News & Views

The Knowledge 4

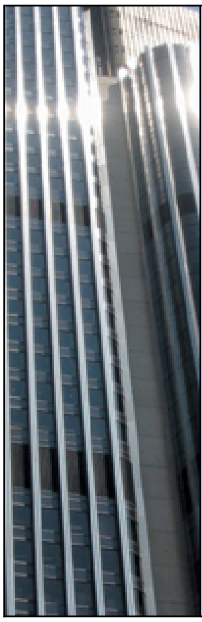
Worried about inflation?

The UK Consumer Price Index rose to 5.2% in September thanks to continued high oil and food prices. Despite this, interest rates have been cut again, to 4.5%, yet the Bank of England believes inflation might rise a little further. So should investors be worried?

Inflation is far below historic highs. In the late 1980s and early 1990s, monthly inflation figures were well above current levels – as high as 8.5% in April 1991. But many will remember the economic slump of the 1970s, triggered by double-digit inflation, and be nervous (source: www.statistics.gov.uk).

The recent peaks in inflation have come from rising energy costs plus higher prices for vegetables, furniture, and cigarettes. House prices and housing costs are also still ahead. However, the Bank of England's Monetary Policy Committee emphasises the longer term when determining the UK's interest-rate policy as it takes time for a change to take effect.

Data from the British Bankers Association (www.bba.org.uk, as at 14 Oct 08) shows that consumer credit card debt remains high at £65.1 billion and the Bank of England expects inflation to stay high for a while, before falling back towards 2%. However, there is less reason for concern than in the 1970s and early 1980s. The economic outlook is nervous but companies appear robust - investors should take heart from this benign macroeconomic backdrop. Even so, this does provide a timely reminder for investors to review and inflation-proof their portfolios.



The benefit of advice

The mortgage market is highly competitive and lenders constantly bring out new deals. They are required to provide Key Facts and illustrations, but many can only provide information – they cannot give advice on whether their loan or another provider's is best for you. In the UK, residential mortgage advice is regulated by the Financial Services Authority. Advisers use their research skills and sourcing systems to keep up to date with details of all the latest mortgage products so they can find the best rates and deals - and explain which one will best suit your requirements. So, if you want someone to do the hard work, then see an expert.

Welcome to the latest edition of News & Views, our update on developments in the world's stockmarkets.

If you would like to discuss any of the issues raised in this newsletter, please do not hesitate to give us a call.

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On your best behaviour

Investors are strange creatures: they wait until the market has risen before they put money in and then sell out when the market has plunged - or worse, hold on to a floundering stock, waiting for it to get back to the value they paid for it.

Why do we behave irrationally? We would not wait for the price of our morning coffee to go up 20% before buying it, so why do we do this with investments? Why do we panic when markets drop, even though we knew it would happen? And why do we become attached to lame ducks when selling them and moving on would get our money back quicker?

Many theories abound: go back as far as the 18th century and economists like Adam Smith were seeking an explanation of why markets behave as they do. One that has gathered force of late is behavioural finance.

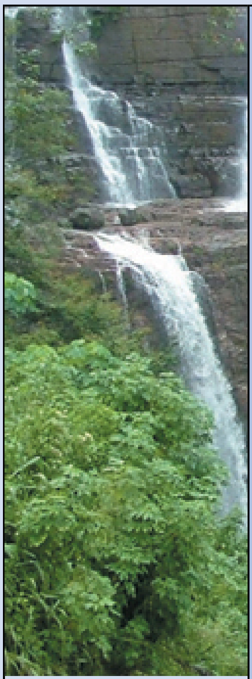
Behavioural finance suggests people often make decisions based on so-called rules of thumb, rather than after rational analysis. Technically referred to as heuristics, it involves understanding that the way a problem is presented can affect the outcome (a process called framing). Therefore, market inefficiencies are not the only way to explain outcomes that go against rational expectation.

Two of the most influential psychologists in the field are Daniel Kahneman and Amos Tversky who, in 1979, published a paper comparing models of rational economic behaviour with decision-making during times of risk and uncertainty. Their theories sought to explain anomalies in the way investors and financial markets react.

These theories help explain how we all got pulled into phenomena such as the technology boom (mostly too late to make any real money), despite the irrational theories which support them.

It helps explain why we sell out of a falling market, just when our loss is at its greatest. It also explains why we hold on to ‘loved’ investments long after they have started to go wrong. And it is why we shy away from markets that have underperformed, despite indications of great potential.

Increasingly, asset managers are using pricing models to take behavioural biases into account, as they believe it gives them an advantage. If you understand these theories, you could have that advantage too. It can be difficult to swim against the tide - but long-term, you may be very glad you did.



The UK market

As a UK investor, you’ll probably be most familiar with your national stockmarket. It is full of household names, which can offer a certain reassurance that you know the businesses in which you are investing.

Shares here are traded on the London Stock Exchange, and are split across two primary markets – the Main Market and AIM – with indices tracking the performance of different elements. The FTSE 100 Index tracks the largest 100 companies (which make up around 80% of the stockmarket by value), followed by the FTSE 250 Index. Combine the two and you get the FTSE 350 Index. Smaller companies make up the remainder, and bring the total market capitalisation of the UK market to around £3,500bn. AIM (Alternative Investment Market) is composed mainly of smaller, high-growth companies and now boasts more than 1,000 participants (Source: ftse.com as at 31 Dec 07).

Average company profits have grow in recent years, buoyed by strong economic growth, merger and acquisition activity and efficient management. Some of the largest FTSE 100 companies are global leaders in their fields, which means future progress is increasingly influenced by events in other parts of the world, and many UK companies are now as dependent, if not more so, on international business than on the UK. The UK is traditionally seen as a 'defensive' market because it is dominated by banks, pharmaceuticals and oils, which are less vulnerable to the economic cycle.

Planning for Personal Accounts

With personal accounts due to launch in 2010, employers will soon be forced to set up pension provision for their employees. Group personal pension schemes have emerged as one potential solution.

The main attraction is their simplicity. The employer passes contributions straight from payroll to the provider. This is then invested as per the employee's instructions. Although a group scheme, each employee has their own plan so they benefit directly (and only) from their own contributions and can also decide how this is invested. Contributions benefit from tax relief at the employee's highest rate and employers can also contribute - usually around 3-5% of gross pay.

This not only helps the employee but also the company tax bill - and can also reduce national insurance contributions. In addition, a contribution of at least 3% might help to cover any future requirements demanded by the Personal Account rules, pre-empting the need for a separate scheme. Please note, however, these rules are still being finalised, so final details are subject to change.

Finally, at the end of the employment, employees can simply take their sub-plan with them and keep contributing to it themselves. This reduces the need for the administration of retained benefits and also helps prevent the employee from running up lots of different pensions as they change employers through their careers.

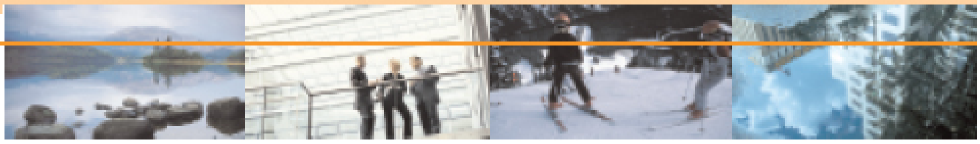
In the best of health

Providing private medical insurance (PMI) is one of the many benefits many larger corporations now offer to attract and retain staff.

It is becoming almost a standard offering so many new employees now expect some level of private health care as part of their overall package. However, it can also be a useful for companies. Ensuring people have speedy access to medical care means they take less time off work when sick. According to figures from Laing & Buisson (based on 2003), over 4.6 million people are covered by company-funded PMI schemes.

Providing private health care is an allowable business expense for companies that pay corporation tax. However, directors and employees earning over £10,000 (including expenses) will have to pay tax and national insurance contributions on premiums paid on their behalf. Any payouts in respect of claims are, of course, tax-free. Medical check-ups and screening provided by an employer are tax free, as are eye care tests.

Most PMI providers will offer tiered schemes. The basic schemes will offer hospital care as an in-patient or out-patient for serious illness. Mid-tier policies will also offer diagnostic tests and medical treatment, while top-tier schemes will bring in perks such as free prescriptions, home nursing and dentistry. These schemes can usually be tailored for the number of employees in an organisation and adjusted for employees who work abroad.



Investing: Rule no 2

DIVERSIFY TO SPREAD YOUR RISK.

You can spread the risk in your portfolio by investing across a mixture of different areas. This might be different asset classes, different industry sectors or different areas of the world but if you mix your portfolio up then, when one area is going down, chances are another area could be going up and can therefore help compensate. However, if you put all your money into just a single asset class, sector or company, you are tied to their fortunes alone - and performance could be highly volatile. As the saying goes, never put all your eggs in one basket.

Gifting your house to your children

Inheritance tax allowances have failed to keep pace with soaring house prices and many more people now have to consider the IHT legacy they are leaving to their beneficiaries. What options do you have to avoid IHT if your home takes you close to or over the current £312,000 IHT limit (£624,000 for married couples and civil partners) without allowing unscrupulous or disorganised relatives to leave you without a roof over your head?

Firstly, the one thing you definitely can't do is simply sign your house over to your descendants and continue to live in it. This is called a 'gift with reservation' and is ultimately inefficient for tax planning purposes as the house will continue to form part of your estate. The only way to get round this is to pay the beneficiaries a market rent, but this is unlikely to be a popular option for those who have scrupulously paid off their mortgage in order to enjoy a comfortable retirement. It also opens the door to your house being sold from under you if your beneficiaries get into financial trouble.

So what options do you have? You could move out and rent or move somewhere smaller and gift the remaining capital to your beneficiaries. This gift is called a potentially-exempt transfer (PET) and becomes IHT-free as long as you survive 7 years. If you have a big enough house, you could arrange joint ownership and live together in the house. That proportion of the house then is then a PET and again, is IHT free as long as you survive 7 years.

For larger estates, there are some more complex schemes. 'Shearing' involves selling the freehold and obtaining a short-term lease. Another arrangement involves selling the freehold in return for a lease for life and cash. This cash goes into a trust and the freehold becomes a PET. However, such schemes need to be constructed with the help of a financial adviser to make sure they meet the regulations – and that an equitable deal is done.

There are no easy ways to avoid the IHT on your main house, but you can maximise your allowances to ensure you at least way lay the tax man and still keep a roof over your head.