KILSBY WILLIAMS & GOULD

# FINANCIAL BULLETIN

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

FEBRUARY 2013

## Kilsby Williams & Gould - Investing in the process

Welcome to our first bulletin of the new era following the Financial Services Authority's Retail Distribution Review (RDR) 2013. The main focus of this review was to increase adviser qualifications, and make adviser remuneration more transparent. As a result of RDR many advisers have chosen to 'restrict' their advice to a panel of providers and/or products; Andy Gait gives his view as to why Kilsby Williams & Gould will retain the 'independent' label.

The Kilsby Williams & Gould Investment Committee are involved in ensuring that our investment process remains robust and appropriate for our clients. In this bulletin each member of the Investment Committee gives their view on a current topical issue.

CONGRATULATIONS to Rhonda Newman, who, as of 1st January 2013, has been promoted to Compliance Officer and to Richard Haines who has passed his Diploma in Financial Planning.

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## Restricted or independent advice – does it really matter?

From 31 December 2012 financial advisers have had to choose whether they are independent or restricted with regard to their advice following the Financial Services Authority's Retail Distribution Review (RDR).

Those advisers who wish to retain the 'independent' label will need to demonstrate knowledge and have access to all defined retail investment products (such as pension products and ISAs). Kilsby Williams & Gould will be fully independent offering advice on all relevant products from all providers.

If a company can only provide advice on certain investment products, or on all products but from a restricted list of providers they will be providing restricted advice. We would argue that the benefit of taking independent advice is choice.

By restricting the number of providers there is a strong possibility that the most appropriate deal cannot be selected. Take an example from the car industry 'What Car' currently pick the Ford Mondeo in its best family car category for 2013, and I am sure if I visited a Ford dealer looking for a family car this would be the first car the sales executive would take me to. In 2010 the winner was the Mazda 6, and I am equally sure if I went to Mazda dealer today I would be pointed in the direction of the Mazda 6 not the Ford Mondeo! The Mazda 6 is still probably a fine car, but the benefit of reading 'What Car' is that you get an independent view across the whole market.

The taxation and legal framework for financial products in the United Kingdom is complex and profitable, this means that the marketplace is fast moving leading to innovation and strong competition. The industry is currently experiencing downward pressures on price for both fund managers and product administrators; for example 5 years ago purchasing a passive, index tracking fund such as a FTSE 100 tracking fund would have cost in the region of 0.75% per annum whereas now some fund groups are offering it as low as 0.1% per annum providing obvious benefits to the investor. If you are restricted to one, two or three companies is your adviser able to get you the best deal?

I, however, feel that there are two further significant benefits for clients that have resulted from RDR:

i. Improved standards amongst advisers. All advisers must meet a minimum level of qualification and follow a code of ethics set out by the Financial Services Authority which entails an agreement to treat all customers fairly. Kilsby Williams & Gould continues to hold corporate Chartered Financial Planners status, and we actively encourage all employees to increase their skills by passing examinations. We are proud to advise that of our 12 members of staff currently two are Chartered, four are diploma qualified (the new minimum standard of qualification for advisers), and of the remaining six, four have already passed a number of financial planning examinations. One of our firm's key principles is to continually improve our qualifications as we believe that having highly qualified staff leads to a robust business that reduces the risk of inappropriate recommendations and poor service to our clients.

ii. The separation of adviser remuneration from product commission. It has always been a concern of the FSA that advice could lead to recommendations of products that paid the advisor the highest level of commission rather than the product that was most suitable to the client. We have now been in business for 12 years and have always charged a fee for our work rather than been paid a commission for the successful sale of a product as we have always felt this was the most professional method of providing financial advice.

In summary the RDR has led to some overdue changes that were needed within our industry, however, this has meant no change to the way Kilsby Williams & Gould conducts business with clients. We will continue to ensure that our qualifications are amongst the best in the advice community, provide estimates of our fees based on the amount of time our work will take rather than a percentage of the amount invested, provide bespoke solutions to our clients based on their circumstances and objectives, and research from across the whole marketplace of providers, products and funds.

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## Introduction to the Kilsby Williams & Gould Investment Process

There are currently over 2800 Unit Trusts and Open-Ended Investment Companies (OEIC's) and this does not include Investment Trusts, Equities, Pension Funds, Life Funds, Offshore Funds and Exchange Traded Funds. This demonstrates the choice available in the investment universe.

The problem is how do you decide on whether the fund is a dog or a gem? Today, the consumer is flooded with information; Morningstar, Trustnet, Citywire, Bestinvest, Newspapers or even the man in the pub, each offering their "best buy", "fund of the month" or "pick of the day" and it can be difficult for the consumer to see the star amongst the noise.

Kilsby Williams & Gould operate an investment committee where a range of topics are discussed quarterly. There are robust discussions and conclusions are drawn and voted upon at the end. Its members comprise of Richard Haines, Simon Gould, our new Compliance Officer Rhonda Newman and myself. One of my main tasks for the investment committee is to collate and analyse data from a variety of sources, to rank and score funds, so that as a group, we can decide whether a fund should be a "buy" "hold" or "sell."

The funds in any particular sector are scored using 11 separate criteria, looking at independent ratings and fund manager performance such as its ranking amongst its peers and its volatility.

There are 8 non-scored secondary pieces of information; such as its Fund Manager performance (opposed to the fund performance) which tracks a particular manager through their career. Combining both quantitative and qualitative research, we can draw a conclusion of a fund and how we should proceed with our clients.

As you can imagine, this process can be very time consuming. For the average investor who is looking for the "hot tip" in the financial section of a newspaper, this approach will probably not be appropriate. But there are simpler ways that may be appropriate for some individuals. The use of passive (tracking) funds or using a Discretionary Fund Manager may be more of an appropriate option and this is covered later in this bulletin.

The cost of reviewing funds and managing portfolios for certain smaller sized portfolios may outweigh the potential benefits. We have been formulating a solution to make sure that our clients get value for money with fair and cost-effective management of their portfolios. We have been monitoring Architas's range of funds since 2008 and we particularly like the "Multi-Manager Passive" range of funds. These funds invest into a range of passively-managed, index-tracking funds and the allocation to each is reviewed and rebalanced regularly - far more regularly than is cost-effective for us to do.

We have been able to negotiate terms with the Axa Elevate platform for our clients to achieve a total fund management charge from their investment portfolio excluding advisor costs at 0.8% per annum - this annual charge is in line with our investment proposition to clients.

Watch this space! The Investment Committee will continue working together to ensure that our clients are getting value for money and the terms we hold with existing insurance companies and their fund charges are as competitive as possible.

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## Can 'Passive' and 'Active' funds work together to add value?

We have spoken in previous issues about the differences between passive funds (those which look to track an index) and active funds (those which look to add value over and above an index). In this issue we will discuss how these funds can play an important part within a diversified portfolio.

The argument as far as we are concerned is that in developed markets the scope for out performance of an index is far less than in, for example, emerging markets. Markets are far more efficient and although there are active managers out there who do consistently add real value, this comes at a cost.

Many active funds suffer from periods of underperformance as well as enjoying periods of out performance and over the longer term we feel that reducing the burden of cost upon a portfolio by using passive funds to track the most efficient markets is a less volatile approach. The compounding effect of higher charges on funds which can intermittently fail to perform against their benchmark is also not to be ignored.

Conversely, in those markets which are less efficient and that carry less legislative security, we feel that the scope for out performance of an index is significantly higher.

Therefore in sectors such as emerging markets, commodities, income and alternative investment solutions we will be looking to complement the core equity holdings with actively managed funds with superior track records against their respective peer groups.

You may have detected a noticeable shift in our approach over the past 12 months or so towards passive investments. This has been a deliberate ploy from our Investment Committee in order to move to what is known as a ‘core-satellite’ approach. Not only does this approach keep a lid on costs but in our opinion it also offers the best prospect for stable, efficient growth potential.

The core-satellite process is commonly used by many ‘discretionary fund managers’ and these managers too can play an active part in portfolio construction and management. Indeed, we at Kilsby Williams & Gould will shortly be offering clients the option of utilising the expertise of the external Investment Committee of a specialist discretionary fund manager to be encompassed within our strategic planning. This would leave our clients with three potential options:-

1. Continue using the Kilsby Williams & Gould Investment Committee and the highly bespoke nature of portfolio construction that this brings.

2. Utilise the expertise of an external discretionary fund manager to look after the investment side of things, whilst continuing to use Kilsby Williams & Gould to provide strategic planning. This would likely involve sacrificing much of the highly bespoke nature of portfolio construction.

3. A combination of the above.

Of course, using an external manager to select and maintain individual investments adds another player into the team, which brings additional costs. If you would like to discuss this at greater length please do not hesitate to get in touch.

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## Meeting your financial objectives – projecting into the future

Financial planning involves the establishment of a goal and a plan to meet that goal. This involves providing a financial projection into the future. When making projections it is necessary to make some assumptions; our assumptions of the future are based on our experience of the past…….this is dangerous as I am sure you are all aware of the frequently used risk warning:

‘Past performance should not be used as a guide to future performance’.

At Kilsby Williams & Gould we try and ensure our client’s financial objectives have the best possibility of being met. To achieve this we review both our client’s progress towards their objectives and our own growth assumptions.

We have long held the view that, over the long term, risk free investments should not produce a real loss and at least make an investment return sufficient to cover inflation. For much of the time, since the 1980’s, government bonds and fixed interest stock have produced a real return.

That does not mean that for the next decade this will continue. Indeed, any premium return enjoyed over the last couple of decades as interest rates have gone down, cannot, in our opinion, continue now interest rates are virtually zero in nominal terms and negative in real terms.

At the same time it seems inconceivable that over the long term negative real returns on risk free capital can be maintained.

It is a fundamental tenet of capitalism that risk must be rewarded. Over the past 40 years, over rolling 10 year periods, gross equity investment returns (100% growth assets) have exceeded risk free returns (100% defensive assets), on average by about 6% per annum. However, over the last decade this has not been the case, as equity returns have suffered.

Taking all of the above into account, the current 2013 position appears to suggest that risk free returns are expected to be about 3% behind inflation and equity returns therefore just 3% ahead of inflation. As the risk free return position normalises over time, so the real return on equities should also increase.

The following tables provide details of how our interpretation of the above information has changed the annual returns we expect for our client portfolios.

The table is providing an estimate of the 'real' annual return above inflation before the impact of charges and taxation. Typically the effect of charges and taxation can reduce the returns above by anything between 1% - 1.5% per annum.

| **Risk Profile & timeframe of objective** | **Current Growth Assumptions** | | | **New Growth Assumptions from February 2013** | | |
|---|---|---|---|---|---|---|
| | **< 10 years** | **10 to 20 years** | **> 20 years** | **< 10 years** | **10 to 20 years** | **> 20 years** |
| **Conservative** | -1% | 0% | 1% | Unreliable data but strong possibility of negative 'real' return over all time periods but particularly less than 10 years | | |
| **Careful** | 2% | 2.75% | 3.75% | -1.5% to 0.5%* | 0% to 1%* | 1.5% to 2.5%* |
| **Cautious** | 2.75% | 3.5% | 4.5% | 0% to 1%* | 1.5% to 2.5%* | 3% to 4%* |
| **Moderate** | 3.5% | 4.25% | 5.25% | 1% to 2%* | 2.5% to 3.5%* | 4% to 5%* |
| **Aggressive** | 4.25% | 5% | 6% | 2% to 3% | 3.5% to 4.5%* | 5% to 6%* |
| **Speculative** | 4.75% | 5.5% | 6.5% | 3.5% | 5% | 6.5% |

*Notes: * We now have a range for these risk profiles for example 'low Careful', 'mid careful', and 'top careful' with anticipated real returns over time frames of less than 10 years of -1.5% pa, 0% pa, and 1.5%.*

Please note such forecasts as those above are not a reliable indicator of future performance and should not be interpreted this way.

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## Economic Commentary January 2013.

### Lending to governments – is this risk free return or return free risk

We live in unusual times!

One imagines that lending money risk free to a government will not produce much of a profit – because it is a risk free loan. However, it seems equally logical that the lender should not make a loss by lending money to a government. So, the logical long term position is that the interest rates being earned from a loan to a government should, at the very least, equate to the rate of inflation as in this way the lender is not out of pocket.

Indeed, history tells us that, since the Second World War, lending to the UK government has produced a small profit – but within that period there have been times when the lender makes a real loss after inflation. This position becomes even more precarious when investors buy and/or sell the government debt during the term of the loan. In truth, an investment in UK governments bonds is not always risk-free. For example 1955 to 1957 were particularly bad and 1972 to 1974 was even worse; during both periods holding government bonds was a really poor investment decision.

Holding government bonds does not look like a good idea in 2013; for two reasons.

- Western governments, Greece and Spain apart, are paying virtually nothing by way of interest and certainly paying less than inflation – so the lender will get back less in real terms than he invested in the first place – about 3% per annum less.
- Secondly, if, or when, interest rates do rise, holders of fixed interest investments will see the capital value of their holdings fall as the rate of interest becomes less attractive.

***Hence the thought that, in 2013, holding government bonds is a return free risk investment.***

### 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.

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 just 3% ahead of inflation.

Over time, the theory suggests, lending to governments will once again return to normal and equity investments will once again produce proper profits.

### Sleeping at nights

It is inevitable that most clients are neither totally risk averse or compulsive gamblers. Most fall somewhere between the two. The greater the propensity for risk the greater the long term prospect for profit – but, at the same time, the more exposed they become to losses.

We endeavour to build portfolios with clients that will enable them to sleep at night. Over the last 40 years even the most cautious investor will have lost money in some years and the figures below take into account the effects of inflation – but not taxation and the costs of investing.

| | BEST YEAR | AVERAGE | WORST YEAR |
|---|---|---|---|
| Cautious | 31% gain | 4% gain | 22% loss |
| Aggressive | 43% gain | 6% gain | 38% loss |

**(Source: Finametrica)**

**And our politicians continue to hide the truth from us**

I understand that headline inflation remains close to 3% 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. 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, and cash on deposit now pays, net of tax, less than the rate of inflation. This means that, money put in the bank this year will buy less next year than it can now.

***Verdict: Holding cash is not a good investment decision however, in the current climate, holding fixed interest government debt is worse and therefore we expect most clients to be overweight in this sector. 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:** Simply put, if the US fail to agree a budget, and/or the UK and other countries in Western Europe lose their triple AAA ratings, governments will have to pay more to borrow money. With 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. 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 this sector should be restricted to 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 6060 in the latest intra-day figure, and the FTSE 100 price/earnings ratio at under 12 remains low in historical terms but we do not expect this to revert to normal any time soon., With so much world debt to correct the prospect for significant growth is curtailed so we do not expect the bumper rises in equities that would happen if the price earnings ratios were to rise. 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 as a small proportion of overall wealth unless there are specific objectives to reduce inheritance tax or tax benefits being accessed.

***Verdict: Overweight – 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.***

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

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

**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.

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