KILSBY WILLIAMS & GOULD

Newsletter August 2013

Kilsby Williams & Gould - Investing in the process

Welcome to our latest Investment bulletin of 2013, in which we will provide you with information on some of those areas that influence the thoughts of our investment committee.

In this bulletin we provide a first introduction to our team members and who best to start than me. As is customary within our Investment bulletin Simon Gould provides our house view on the current economic climate and how this impacts on each of the investment sectors.

CONGRATULATIONS to Nicholas Williams who has recently obtained his Certificate in Financial Planning. Nicholas, who also sits on our Investment Committee, finishes this bulletin with a valuable insight into the UK Smaller Companies market and specifically AIM shares being an allowable investment through ISAs.

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Know the Kilsby Williams & Gould Team

In order to provide appropriate financial advice to our clients it is vitally important that we understand their circumstances and objectives. We are now in our 12th year of business and the team has grown from 3 to 13 over this period, and we would like to provide you with a little more background on our team members starting with myself!

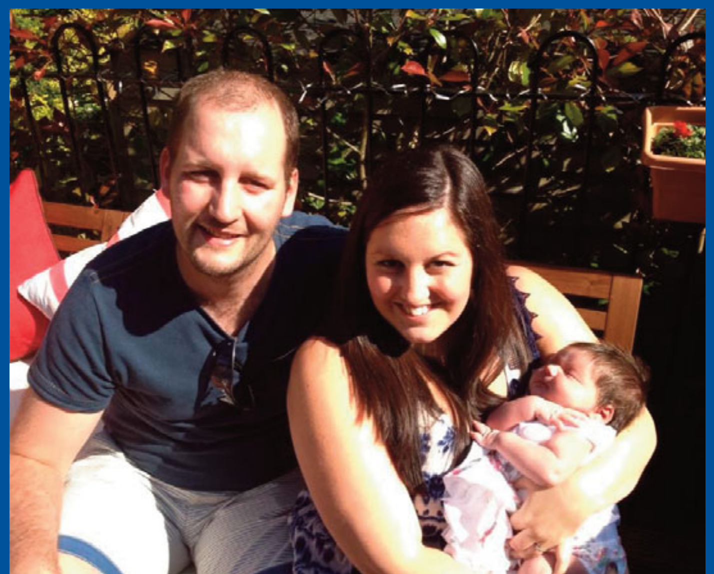
I started as an administrator with Kilsby Williams & Gould some 8 years ago now; doesn't time fly when you are enjoying yourself!

I was a young kid back then, working hard to enjoy the 1 or 2 (or 10) beers on a Friday and Saturday. My interests (other than the Friday and Saturday nights) were football. I enjoyed playing the sport where I represented Wales at 19 years of age. However, it soon became apparent that my body and mind belonged away from Football. I loved my day job and started down the exam path with Kilsby Williams & Gould, and since that first pass I have never looked back.

Some 13 exams later I am now an adviser at Kilsby Williams & Gould. My aim for the next 18 months is to become a Chartered Financial Planner and to build relationships with the existing Kilsby Williams & Gould client bank.

I also expect to continue building our new corporate business, Kilsby Corporate Financial Planning. I have already built relationships with a number of businesses and expect to see significant growth in this area due to the impact of pension auto-enrolment; if any of you are connected to businesses which require advice in this area please let me know!

My home life has seen some changes recently. My wife Grace & I have been married for 2 years and only weeks ago introduced our first mini Redman into this world; Ella Violet born 31st May. She eats and sleeps well so I am writing this with eyes open (and no props for assistance). I now have to figure out how I adapt to dealing with two women in my life.



Economic Commentary July 2013

In my last economic commentary in January I made the case that lending to governments was a 'return free risk' and that bond yields were so low that this was a one way bet to failure. We also stated that, over time, the theory suggests, lending to governments will once again return to normal and equity investments will once again produce proper profits.

Even governments can't get away with cheap borrowing for very long!

From a yield of 5% ten years ago, the yield on 10 year UK government bonds had fallen to under 1.5% in July 2012 – well below the rate of inflation. Today these yields stand at 2.5%. This means that during the past twelve months, investors have seen losses to their capital and for the first time for many years these yields at last represent a gross return broadly in line with inflation – however, after income tax has been deducted, the net return will still be insufficient to protect the purchasing power

There have been periods in the past, most notably during the Suez crisis in the 1950's and the oil crises in the 1970's, when lending to governments has been regarded as return free risk – but in each case this untenable scenario only lasted a few years.

It looks as if normal service will shortly be resumed and after two years of negative real returns, investors in bond funds may at last see some hope. At Kilsby Williams & Gould we will be monitoring bond funds carefully and may shortly be suggesting to clients that they re-enter this space.

So, what about equities and property

Well, it is a fundamental tenet of capitalism that risk must be rewarded. Over the past 40 years, equities and property have produced investment returns of six percent above the risk free return. This is the average premium profit earned by investors for being prepared to take a risk.

At the start of the year, we suggested that at 6027 (2nd January 2013), the FTSE 100 index was undervalued. After a roller coaster ride it rose to 6840 on 22 May, fell back to 6029 by 24 June and by 9th July had recovered to 6500.

If 2013 turns out to be an average year then, based on the above theories, we expect equities and properties to produce an investment return of 6% ahead of the risk free investment and therefore based on government bond yields matching inflation, it is possible that the current equity levels are about right.

But … life is not that simple. Governments are in debt, still spending more than they are earning and borrowing off the next generation of taxpayers – so don't expect a flat and easy ride over the next few years.

One reassuring aspect of our monetary policy is the appointment of Mark Carney as the new Governor of the Bank of England. He oversaw a remarkable economic performance in Canada (albeit under favourable economic conditions and in a country with mountains of natural resources!) – let's hope he can achieve the same in the UK.

This is the background for this review. I now comment on each of the asset classes in turn

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 expected low economic growth, interest rates are not expected to rise much if at all in 2013 or 2014. With the current policy of the BoE 'printing money' the banks do not need to offer high interest rates to attract private money. Cash on deposit now pays less than 2% - 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; the markets do anticipate increases in interest rates at some point between 2015 and 2017. Index linked national savings should also be retained and, if they become available again they should be considered.

Other Low Risk Assets: With continued worries over world sovereign debt, a flight to quality still continues, and many governments continue to borrow, paying interest less than the local rate of inflation.

We remain convinced that the recent rises in bond yields will at worst be maintained and in theory they may well increase further as investors become more concerned about the safety of the national governments; and with inflationary pressures continuing. Fixed interest government and corporate bond prices have started to fall and this sector must soon become once again interesting to investors.

Verdict: Remain underweight in corporate and fixed interest government bonds but now may be an appropriate time to start dipping toes back into the water – we still prefer investments in this sector through strategic bond funds to benefit from the experience of the specialist fund managers and with multiple strategies available to them

Commercial property: Commercial Property should continue to 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 especially ones with low vacancy rates. We also think that freehold property ground rents (see article) and infrastructure funds assist in the diversification process

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

UK Equity: As of 9th July the FTSE 100 stands at 6500 in the latest intra-day figure, and the FTSE 100 price/earnings ratio at 13.7 which still 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 generally only if inheritance or other tax benefits are available. Demand for AIM listed stock may well increase following the recent announcement that these shares will soon be able to enjoy ISA status.

Verdict: Neutral – concentrate on larger cap companies with strong dividend streams to provide stability and an income stream in volatile times – they offer better long term prospects than cash or non-risk holdings. For those clients prepared to take the additional risks, investments in smaller and Micro UK funds continues to offer exciting prospects for growth and additional tax breaks.

Alternative Investments; This asset class covers many different investments, all designed to produce growth, but with varying degrees of capital protection.

Verdict: Neutral - Concentrate on 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. We have noted that commodity funds and prices, particularly gold prices, have taken a tumble this year and now may well prove to be an opportunistic time to buy.

Commodity prices in particular have fallen away sharply over the past 18 months and these now look relatively cheap – especially in a world of finite resources.

The USA in particular may have its own macro economic woes, but the general consensus is that it is in good shape at 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!

Japan has been astounding over the past six months with the Nikkei 225 index increasing from 10688 at the turn of the year (4th January 2013) to 14500 now. This is still a long way short of the all-time high of 38295 on 8th January 1990 – but if the recent improvement means that the Japanese have at last gained confidence in their own markets, now just may prove to be a good time to buy.

Europe continues to cause us concerns and this is one area where we remain concerned in the short term

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 – consider increasing holdings in commodities and Japan.

Risk Warning

Whilst we have mentioned a variety of market opportunities; investment or encashment in any area is very much dependent on individual 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.

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Additional tax breaks the AIM within ISAs

The Government have now confirmed their intention to change the ISA rules allowing investors access to the small and medium-sized enterprise (SME) equity markets such as the Alternative Investment Market (AIM) within their ISA portfolios from Autumn 2013.

Many AIM and unlisted shares benefit from Business Property Relief which gives an inheritance tax exemption if the shares are held at the date of the investor's death, as long as they have been held by the investor for at least 2 years.

What are the advantages?

This change in allowable investments through an ISA could result in investors potentially benefitting from income tax, capital gains tax and inheritance tax relief within the same investment portfolio. Cash starved Small and Medium-sized companies who have struggled for backing from their banks will have access to another source of funding through ISAs. By April 2012 investors had accumulated a total of over £190 billion of stocks and shares ISA monies. If only a fraction of those monies found their way into AIM shares the sector would receive a significant boost.

A further bonus is that from April 2013 the Government has abolished Stamp Duty tax on trading on AIM shares providing another incentive for investors to invest into this sector.

What are the risks?

Investing into AIM shares does not always represent a good investment opportunity. The track record of AIM shares vary from extremely good to extremely poor. For example, shares in Silvermere Energy (an Oil and Gas producer) have lost virtually all of their value (99.9%) over the past 5 years. Over the same period shares in ASOS (As Seen On Screen – the online clothing retailer) have risen from 324p per share to £43.55 per share – a rise of 1344?%. These extremes in performance demonstrate the risks involved with investing into the AIM market. Stock selection is therefore vital and should be left to the professionals who have the knowledge and experience of working in this sector. Another consideration is that not all stockbrokers specialise in the AIM market and performances between the different stockbrokers vary. It is important that investors get advice, not only on the stock selection but also the stockbroker tasked with administration of their portfolio.

Conclusion

The changes in ISA rules will present tax planning opportunities for high net worth individuals with an inheritance tax liability that have existing ISA portfolios. As detailed above, there are benefits of investing into the AIM market but these are countered by the risks involved.

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