is the rent the bank pays you for the use of your money. If you lend it £1,000 and the interest is 5 per cent then you should get £50 back for each year they have it. Ah, if only it were that

AER AND GROSS INTEREST

Interest can be paid monthly or annually or sometimes at the end of the deal when you take your money back. Let's say you put £1,000 in a bank account and the interest is paid monthly. Say the gross rate is 6 per cent but it is paid monthly at 0.5 per cent (6 per cent/12 = 0.5 per cent). So each month 0.5 per cent is added on to your £1,000.

At the end of month 1, you have £1,005. In month 2 that £1005 is earning interest, so at the end of month 2 you will earn not £5 interest but £5.03. That is because the £5 is also earning interest. By the end of month 12 you have earned £61.68 instead of the £60 that 6 per cent on £1,000 might imply. The AER rate is therefore not 6 per cent but 6.168 per cent, which is always rounded to two decimal places so it will be expressed as 6.17 per cent.

This is because, over the year, the money you invested (the £1,000) has earned £61.68. Now that bonus of £1.68 may not seem very much. But if you let it run another year instead of £120 you will have earned £127.16. And after five years you will have earned £348.85 instead of £300. So where interest is paid more frequently than annually, AER is higher than gross.

simple! Interest on savings can be quoted gross or using something called AER (which stands for Annual Equivalent Rate: in other words the rate your money would earn if you left it in for a year). When making comparisons, always look at the AER because you can be (fairly) sure that the one that is bigger is the one that is better.

The box above explains the difference between AER and gross interest. Skip it if you do not need (or want) to know.

As you have realised, AER and gross are the same when the interest is paid annually. Accordingly, of course, where the interest is paid

less frequently than every year AER is less than gross. For example, if your £1,000 earns £60 a year but it is not paid until the end of two years (so £120 is added to your money), then it still 6 per cent gross but is 5.68 per cent AER. And if you let it run five years and it earned just £300, still 6 per cent gross, but just 5.26 per cent AER.

That is why it is important only to compare AERs and why the law says the AER must be shown as the most prominent figure. So the important thing to check is the AER. If company A offers a rate of 5.89 per cent gross and company B offers 5.95 per cent gross, which pays the better interest? You might think it was company B as its interest rate is higher. But no. Company A pays interest monthly but company B only pays it annually. So company B has an AER of 5.95 per cent but company A has an AER of 6.05 per cent. So if you leave the money invested company A pays the better rate.

BEST BUYS

So, with one number to look out for – AER – it should be easy to compare savings accounts. You can do that easily by logging on to one of the many comparison sites on the internet or looking in a 'best buy' table in the paper. But sadly, it is not that easy. Best buy tables are a blessing and a curse. There are three problems with them.

First, none of them has data on every single savings account (or every single one of anything – this is a general problem of these tables, not just a savings account problem). There are various reasons for this.

The sites generally charge companies to be featured (they dress this charge up in many ways, such as calling it a 'subscription' to their services, but basically it is a charge). However, some smaller companies – especially building societies and credit unions – cannot afford the fee, which can run to tens of thousands of pounds a year. Some companies just choose to opt out of the tables. And others can be excluded. For two years one foreign-owned bank which operated in the UK did not appear simply because it did not subscribe to the Banking Code. Once it did, the bank and its very good savings offers appeared in the comparison sites.

Secondly, because the best buy lists are businesses and want to make money they offer special deals to some customers in exchange for a fee. That is why you will see a series of 'sponsored links' above a best buy list. They are *not* the best buys – they have just paid to be there. So always look down the page to where the genuine best buys begin. As ever, the AER is the clue.

The third problem with best buy tables is more subtle. Banks and building societies add bells and whistles to push their product up towards the top of the table. On savings accounts many offer a 'bonus' which is a higher rate of interest for six or 12 months so that the AER appears very good. But in fact at the end of that period the rate is rubbish. For example, at the time of writing six of the top 15 instant access savings accounts have a bonus for a period ranging from six months to a year. One building society offers 6 per cent, putting it in the top three, but after a year that rate plummets to 5 per cent, which would take it down to 56th place. So unless you remember to move your money after a year you will stop getting a decent return – and clearly, a lot of people do just that. They let their money languish in accounts that may once have been good but are now rubbish: one of today's examples pays just 1.11 per cent. Even that is not the worst. Some pay 0.25 per cent a year.

Not everyone agrees that AER is the thing to use. For example, MoneyFacts, the oldest comparison service, always quotes rates gross. It does that because some people do not leave their money invested. They want interest paid monthly because they use it to boost their income. In the above example, company B would be ahead of company A in Moneyfacts' best buys because it has the higher gross rate. But it would be the other way round in some other best buy tables. For example, fool.co.uk ranks savings accounts according to AER but it gives both AER and gross rates.

CHANGING RATES AND OTHER PITFALLS

Whichever measure you use, rule number one of cash savings is – watch the rate (it will change). The Dutch bank ING burst on the UK

savings scene in 2003 offering a market-leading rate. But now it languishes in the bottom half of the top 100, having decided not to pass on three rate rises to its customers. Many voted with their feet – there were reports that £3 billion was moved to its competitors. That is one kind of stampede to follow.

Rates change so frequently that every example in this book should be treated as just that – an example, and like any information or advice to do with the financial world, it goes out of date quickly.

There are less obvious traps, too. One is the withdrawal fine. For example, Halifax offers an apparently OK rate of 5.5 per cent on its guaranteed saver account as long as you invest at least £5,000. But if you make more than four withdrawals of money in the year you lose 30 days' interest. That would slash the rate to little more than 5 per cent. Some fine you for one withdrawal, others for more than a certain number. Always avoid them.

Another is the 'regular saver account'. Some of these offer mad rates – one recently offered was as high as 12 per cent. But these accounts only last a year, then dump your money into a rubbish account at the end of it, while you have to commit yourself to paying a fixed amount in each month – and nothing more. So in fact you will end up with about half the advertised rate on the total amount you put in.

Other tricks are to encourage you to open a linked current account – which may be not very good – and some building societies allow only local people to get the best deals.

So the way to get the most on your savings is:

- go to several 'best buy' sites
- tick the boxes to get instant access and no bonus rates (and then monthly or annual interest, depending which you want)
- pick the best AER for the amount you have to save.

Remember, these accounts pay a variable rate of interest. That means the bank can put the rate up or down as it chooses. Usually

it will happen when the Bank of England and its grandly named Monetary Policy Committee decide to change the official bank rate. So after a year check what rate you are getting. If it is not the best, move your money. Banks show no loyalty to us. We should show none to them.

FIXED-TERM ACCOUNTS

There is one way in which a bit of loyalty, or at least commitment, can pay a small bonus. Instant access is fine. But if you do have money that you absolutely, completely, 100 per cent know that you will not need for a period of time you can earn a bit more and, unlike instant access accounts, the rate is guaranteed; unlike instant accounts you of course have no instant access to your money. These are called fixed-term accounts or sometimes bonds (however, bonds can mean many, many things, some of them not in the least desirable, so do not assume that they are a Good Thing). The deal is this: you deposit your cash and promise not to take it back for, say, a year and the bank or building society gives you a guaranteed fixed rate.

Two things push up the rate you might get over an instant access account:

1. the bank knows it has your money for a fixed term and can use that money for its own fixed-term deals in loans and mortgages
2. to do those deals the banks need money and, at the moment, banks trust us more than they trust each other. So your cash attracts a premium rate

But fixed-term deals are a gamble. You are betting on whether interest rates will rise or fall during the time your money is tied up. If they go down you win the bet. If they go up you lose and – guess what? – the bank wins. Fixed-term savings accounts require a serious amount of money – at least £1,000 (the usual minimum) – to take them up. As ever, look at the AER to decide which is best.

CURRENT ACCOUNTS

You may not keep much in your current account – or indeed it may have a minus sign in front of it (see pages 145–71 for more on debt) – but however little is in there, it should be working. Nowadays you can get a reasonable rate of interest on your current account too.

Generally the high street banks pay a derisory 0.1 per cent interest on standard current accounts – though a couple of them pay nothing. That means you are lending the bank the money for nothing. Suppose your balance on average over the year is £100. If you got 5 per cent paid on that (which is possible), at the end of the year your money would have earned you a fiver.

Not much, you may say. But if you saw one lying in the street, would you pick it up? Or, if that makes you feel uncomfortable ('Yes, but I'd take it to the police station'), put it another way. Do you have a fiver in your pocket or purse now? Take it out. Hold it up. And tear it in half. Not so easy is it? Letting the bank keep a fiver we could get on our money is just the same as tearing up a fiver you already have. We are a nation which waits for 1p change at the shop but happily lets the banks take pounds off us not so much without bothering about it, more without even noticing.

Just think what is happening to your money. While the bank is paying you 0.1 per cent (and on £100 that is just 10p interest over the year) it is using it, lending it out, doing deals – in other words, making your money – *your money* – work for it. Over the year that £100 might earn the bank anything up to £15, while you get 10p. It is a scandal.

Lecture over. Now, what about good current accounts?

CHOOSING THE ACCOUNT THAT WORKS FOR YOU

The first question is, how will you use your account? If you will go overdrawn occasionally or even often (but not all the time because you agreed at the start of this chapter to pay it off: if you have debt there is little point in reading the next bit until you have done that), you need to find an account which offers the best deal on overdrafts. If that is you, turn to page 159 where debt and overdrafts are discussed.

So, goody-two-shoes, you do not go overdrawn and you want to find the best current account. Once again, it all comes down to AER. Some, the big high street banks, pay 0.1 per cent – or even nothing. But others pay you a decent rate – 3 or 4 per cent. You can get more, but that usually comes with strings attached, and in banking and financial services strings are generally not good.

Here are some of the strings you will find.

'The first slice is the biggest' Under this scheme, you get a better rate on a certain amount but nothing (or maybe 0.1 per cent) on amounts above that. The idea is to stop you using your current account as a savings account. What's wrong with that? No one knows, but the banks don't like it.

The monthly fee Some banks charge you for running a current account. The bank spins the fee to say it is to pay for exciting stuff such as insurance – which often you do not want and may not need (or *vice versa*). It is never worth it.

Buy another product This gives you a better deal if you open another account or buy an investment or a mortgage. This 'string' is held by the sales department and should never be followed.

Pay in a minimum amount This is the only condition, or string, worth considering. If you pay £500 or £1,000 into your account each month you may get a better rate. If you have that sort of income (and with a joint account that usually means between you), doing this may lead you to a decent higher-interest rate.

There is something else you can do to get a better rate of interest: go online. Many of the better no-strings rates are found with accounts you run through your computer.

ONLINE BANKING

Some people are afraid of doing their banking online. They are afraid of someone stealing their money – or their identity. If surveys are to be believed ID theft is one of our biggest worries. But online banking itself is safe. Yes, there are thieves around the world who will try to

get hold of your money. Yes, sometimes they are successful. But you can protect yourself against them quite easily. It is just like closing your windows at night or locking your front door when you go out. To stay safe online you just need to follow a few basic security steps.

First, deal with your bank only through its own website and by logging on in the normal way. If you get an email that claims it is from your bank, delete it unread. Never ever click on a link in an email: it can lead you into trouble. And never put any details of your bank into an email. Unfortunately, it is just possible that your bank might send you an email. Marketing departments like to do that, if only to see the security guys tearing their hair out. But it will never be anything important, so delete it. If you really want to follow it up, log on in the usual way or call the bank (all online banks have a telephone helpline as well).

Even emails that are not from your bank should be treated with care. Never click on an email link or open an attachment with an email unless it is from someone you know and trust (and does not look as if it has just been forwarded). Attachments can contain software that downloads to your computer and steals passwords as you type them in the keyboard.

The other big thing to remember about online banking is that if you do lose money (which is very rare, but of course very upsetting if it happens to be you), the bank will reimburse you – perhaps not as quickly as you would like, but it is the bank, not you, that bears the cost.

For more on ID theft and staying safe online see pages 168–71 below.

OPENING YOUR NEW BANK ACCOUNT

Once you have decided on your new current account – perhaps online and definitely paying a decent rate of interest on your money – you have to change to that new bank. It is very easy to do. Open the new account. Tell the old bank you want it to close your account and transfer any balance to the new account. It will move all the standing orders and direct debits you have coming out of your account: this should

all happen within a couple of weeks or so. You will have to tell your employer or pension provider and anyone else who pays money into your current account. And that's it: money working harder.

TAX

Before we move on to other savings products, a word about tax. HM Revenue & Customs likes to take money off us and then wait for us to claim it back if it has taken too much. So it automatically whips off 20p of every pound earned in interest on our savings, even from accounts opened by children. Almost half the population does not pay income tax – just over 30 million of us do, out of a population of about 60 million. The non-taxpayers include almost all children, about one in two pensioners, and many adults who are parents, unemployed, disabled or simply kept by someone else. If you are not a taxpayer but you have some money in a current account or savings account, stop the Revenue taking the tax it has no right to by filling in a form called R85. You can download it from www.hmrc.gov.uk/forms/r85.pdf

If a couple has a joint savings account and one partner does not pay tax, the bank or building society should be willing to pay half the interest tax-free if R85 is filled in. Some are awkward about doing it. If they are, be insistent.

If tax has been wrongly deducted in previous years it can be claimed back for up to six previous tax years. Hence, in 2008/9 it can be claimed back to 2002/3 but not before. You do that using form R40. Note that you will need one R40 for each past tax year. Download the form from www.hmrc.gov.uk/forms/r40.pdf. You can use the same form as long as you put the correct tax year at the top.

Remember that you can reclaim tax not only when no tax has been due but if you are due to pay tax only at the lower 10 per cent rate. That rate is much rarer now (see pages 187–8 for details) but if your income is low you may have a claim to make. Find out more from the taxback helpline 0845 077 6543 or at www.hmrc.co.uk/taxback.