KILSBY WILLIAMS & GOULD

FINANCIAL BULLETIN

"Helping our clients to achieve their personal financial objectives through our integrity, skill, diligence and experience"

August 2012

Welcome to our summer investment bulletin, in which we will aim to provide you with useful information on topical subjects. As part of my development, Simon has asked me to chair the Investment Committee. Simon, together with Andy Gait and Nicholas Williams are also heavily involved in ensuring that our investment process remains robust and appropriate for our clients.

As usual Simon has prepared an economic commentary. In this edition Hollie Coomer has looked at the positives and negatives of using passive funds, whilst I have considered the question of traditional 'low risk' assets and their place within a portfolio.

Whilst on this topic, one of our bugbears for some time has been the way in which many Banks and Building Societies disadvantage the disadvantaged. Interest rates for accounts where a registered Enduring Power of Attorney is in place or where a trust fund is the depositor are, generally speaking, a lot lower than those available to individual depositors.

We have compiled a list of institutions who are both willing to accept monies from EPA's and trusts whilst also offering reasonable levels of interest. Our shortlist is updated quarterly and I have listed below some of the 'good eggs'!

> Aldermore, Barclays, Cater Allen, Cheshire Building Society, Close Brothers, Investec, Julian Hodge Bank, Kent Reliance Building Society, Monmouthshire Building Society, Secure Trust Bank, Principality Building Society, Permanent Bank International.

If you would like further information on any of these accounts, or have any questions regarding any of the other content of this bulletin, please feel free to contact me.

RICHARD HAINES
01633 653 171
Richard.Haines@kilsbywilliams.com

ACTIVE VS. PASSIVE

One of the biggest debates in portfolio design has been the active versus passive debate; which is the more efficient way of investment?

An actively managed fund aims to outperform its respective benchmark. The fund manager will seek to do this by using their knowledge and expertise to analyse the market. To achieve an out performance the fund manager will try to identify companies whose shares look to be undervalued or those companies which have potential for growth. The manager will also adjust their portfolio to minimise potential losses by excluding individual shares, sectors and industries from their portfolio which are suspected to under perform over a certain period. These tend to be the more expensive funds.

Passive managers will track a specific index (or a certain sector). Their objective is simply to match a specific index, rather than try to beat it. Passive investments are often called index funds or tracker funds. These funds can be held very cheaply.

Tracker funds vs. Exchange Traded Funds (ETFs)

Discrete performance

Key	Fund	Year to 08-Aug-2012	Year to 08-Aug-2011	Year to 08-Aug-2010	Year to 08-Aug-2009	Year to 08-Aug-2008
■	L&G UK Index Ret Acc	16.45%	-1.52%	20.43%	-10.78%	-13.11%
■	IMA UK All Companies	14.18%	-1.35%	19.58%	-12.69%	-14.78%

There are two types of passively managed instruments; tracker funds in the form of unit trusts and OEICs or an Exchange Traded Fund. The emergence of ETFs has enabled investors to get access to markets and assets previously unavailable. ETFs are able to track almost any stock market index and also the price of commodities, such as precious metals, oil and natural gas.

Like unit trusts and OEICs, ETFs are open ended, meaning that you can buy or sell at any point and their price directly reflects the underlying value of the investments it holds. ETFs are listed on a stock exchange, and can be traded at any time that the market is open. However an index tracker fund can only be traded at one or two points in the trading day.

There are also differences in charges. As an ETF is stock market traded you only have to pay the stockbroker's commission, and significantly, no stamp duty. The ETF will have running costs which are typically very low. With an index tracker fund, you pay both initial and annual management charges, as well as the stamp duty charged on trades made within the fund itself.

ETF Structures: Physical vs. Synthetic

ETF providers can use either physical or synthetic replication to ensure their ETFs mimic their designated indices as accurately as possible.

Physical Replication - ETFs that use physical replication will buy and own most or all of an index's constituents in order to replicate the index's performance. This method is relatively simple and transparent.

Synthetic Replication - The index exposure is provided by purchasing complex investment instruments (derivatives) which replicate price movements, as opposed to buying the actual constituents and therefore this has to involve the use of investment banks to provide this synthetic replication. There is a critical risk with ETFs of this nature – if the counterparty bank fails (such as Lehman's) the whole investment is at risk

Kilsby Williams & Gould Proposition

At Kilsby Williams & Gould we do not favour one investment strategy over another, but instead believe that a combination of both passive and actively managed funds offers the best solution for our clients.

The reasons for this are two-fold:

We look for the passively managed funds to provide you with a 'core' equity holding, giving you an initial exposure to a variety of markets, including the UK, USA, Japan and Europe.

These funds will always perform broadly in line with the market (with a small tracking error built in due to annual management charges). We then invest the rest of your portfolio monies into actively managed funds, using our research process to pick the top performers in each sector. These actively managed funds are specifically picked to 'add value' on top of the normal market return, and are reviewed in your periodic valuations to ensure they are still fit for this purpose.

Including passively managed funds in your investment portfolio greatly reduces overall charges. We pick the cheapest and most transparently structured funds wherever possible to give you initial market exposure.

Investment within a wrap

Many of our clients are using ‘wraps’ to hold their investments, be it through an ISA, SIPP or general investment account, and we review the wrap market regularly to ensure that our clients continue to get the best possible deal.

There are certain ETFs now entering the marketplace offering index replication at annual charges in the region of 0.1%, however, not all ‘wraps’ are offering access to this area of the market. Reducing the burden of cost on our client’s portfolios is currently at the forefront of our thinking, and therefore this is an area we will shortly be reviewing and making recommendations to move if appropriate.

HOLLIE COOMER
Client Manager
01633 653 193

ECONOMIC COMMENTARY AUGUST 2012

Fighting amongst ourselves

It was one of the most memorable quotes of the twentieth century when Tory Prime Minister Edward Heath described the African conglomerate Lonrho in 1973 as “The unpleasant and unacceptable face of capitalism”. At the time the company’s Chief Executive, Tiny Rowland, had been breaking sanctions to deal with the Smith government in Rhodesia.

It is a quote which is just as pertinent today as it was then – only now the target for the venomous comment would not be a swashbuckling and cavalier business man it would be almost every member of the banking directorate, the money marketers and price fixers, (and professional footballers) all of whom are paid far more than the value they add to our quality of life. Riding the gravy train in the first class carriages has become the Olympic sport for the greedy – and new world records are being broken.

The excessive spending of the last decade has left us in the western world so debt-ridden there is virtually no room for growth. The last time this happened in the UK in the 1970’s Margaret Thatcher was able to deploy a growth strategy to boom our way out of the depression – there is little or no ‘wriggle-room’ to adopt the same strategy this time round. We are all spent out!

As a result we all live in a world of zero economic growth. In this environment for every winner, there are thousands of ordinary folk who are witnessing a decline in their living standards.

And we are still stealing from our children!

And yet! Our government and others in Europe believe that the way to soften the blow is for the governments to continue to spend more than they take in taxes - leaving the increased indebtedness for someone else to pick up the bill. The 'someone' in question is our children.

The French government is one that has decided that 'austerity' is not populist policy and are looking to soften the blow. So governments are still spending more than they have and as a result they still run an annual deficit and their debts are increasing. Economic growth will continue to be slow, and in a zero growth world, corporate profits are in danger of becoming increasingly dented, there is no extra wealth being generated and share prices are likely to reflect this.

With an election in the USA later this year, it is hard to imagine that the incumbent over the pond is going to ask his electors to cut back. In the US, interest rate payments are currently greater than federal-level education spending, but by 2015, will eclipse their welfare budget, coming in at an estimated $500 billion a year. Even with the recently agreed debt reduction deal, it is clear that not enough is yet being done, and the political wrangling will no doubt continue through the upcoming election period.

Debts created in our generation will have to be recovered at some time in the future. This is stealing from our children. They will have to pick up the pieces.

And our politicians continue to hide the truth from us

I understand that headline inflation is now running at just 2.4% according to the official statistics. The only problem with this measure is that it does not reflect what you and I have to pay for - the things that matter most to us. Rates, utilities, food (especially food) are increasing at an alarming rate. Our clients find that the money in the wallet is just not lasting as long.

My concern is simply this, 2013 may well be worse than 2012 and it is in this environment we find ourselves trying to advise clients how to protect their wealth and if possible invest for a better future for themselves and their children.

This is the background for this review.

Debts: At Kilsby Williams & Gould, as always, we take the view that debts and mortgages should be repaid. After all, debt reduction is another form of saving – and one that leaves you less at the mercy of the banks.

Verdict: Repay Debts – consider helping your children reduce their mortgages too

Cash: With continued zero economic growth, interest rates are now no longer likely to rise in 2012, and cash on deposit now pays, net of tax, less than the rate of inflation. That means that money put in the bank this year will buy less next year than it can now.

Verdict: cash will offer short term protection but, steer clear of fixed rate accounts of more than twelve months. Index linked national savings should also be retained and, if they become available again they should be considered.

Other Defensive Assets: With worries over global stock markets and world sovereign debt, a flight to quality continues. UK government borrowing now joins the ranks of the USA, Switzerland and Germany pushing yields towards a negative investment return. Fixed interest fund managers are being forced to purchase ever more risky corporate bonds to provide both capital growth and a decent yield, whilst several of our preferred 'savvy' fund managers have been running 'short' positions in developed world government debt for some time.

We remain convinced that interest rates must inevitably rise as those with funds become more concerned about the safety of the national governments; and with inflationary pressures continuing, fixed interest government and corporate bond prices will at some point fall.

Verdict: Be underweight in corporate and fixed interest government bonds – investing in strategic bond funds to benefit from the experience of the specialist fund managers.

Commercial property: UK Commercial Property will be an excellent diversifier during the market turmoil, and although gains may be restricted over the next twelve months these funds generate rental returns of between 4-6% It will be important to prudently pick the correct funds to capture these returns and as such we will look to shortlist funds that are large, well diversified in both property type and geographically, relatively cash rich and with low vacancy rates.

Verdict: Neutral – continue to invest in funds as described above for the rental yields running above inflation, even if there is little by way of growth.

UK Equity: As I write this the FTSE 100 stands at 5,745 in the latest intra-day figure, and the FTSE 100 price/earnings ratio at around 10.8 remains low in historical terms; this is the best we can hope for given the uncertainty over the next decade. Mega-cap companies look the most attractive prospect at the moment, and funds that primarily invest in this space take up some of the top positions on our shortlist. We would still recommend investments in smaller and micro-cap companies, but only if inheritance or other tax benefits are available.

Verdict: Overweight – concentrate on larger cap companies with strong dividend streams to provide stability in volatile times – they offer better long term prospects than cash or non-risk holdings.

Alternative Investments: This asset class covers many different investments, all designed to produce growth, but with varying degrees of capital protection. Unregulated products occupy this space, and these investments do not enjoy the same level of government backed protection as the regulated investments.

Verdict: Overweight: Concentrate on regulated funds; the top Cautious & Balanced managed fund managers with proven track records and prudent portfolios.

Overseas Equity: As with the UK, we believe overseas equity markets also look fair value. We still hold the view that the emerging markets and commodity funds play an essential long-term part in building a balanced and diversified portfolio.

Commodity prices in particular have fallen away sharply over the past twelve months and these now look relatively cheap – especially in a world of finite resources. The major international banks are mostly forecasting increases in the prices of gold and oil!

The USA in particular may have its own macro economic woes, but the general consensus is that it is in good shape at a corporate level, with companies still enjoying high cash balances and historically low valuations. Indeed, one financial research house currently believes that the US equity space is 'safer' than international government lending!

There will be winners and losers through this decade, and we will only be looking for funds with a long track record of good performance, and manager stability. Again as in the UK, larger-cap companies with a strong dividend stream and good brand image are likely to provide stable growth in these times, and our shortlists show a bias towards this.

Verdict: Overweight – concentrate on larger-cap, global and regional equity income funds to provide more stable returns.

Risk Warning

Whilst we have mentioned a variety of market opportunities; investment or encashment in any area is very much dependent on client needs, objectives and attitude to risk. We encourage all readers to take advice before acting on the content of this publication. This publication is not intended to represent personal financial advice.

As is clearly evident from the above, past performance cannot be used as a guide to future returns and capital loss may occur in some of the sectors outlined earlier.

SIMON GOULD Chartered Financial Planner
Director
simon.gould@kilsbywilliams.com

DEFINE A LOW RISK FUND!

At this stage of proceedings (I am reluctant to use the term ‘economic cycle’) a common conundrum we, as advisers and researchers, are faced with is selecting appropriate low risk funds for our clients.

Many commentators are now advocating that the more traditional homes for the low risk element of a portfolio do, at the present time, appear to offer very poor value and could be more susceptible to volatility in the medium term than mega-cap equities which appear to be offering good value.

Firstly, we will look at GILTs, which traditionally have been a safe haven for investors’ capital. Many commentators have been stating for over twelve months that GILTs are overpriced, however, yields continue to fall whilst capital values continue to rise – this cannot last forever! As is the case with all asset classes, eventually the tide will turn and they have seen such a formidable rally over the last eighteen months that a rise in interest rates or even a downgrading of the UK’s financial strength rating could see a sharp reduction in the capital value of GILTs. In summary, they appear expensive at this moment in time.

Secondly, fixed interest securities which is another area traditionally seen as a relatively safe haven is likely to experience similar problems. With interest rates so low they are only going to move in one direction, and whilst this may not be imminent, an increase in interest rates will see reductions in the capital values of these holdings.

The corporate bond sector is an asset class from which some investors profited as the world began to awaken from its slumber in 2009, however, many believed that the market was becoming illiquid due to over zealous investor sentiment and, indeed, the sector has experienced somewhat of a slowdown over the past 2 years as over-pricing corrected itself.

Finally, is the obvious home – cash! Whilst cash is an asset that will always form part of even the most speculative portfolio, returns are currently very poor (even for fixed term accounts), and with inflation eroding capital values as it has over the past 2 years, holding an overweight position in cash is not the ideal.

We may have reached a point where making calls on the various sub-classes across the low risk spectrum is nigh on impossible to call and therefore our stance has been, and will continue to be for the foreseeable future, to pass the decision making onto a qualified professional with a proven track record, and the ability to pass between these sub-classes at low cost.

Such teams of people can be found in the strategic bond sector. Strategic bonds have the freedom to invest anywhere within the low risk spectrum, and fund managers are able to respond to changes in the economic environment quickly whilst sourcing the best investment opportunities within each sub-class. As always some funds will perform better than others, and following our own research and meetings with various providers, we have arrived at a shortlist of four from which we will be selecting strategic bonds for our clients depending on their individual circumstances.

CONTACT US:

Tel: 01633 810 081 • Fax: 01633 653 199 • Web: www. kilsbywilliams.com

Kilsby Williams & Gould Limited, Cedar House, Hazell Drive, Newport, South Wales NP10 8FY.

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