360

from AW Financial Management

April 2016

Happy Easter! Welcome to our April 2016 edition of 360. This is our quarterly update on all things financial and we hope you find the articles, reports and commentary both useful and informative.

In this issue

Osborne lets lie pension tax relief—for now

In recent Budgets and Autumn Statements, Chancellor George Osborne has sent warning shots across the bows of salary sacrifice schemes. This year's Budget reiterates that the Government is concerned about the growth of salary sacrifice schemes and is considering limiting the range of benefits that attract tax or National Insurance Contributions breaks when provided as part of salary sacrifice schemes. Reassuringly, the Government does want to encourage employers to offer certain benefits and so the intention is that pension saving, childcare and health-related benefits should continue to benefit from income tax and NICs relief when provided through salary sacrifice arrangements.

The Chancellor's turnaround on his idea to dramatically change the way pensions are funded and then (not) taxed in retirement is in some ways helpful. With so many other pension changes coming through, the industry as a whole could probably not take yet another change, so quickly. The pensions freedoms which have been rolled out in the last couple of years have helped to ensure that pensions are an attractive vehicle for saving for retirement whilst continuing to benefit from tax relief.

However, it remains to be seen where the Conservative Government will be able to trim significant expenditure from the welfare budget to fund the deficit without touching pensions. With disability benefits forecast to increase by £2bn over the next five years, and sickness benefits by £1bn, the government have argued that there is room to trim the budget here. However, these figures pale in comparison to the £15bn projected rise in pensions tax relief that they must fund. Eventually, something will have to give.

Global markets and your portfolio

The portfolio performance figures below provide a reasonable indication of the levels of return each investor will have received over the time scales shown, according to the level of risk they wish to take and their likely investment term.

Description	AWFM risk model	3-5 year Portfolio (shortest term)		21+ year Portfolio (longest term)	
		3 months	1 year	3 months	1 year
Cautious risk	1	-0.04%	-0.02%	0.82%	0.60%
Cautious to moderate risk	2	0.35%	1.09%	1.20%	1.03%
Moderate risk	3	1.13%	2.57%	0.83%	1.70%
Moderate to adventurous risk	4	1.04%	2.65%	-0.71%	1.09%
Adventurous risk	5	0.78%	2.98%	-0.68%	0.44%

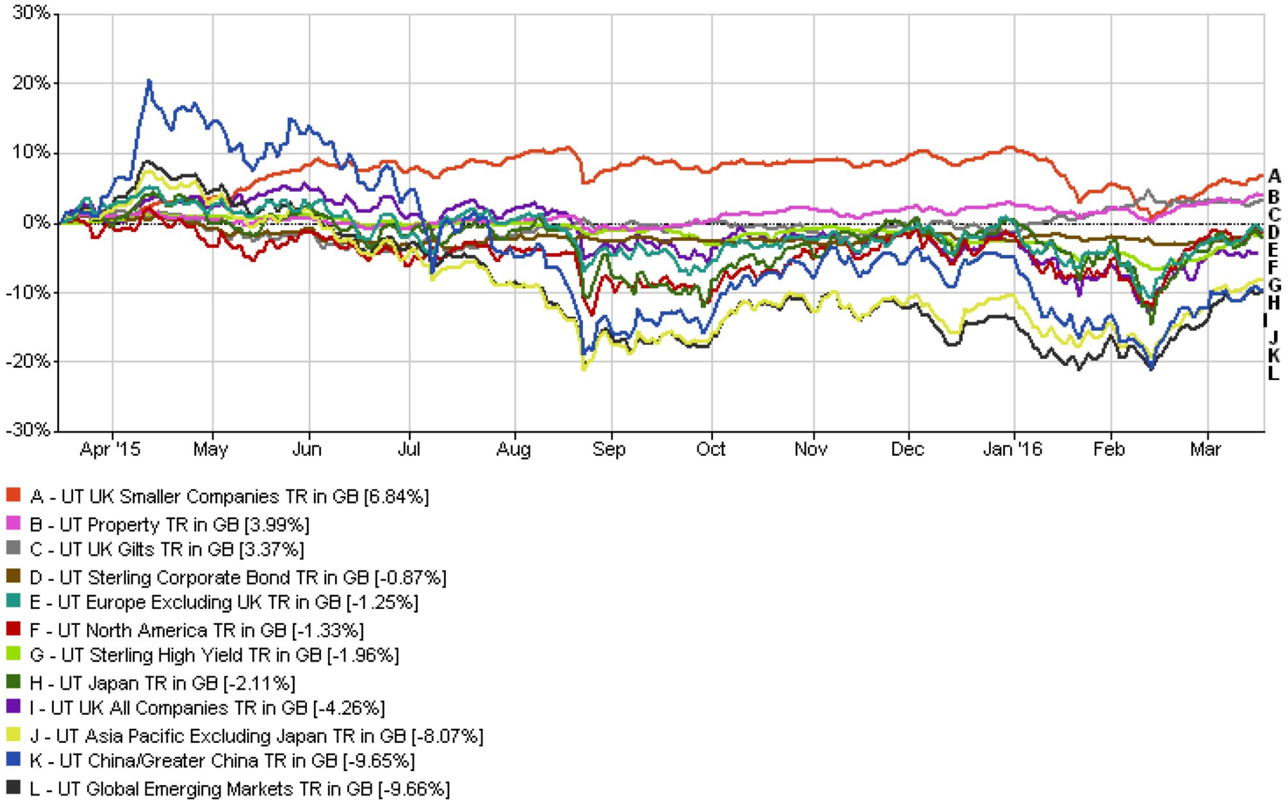
The trends of the last twelve months have continued, with fears over China's economic slowdown, a slight reduction in global growth and a collapsing oil price causing a somewhat indiscriminate "sell off" amongst equity investors.

However, as you can see our strategy of holding a diversified portfolio continues to pay dividends, protecting against downside risk, and we have managed by and large to consolidate the strong returns of the previous twelve months. The potential for further growth as the markets continue to recover is encouraging, although of course we cannot be certain of future investment returns.

The angel said to the women, "Do not be afraid, for I know that you are looking for Jesus, who was crucified. He is not here; he has risen, just as he said." — Matthew 28:5-6, New International Version

Investment returns & outlook

In our newsletters last year, we commented at length on the mixed fortunes of various sectors. Trends have largely continued as they were, with Asia and the Pacific (other than Japan) having risen, fallen and risen again. Being influenced heavily by the fortunes of China's economy and commodity prices, they have seen a period of high volatility and, despite having recovered somewhat in the last month, still finish the last twelve months down 8-10%.



As we discussed in last July's edition of '360', the large spike in mid-April turned out to be somewhat "overcooked". Unfortunately, the anticipated recovery driven by intervention from the Chinese Government, forcing state-owned companies to buy Chinese shares, did not materialise, and as the bubble well and truly burst there were sharp falls in July, August and in the New Year. Of course, we are wary of such markets for this very reason and so continue to have very little exposure to China, if any, in most of our portfolios. Since the world's Emerging Markets, including those in the BRICS group (Brazil, Russia, India & China, and more recently South Africa), tend to impact upon each other, Global Emerging Markets have also suffered after a promising start, finishing in last place among the sectors shown with a return of –9.66%.

The stand-out performers in an otherwise 'down' market have been UK Smaller Companies, UK Property and UK Gilts (Government Bonds). UK Smaller Companies has been a strong sector in the last year, including the Liontrust UK Smaller Companies fund which we use in our model portfolios. It has continued to hold out well against its larger FTSE 100 peers thanks to the relative strength of the domestic UK economy. UK Property continues to be a steady source of income and growth as the British economy continues to strengthen, remaining stable in recent weeks despite uncertainty over Britain's membership of the European Union. There has been an expectation for the last few years that at some point the Bank of England will raise interest rates, and whilst this has checked the performance of UK Gilts somewhat, a rise has not yet happened and so, with Equity markets very volatile and investors flocking to "safe haven" assets such as Gilts, they remain elevated in value. As this inevitably occurs the value of UK Gilts is likely to tail off towards historic levels. This is no doubt why commentators hold a negative view of UK Gilts, shown below.

POS	**A POSITIVE outlook**	European Equity; Japan; Global Property
NEU	**A NEUTRAL outlook**	UK Equity & UK Smaller Companies; Emerging Markets including BRICS; UK Property; UK Corporate & International Bonds
NEG	**A NEGATIVE outlook**	US Equity & US Smaller Companies; UK Gilts (Government Bonds)

The other major economies across the world (Europe, Japan and the United States) have had a steady if not wholly reassuring year as they fight to resist the effects of China's economic woes. Whilst these regions' stock markets were dragged down in the first month or so of this year, each has since done well to bounce back, finishing the year marginally down on twelve months ago.

Looking at the table on the left, you can see that market sentiment has not changed dramatically: Equities are looking neutral to positive as the major developed economies continue their recoveries. The feeling remains that US shares are looking slightly expensive and therefore potentially subject to profit-taking resulting in falls in value. Gilts continue to be negatively viewed by most investors, which is not particularly surprising when these bonds are yielding so little and interest rate rises are perhaps, finally, around the corner.

As ever, we recommend a diversified portfolio is held, rather than aiming for short term gain based on market sentiment.

What is the new 'Lifetime ISA'?

One of the biggest stories of the spring budget was the announcement of a new 'Lifetime ISA', to be introduced in April 2017. Along with this announcement was the news that the annual ISA allowance will be rising from £15,240 to £20,000 from the same point. The Lifetime ISA is an extension of the 'Help to Buy' scheme which the government has been championing, and is one of several initiatives designed to encourage younger savers to put aside for retirement, and to give first-time buyers a leg up onto the housing ladder.

Available to everybody between the ages of 18 and 40, holders of Lifetime ISAs will be able to save up to £4,000 a year. The government has then promised to add a further 25% bonus on all contributions made before your 50th birthday, providing the funds are used towards a deposit on a first home worth up to £450,000. Alternatively, if funds are left until your 60th birthday, you can then draw your savings and the government bonus tax-free. Should you wish to withdraw the money before you turn 60 without using the proceeds to fund the purchase of a first home you will lose the government bonus, including any interest or growth on it, and suffer a 5% exit fee.

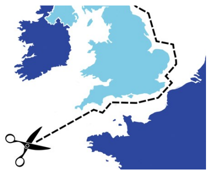
The incentives to save into a Lifetime ISA are clear. The government top up is the equivalent of pension tax relief of 25%, and that is before any fixed-rate or investment growth, tax free. As a quick case study, if a 25-year-old took out a lifetime ISA and was able to pay in £4,000 every year, with average annual growth of 5% and the government 25% bonus, they could end up with a tax-free pot worth more than £450,000 at age 60. It is also good news for parents and grandparents wishing to put aside for their children or grandchildren. A couple could give £2,000 each to put into the Lifetime ISA, and this would fall within the £3,000 Inheritance Tax allowance. This is already possible with a pension, although the saver is not able to access the money until 55.

Fundamentally however, for the majority of savers, the most tax-efficient way to save for *retirement* will remain via a workplace pension. Valuable employer contributions will be added to the government tax relief on employee or personal contributions making company pension plans very attractive. The worry from some commentators is that some younger savers will eschew their workplace pension in favour of the Lifetime ISA. Pensions may be going out of fashion as people dislike the idea that their money is 'locked away' until retirement age, but there is still an important place for company-sponsored pensions when looking towards retirement. For personal pension plans the situation is a little different, given there is no employer contribution involved. Based on the current information, personal pension plans remain very attractive for higher rate tax payers but less so when compared with a Lifetime ISA for basic rate tax payers. However, as ever, people's situations vary and so individual advice will be very relevant to those saving towards retirement.

Britain's place in the European Union

Last year we talked about the impact of fears over 'Grexit'. This year, the focus has moved much closer to home, as a referendum on Britain's place in the EU approaches and all eyes turn towards a potential 'Brexit'. Putting aside the rhetoric being peddled by both sides of the political campaign, we wanted to look at the debate from a purely economic and investment management perspective. Here are the thoughts of two industry leaders, Neil Woodford of Woodford Investment Management and Leigh Harrison, Head of European Equities for Threadneedle Asset Management.

Leigh Harrison has stated that, if we exited, the UK would arguably find trade with Europe both harder and more costly, with the consequence being reduced economic growth. One of the biggest areas of growth within the UK economy in the last 15 years has been that of the financial services industry as London has increased its dominance of European financial markets. Whilst the many advantages enjoyed by the UK may well limit the impact, there is no doubt that business would drift to within the EU as regulatory requirements and legal practicalities favour Europe over the UK for future investment.



However, Neil Woodford points out that, in terms of property, the driving forces of office creation in London are scientific, professional and technical services—not financial services as often perceived. Woodford has criticised both sides of the economic debate over Brexit, saying, "It is really hard to see any credibility in an argument to stay or to leave constructed around economics. It's a nil-sum game. If we stay or we leave, the fundamentals of the economy will be relatively unmoved."

Both agree however that the uncertainty caused by the lead-up to a referendum in June is having a non-trivial, negative impact on the UK economy and UK stock market. In the context of the low inflation, low growth environment we are experiencing, the Government therefore wishes to bring about the vote at the earliest opportunity.

In our view, the global economy is likely to remain largely unaffected whether Britain remains in the EU or not. Thus, whilst up to 35% of our portfolios are invested in UK Equities, for those in a medium risk or higher there is security in a greater weighting in Global Equities. Harrison also points out that, "given that 75% of the UK market's earnings base is outside the UK, a weak currency may substantially offset the impact on investment and business confidence" of a British exit. We continue to believe that diversification is a vital facet of our investment recommendations, and so the effect of any short or medium term stagnation of UK economic growth on our portfolios is limited. As always, the longer term picture is important to keep in mind.

Spring 2016 budget summary

Other than the new Lifetime ISA, cuts to Capital Gains Tax and other stories commented on elsewhere in this newsletter, here is a summary of the major announcements from the Chancellor's spring budget:

- An increase in the personal allowance for 2017/18 to £11,500 (£11,000 in 2016/17) and the higher rate tax threshold to £45,000 (£43,001 in 2016/17);
- An extension of entrepreneurs' relief to cover long term external investors in unlisted companies, designed to further encourage enterprise;
- Two new £1,000 tax allowances for property and trading income, starting in April 2017;
- Interest is to be paid gross from April, with the introduction of a new £1,000 'Personal Savings Allowance'. This will drop to £500 for HRT payers, and to nil for ART payers. According to HMRC, tax that is due on interest above this will be collected through the PAYE (pay as you earn) system, based on information provided to HMRC by account providers. More information on this is yet to be released;
- A cut in the corporation tax rate to 17% in 2020 and greater flexibility in the use of tax losses by smaller companies;
- A restructuring of stamp duty land tax on commercial properties;
- A major revamp of business rates, permanently doubling the small business rate relief;
- The abolition of Class 2 National Insurance Contributions for the self-employed from 6 April 2018;
- A new 'sugar tax' on the soft drinks industry in an attempt to counteract dangerous levels of obesity in children.

In other important news now in play from last year's budget, the Financial Services Compensation Scheme's (FSCS) limit for compensation should a financial institution go bust has dropped by £10,000 to £75,000 as of January 1st 2016.

To let, or not to let?

First, the good news: along with the planned rise of the Higher Rate Tax threshold to £45,000 in 2017, Capital Gains Tax (CGT) rates will be cut from 6th April 2016. The current levels are 18% for basic rate tax payers (above the CGT allowance of £11,100) and 28% for higher rate tax payers. These rates are being slashed by 8%, to 10% and 20%.

However, these tax cuts are not available to those in the buy-to-let market, since there will be an additional 8% surcharge on any gains on residential property outside your main home. This of course cancels out the cut and is yet another nail in the 'Buy to Let' coffin. This comes after news of the loss of tax relief on mortgage interest payments for higher rate and additional rate tax payers, starting in April 2017. Discretionary Fund Managers Brewin Dolphin provided the following example of how profits might turn into losses:

A landlord has a gross rental income of £10,000 with an 80% loan to value mortgage worth £160,000. Paying mortgage interest of £8,000 a year gives a gross profit of £2,000. Currently a higher-rate taxpayer would pay £800 in tax, or 40% of £2,000. In future, the £8,000 mortgage bill will be added to the £800 tax bill to give total expenses of £8,800, leaving £1,200 of profit for the landlord. However, their tax bill from 2020 will be charged on the full £10,000 (40% of £10,000 equals £4,000) less a 20% tax credit on the mortgage interest, totalling £1,600 (20% of £8,000 is £1,600), which, when subtracted from the £4,000 tax bill leaves a payable tax bill of £2,400. Add that to the mortgage interest costs of £8,000 and the result is total expenses of £10,400, which translates to a £400 loss.

Finally, the Chancellor has confirmed an extra 3% to be added to stamp duty on additional property purchases from April 1st. Clearly the Chancellor believes the financial disincentive will discourage landlords from getting into the buy-to-let market, and perhaps even to sell up and look elsewhere for income. This might do something to counter the continually rising house prices and, along with the government's Help to Buy initiatives, redress the balance in favour of new buyers.

AWFM News

Our business has continued to grow steadily and develop over the last twelve months. David has now been with us for a full year and is thoroughly enjoying his role, especially now he has passed his driving test—commuting to Crockenhill has become much easier.

Edward had a significant birthday just before the Easter break. He is now 21. Martin wonders how it can be possible that one of his children is 21! Equally Jon cannot believe that his son David turns three on the 1st April! How time flies!

We continue to celebrate good times with some of you and stand firmly with others who are going through difficult times.

Martin, Jon and the team.

If you have any questions about this newsletter or your existing investments, please contact us to discuss your situation further.

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