KILSBY WILLIAMS & GOULD

FINANCIAL BULLETIN

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

January 2012

Welcome to our latest financial bulletin; in this issue Simon Gould gives a personal view on the state of the economy and the legacy that is being left to future generations. We give our interpretation of how the current economic and political headwinds will impact on the various asset classes that are available to investors. When selecting appropriate venture capital recommendations we turn to Tax Efficient Review for guidance; Martin Churchill the editor of this publication provides an update on the recent Government consultation and the likely effects on this market. Oliver Stone analyses the comparative level of investment risk between bonds (loans) and equities (shares). Finally, our newest recruit Nicholas Williams provides an insight into the feedback that was generated from you our clients as a result of a recent questionnaire.

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STEALING FROM OUR CHILDREN

In 1957, Ayn Rand, author and philosopher, published her fourth and final book, titled *'Atlas Shrugged.'* In this book she describes a divided western world – split between the industrialists who produce and create wealth and those in government who exploit the industrialists through higher taxation and increasing regulations. This latter group are referred to regularly as 'looters' and 'parasites'.

The book was an immediate best seller but was not well received by the establishment and the ruling classes at the time (hardly surprising). In recent years, coinciding with the current economic crises, the book has once again become an international best seller and again those in power are trying to discredit it.

The last decade has been one of over indulgence, over spending and greed. Governments throughout the western world have increasingly upped the proportion of economic activity taken in taxation – but worryingly during each and every year spent even more thus building up massive sovereign debts.

A bit like the emperor's new clothes, any small child could have told the Governments that if they consistently spend more than they earn they will get into trouble! And trouble we are all in now – and trouble is the legacy we leave our children. They will have to pick up the pieces. Our generation has engaged in profligate spending at a personal, corporate and supranational level, run up unimaginably large debts, and it is the next generation that will have to bear the pain of reduced government spending, fewer jobs, higher taxes and less favourable retirement contracts in order to rectify the situation.

Not content with historical gross mismanagement, Europe's governments are still looting. Consider this; inflation is running at nearly 5%, yet the UK government currently borrows at rates of interest of less than 2% and in many cases pays nothing as 'unaccounted' debt (government employee pensions and the like) is just being left to pile up for future generations to settle.

This is intellectually insane! One can easily accept that lending money on a risk free basis might well not provide much of a reward, but to be penalised for so doing ………..

There lies the problem we all have to face up to. For the last 40 years, lending money on a risk free basis has provided investment returns broadly in line with inflation. Providing risk capital should, and used to, offer the lender the prospect of making a profit over and above inflation. That is how capitalism works.

The issue facing investors is where to place savings and accumulated wealth in a world where risk free lending is undertaken at a loss. Where bank interest on savings is less than inflation, where fixed interest government bonds pay virtually nothing and when economic growth is at a virtual standstill.

Portfolios that do nothing more than just keep pace with inflation in 2012 will have done well. In this environment it is important that we continue to monitor investment costs carefully. Annual management charges levied by active fund managers are typically between 1.0% and 1.5% – at least double the charge levied by passive index tracking funds. Unless the active fund manager has a proven track record that justifies his, or her, premium then replacing these funds with a passive alternative would appear to be sensible.

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ECONOMIC COMMENTARY JANUARY 2012

My friend Clive described to me a scene at a posh bar in Brussels. There were four Eurocrats, a Greek, an Italian, a Spaniard and an Irishman in a bar drinking.

'*A bottle of your finest champagne please barman*' ordered the Greek,
'Certainly', replied the barman, *'are you putting this on your tab or paying cash?'*
'Neither' piped up the Italian, *'there is a German arriving in about 30 minutes, and we expect him to settle the bill for us!'*

As long as there are sovereign states and banks in Europe requiring bail-outs from the European Central bank and the International Monetary Fund, and with all of the uncertainty that the accumulated debt has created, there are few economic sectors expected to prosper in 2012.

Choosing economic sectors is not easy when risk free investments produce negative 'real' returns and the growth prospects for the western world are so uncertain. Despite austerity measures being implemented, European governments are still spending more than they take in taxes and as a result continue to run annual deficits and the debts are still increasing. Economic growth will continue to be slow, and, in a zero growth world, corporate profits are in danger of becoming static.

Worryingly, if investors wake up and expect to be properly recompensed for lending to governments, the interest rates payable on sovereign debt will increase. For example, the UK pays some £44 billion a year in interest costs currently, but over the course of this parliament (until 2015) interest payments are set to eclipse defence spending and exceed more than half of the education budget. Many countries in Europe have already lost access to cheap money for example; Greece, Portugal, Italy and Spain; even France is in danger of losing its triple A financial strength ratings.

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.

This is the background for this review.

Debts; The Western world needs to consume less and save more; the British public continues to reduce personal debt levels including their mortgages. We still take the view that, first and foremost, debts and mortgages should be repaid. After all, debt reduction is another form of saving.

Verdict: Repay debts.

Cash; Despite our Government having a vested interest in keeping interest rates low, we still expect an increase in interest rates and / or a reduced level of inflation during the next 12 months – especially if, as we expect, market-forces drive governments into paying more to borrow. With the Government's CPI measure of inflation still running at nearly 5%, and the best gross interest rates for one year fixed rate savings at about 3.5% per annum before tax, cash continues to appear unattractive.

Verdict: Cash will offer short term protection but, steer clear of fixed rate accounts of more than twelve months.

Other Defensive Assets: With worries over global stock markets and certain developed world sovereign debt, a flight to quality has once again taken place, with the value of UK Government debt seeing a sharp increase recently, pushing yields ever lower - the same applying to investment grade corporate bonds. We remain convinced that when interest rates inevitably rise, and with inflationary pressures continuing, fixed interest government and corporate bond prices will fall.

Over the past two years the demand for Government bonds paying interest linked to inflation has greatly exceeded supply and this has given rise to substantial capital gains. At some point this position will correct itself and the increases currently being enjoyed are unlikely to be sustained for much longer. However, in the short term we remain positive on index linked bonds. Perhaps 2012 will be the time for us to consider strategic bond funds on the basis that the specialist fund managers should be better placed to get the timing of the switch back into fixed interest funds correct.

Verdict: Be patient – the time will come when fixed interest bonds will fall and we will once again see this asset class as attractive, in the meantime you should continue to hold index linked government stock, strategic bond funds and, if as expected, NS&I reissue an index linked national savings certificate in 2012, you should ensure that you purchase these.

ECONOMIC COMMENTARY JANUARY 2012

Commercial Property: UK Commercial Property has a track record as an excellent diversifier during stock market turmoil, and whilst we do not anticipate seeing the significant gains made through autumn 2009 and 2010, we still anticipate returns of between 4-6% through 2012. 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: Above weighting into property

UK Equity: having collapsed in the summer, the FTSE finished the year at 5572 some 440 points below its starting level, a drop of some 7.3%. The FTSE 100 price/earnings ratio at around 10.5% is low in historical terms, which is partly explained by the markets believing that profits will remain static and partly the anticipation of further problems with the Euro. However with dividend yields broadly similar to bank deposit interest rates, we believe equities offer a better long term solution – as long as you can afford to be patient if the markets turns downwards again.

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. Mid-cap and smaller companies have outstripped larger company returns over the past 2 years and it appears that the gains in 2010 and the first part of 2011 became slightly overheated with these positions being corrected in the second half of 2011. We would still recommend investments in smaller and micro-cap companies, but would prefer our clients to access these funds when inheritance or other tax benefits are available.

Verdict: Overweight – concentrate on larger cap companies with strong dividend streams to provide stability in volatile times. Index tracking funds can give you access to this sector without incurring high level charges

Alternative Investments; This asset class covers many different investments, all designed to produce growth, but with varying degrees of defensive attributes. In this space are a number of cautious and balanced multi-asset classed funds where the skills of the fund manager are truly tested. This sector also contains fund managers who are mandated to try to produce 'upward only' returns through Absolute Return strategies.

Verdict: Overweight - concentrate on regulated funds; the top Absolute return investments and Cautious & Balanced managed fund managers with proven track records and prudent portfolios.

Overseas Equity: As with the UK, we believe overseas equity markets look good 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.

Natural resource investments were the shining stars during 2010 but there were corrections last year. Given the finite supply and the growing demand for energy, metals and agriculture, these funds should in the long term continue to grow in value

The US, Europe and Japan all have their macro economic woes, but the general consensus is that they are in good shape at a corporate level – especially in the US, with companies enjoying high cash balances and historically low valuations.

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. If a fund manager cannot prove added value we will prefer to choose an index tracking fund with lower charges 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 index tracking funds and proven fund managers selecting larger-cap, global and regional equity income funds to provide more stable returns. Portfolios should include an exposure to natural resource investments and funds.

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.

GOVERNMENT VCT/EIS CONSULTATION

The Government has stated its desire is to ensure that Venture Capital Trust (VCT) and Enterprise Investment Schemes (EIS) continue to be targeted at genuine high risk capital investments and has a number of concerns about the operation of both schemes, mainly covering what it terms "Companies established for the purposes of accessing relief".

On the 6 December details on the potential changes stemming from the Consultation were announced (the proposals are still subject to a consultation period ending 10 February) and below are my views on the changes and their potential effect for the rest of the tax year.

1. Investee Company Limits: For companies in which VCTs can invest, legislation will be introduced in Finance Bill 2012 to increase employee limit to fewer than 250 employees; the size threshold to gross assets of no more than £15 million before investment and £16 million after and the maximum annual amount that can be invested in an individual company, to £10 million.

   View of impact on the market: This is good news for the VCT market and will allow, from 6 April onwards, VCTs to participate in deals involving larger companies.

2. Maximum Investment per VCT into Investee Companies: The draft legislation also includes changes which would allow an individual VCT to invest over £1million per annum in a particular company.

   View of impact on the market: This could encourage VCT managers running multiple VCTs to merge them and reduce running costs.

3. Disqualifying Purpose Test: Introduced on December 6 for VCTs and EISs. This will apply to shares in underlying investee companies issued on or after 6 April 2012. The test will disqualify shares issued subject to arrangements whose main purpose is to generate access to the reliefs in circumstances where either the benefit of the investment is passed to another party to the arrangements (i.e. the investor), or the business activities would otherwise be carried on by another party.

   View of impact on the market: This is a very smart move by HMRC. It takes any future changes to the VCT offering, needed to allow HMRC to keep it focused in the direction HMRC/Treasury desire, out of public view. It also allows HMRC not to publish a set of rules that the VCT players can work around.

4. Share Acquisition Restricted: Will apply to VCT/EIS involvement in 'buy-outs' or deals providing 'replacement capital' where the VCT/EIS investment replaces existing shareholders rather than injecting new capital into the investee company.

   View of impact on the market: This is potentially a very serious restriction in the kinds of deals done by Generalist VCTs and the future impact is not clear. However, will not affect funds raised this tax year.

Effect of changes on the 2011/12 VCT market

I divide the Venture capital market into two types of products: those offering a long term (seven to ten year) exposure to venture capital through generalist offerings with both upside and downside potential and those seeking a shorter holding period with limited upside and hopefully downside and where the bulk of the return will come from the generous tax breaks. I refer to these as Planned Exit offerings.

GENERALIST VCTs - I do not anticipate that the 6 December changes will have any major effect.

PLANNED EXIT VCTs - work to a different timescale for investing the funds in an effort to reduce uncertainty about their investment strategy and the proposed new disqualifying purpose test.

1. Planned exits investing over 3 years: these VCTs have three years to invest their funds and are most likely not to set out to invest in the types of deal that HMRC is seeking to curtail through the disqualifying purpose test. They may not suffer the risks associated with rushing into investments and will be able to take advantage of the new size limits, investing in larger deals in more mature businesses thereby potentially reducing risk.

2. Planned exits investing before the end of this tax year: VCTs normally have three years to invest their funds; as most funds are raised in the last two weeks of the tax year, these funds will have only a very small window to invest under the current rules.

MARTIN CHURCHILL (Editor Tax Efficient Review). Martin is well known and respected in our industry, providing specialist independent reviews of VCT and EIS investments.

VCTs are high risk investments and there may be no market for the shares should you wish to dispose of them. You may lose your capital.The value of shares in VCTs can go down as well as up. Although VCTs are quoted on the stock exchange, at least 70% of a VCT's capital must be invested in unquoted securities. It is likely therefore that VCT shares will trade at a substantial discount to the Net Asset Value (NAV) of the Trust and you may find it difficult to realise the true value of the investment.

Risk Warning: These high risk investments are only suitable for investors who can demonstrate to the financial adviser's satisfaction, an understanding of the product and have the capacity to lose the capital invested. The availability of various tax reliefs should not cause you to overlook the risks inherent in such product areas.

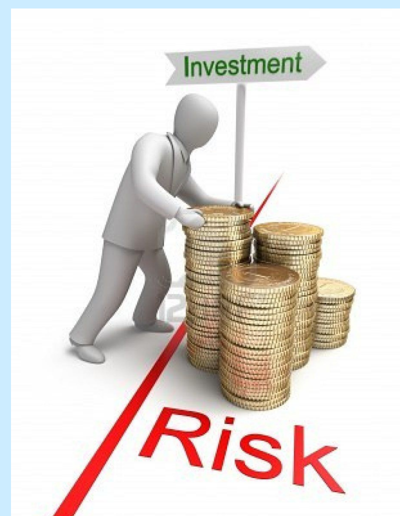
Advice should be sought from a qualified financial advisor prior to investing.

BONDS VS EQUITIES

When ranking the relative investment risk of various asset classes the typical respondent to our questionnaire considered loans to overseas companies and overseas governments (i.e. overseas corporate and government bonds) to be the most risky of asset classes, ranking them higher than UK and overseas equities.

This perception is perhaps not surprising given the macroeconomic crises currently unfolding in Europe and the rest of the world, along with their vast media coverage, dissection and analysis. However it is more than likely that in answering this question the respondent is thinking 'Greece' or 'Italy' rather than USA or Brazil. As long as we are not dealing with a country or a business about to default, lending with a fixed redemption rate should usually provide less of a risk than share ownership.

Bonds effectively represent loans or 'IOUs' made by investors to governments, companies and other entities. These bonds have been issued to raise capital without diluting ownership or control. Investors in bonds do not share in a company's profits; rather, they receive a fixed return on their investment – usually a percentage of the bond's original offering price.



Even though less risky than share ownership, every bond carries the credit risk that a promised payment will not be made in full or on time and interest rate and inflation risks are also inherent in bond investments; if interest rates and/or inflation rises, the payments from the bond may become less attractive and lose their real purchasing power.

The income stream from a bond is generally highly predictable and secure, as the bond issuer is obligated under contract to provide it. A company's capital and earnings must be used first to satisfy its debts, i.e. payments to bondholders, before anything else, e.g. dividend payments to shareholders. Furthermore, whilst the price of a bond itself can fluctuate between its issue and maturity dates due to market sentiment and other underlying factors, its maturity value is known at outset as again, the borrower is in most cases obligated to pay back the loan at a certain value on a certain date.

In the event of a bankruptcy or liquidation, a bondholder ranks above shareholders. The loan itself is often secured against a physical asset such as the company's land or buildings which will be sold off repay the bondholders, and any assets of a company must first be used to satisfy contracts of the most senior bondholders before anyone else is paid. When lending to governments, however, the risk of default is currently being used as a bargaining tool to have the debt written off – so care has to be taken when lending to governments

In contrast, when an investor buys shares in a company, he or she buys part ownership in that company. The value of that company's stock will tend to reflect the earnings experience of the firm - up during profitable periods and down during periods of loss.

In return for this heightened degree of uncertainty and risk however, shares carry higher expected returns over the long term than most other investments, including bonds, whose potential for capital appreciation is far outweighed by equities.

At Kilsby Williams & Gould we firmly believe that to achieve your personal financial objectives, you should always hold a diversified portfolio that includes both bonds and equities. However, we feel it is important to consider the impact of the current economic and political situation on the different asset classes (inflation, interest rates, employment, etc); for this reason our regular economic commentaries give our short term view as to whether we believe the relative holding should be 'high', 'average/neutral' or 'low' in the different asset classes.

Past performance is not a reliable indicator of future returns.

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YOUR FEEDBACK

After ten years in business we felt now was an appropriate time to consider our service proposition and business goals for the next ten years. With this in mind we recently circulated feedback questionnaires and would extend our sincere gratitude for the time and effort our clients have taken in completing the questionnaire. Thanks to this participation, we will be fulfilling our promise and making a contribution to charity, split equally between the Cardiff Rotary and the Nepal Education Foundation, two very worthwhile causes.

Having carefully analysed the responses we were very encouraged that, overall, the satisfaction level amongst the respondents was very high. However, areas for improvement have been identified, and we feel it is good business practice to consider adapting our business to accommodate improvement where possible. Where specific points were raised, these have been addressed directly with the individual respondents, however, I will now run through a selection of the areas addressed:-

* Shorter valuations reports -

- This is understandable, when a client's prime focus is the actual performance of their investments. However, the analysis of current circumstances, objectives, attitude to risk and asset allocation are fundamental if we are to help clients achieve their goals.

* Portfolio Performance -

- Interest was expressed in mapping portfolio performance since joining Kilsby Williams & Gould; with perhaps incorporating diagrams where appropriate- this is being addressed as we appreciate that clients wish to build up a longer term picture of the performance of your portfolio.

* Online access to investment portfolios -

- Arrangements are being made to facilitate this. Most providers now enable clients to access information about their investments online after organising appropriate security; this often includes valuations, recent transactions, and fund specific information.

* Fee structure -

- In the main, this was understood and there was a clear message that time based fees were preferred over a % charge of assets under our supervision. We will continue to strive to be clear about our anticipated costs.

Finally we asked clients to rank the relative level of investment risk of different types of financial assets. Generally the respondents had a similar view to us with the exception of bonds (loans). It is for this reason that Oliver Stone dedicates time in this newsletter to justifying our point of view. Simon and Andy are ready and willing to listen, digest and debate alternative views as I gather robust debates between advisor and client are seen as particularly healthy pursuits at Kilsby Williams & Gould!

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