360

from AW Financial Management

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Welcome to our July 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

The Greek Drama

I'm sure you have all been watching the Greek drama unfold on your televisions, as one "final resolution" falls apart after another. Will this saga never end? Nobody has the answers of course and it is largely in the hands of the European leaders to come to a compromise.

The latest position, after much debating, is that Greece's creditors have offered an €86bn bailout in return for increases to Greece's tax rates and retirement ages. Unfortunately these are the very deals that the Greek population voted against in their recent referendum! Rather unsurprisingly Alexis Tsipras is struggling to get these changes through parliament but what other option does Greece have? Further defaults? Leave the Euro? Who knows what that will bring! Too many questions and not enough answers has made markets jittery and as you can see from the figures below, this has caused falls in Bonds and Equities in the short term.

It is very unlikely that these difficulties will cause a prolonged negative effect on markets over the longer term despite the risk of Europe-wide contagion. Greece itself only represents about 1.3% of the European GDP. Whatever the outcome of this drama, we predict that markets will recover. As ever with investing, it is about patience and the long term returns.

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.

First of note is the slight fall in the markets in recent months, largely driven by the Greek crisis and continued fears of interest rate rises in the US and UK. However, the struggling price of oil has played its part too.

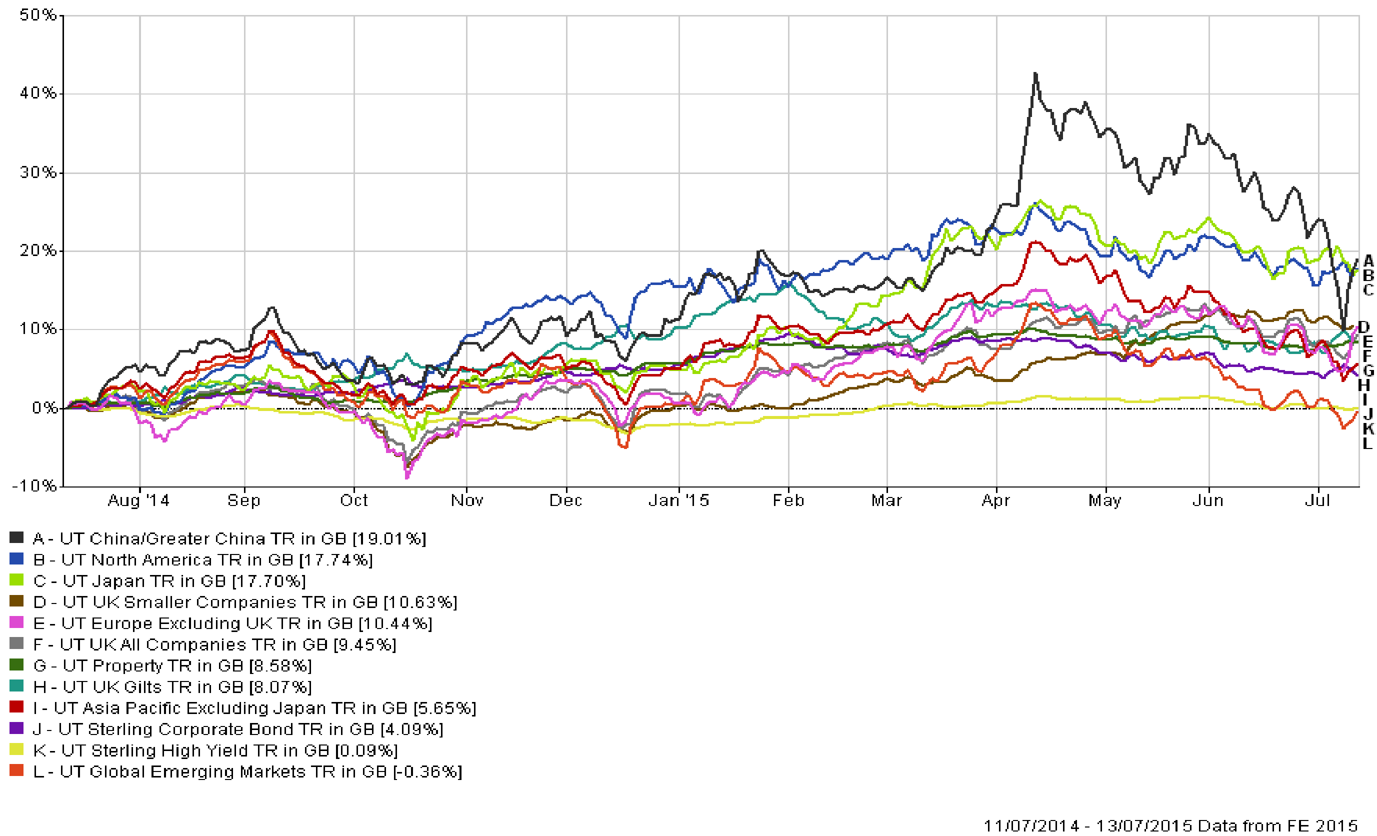
Description	AWFM risk model	3-5 year Portfolio (shortest term)		21+ year Portfolio (longest term)	
		3 months	1 year	3 months	1 year
Cautious risk	1	-0.41%	1.31%	-2.92%	8.00%
Cautious to moderate risk	2	-0.51%	3.58%	-3.08%	7.51%
Moderate risk	3	-1.21%	5.82%	-2.37%	10.84%
Moderate to adventurous risk	4	-1.91%	8.59%	-3.48%	12.36%
Adventurous risk	5	-2.36%	11.41%	-4.33%	10.15%

Slow downs or corrections in the markets are to be expected after a period of such strong growth. Market's often get ahead of themselves and then have to pause or fall slightly to allow companies earnings and profits to catch up, so as to avoid 'bubbles' forming. Over the full year however, you can see that returns continue to remain strong across the board and particularly so for our longer termed portfolios.

Every good action and every perfect gift is from God. These good gifts come down from the Creator of the sun, moon, and stars, who does not change like their shifting shadows.— James 1:17, NCV

Investment Returns & Outlook

In our last newsletter back in April, we commented on the mixed fortunes of UK Smaller Companies. They have continued to consolidate, rising perhaps another 7% over the last quarter, to give a twelve-monthly return of just above 10.6%. While most other sectors have suffered over this period, for UK Smaller Companies to continue to perform well is encouraging, both for our investment portfolios and for the national economy.



China saw a huge spike in mid April, coinciding with more relaxed economic policy from the Chinese government and the gathering pace of financial reform. Clearly this was a knee jerk reaction and somewhat “overcooked” and the resultant collapse in Chinese Equities was in some ways to be expected. However, with the recent start of a recovery driven by intervention by the Chinese Government, forcing state owned companies to buy Chinese shares, the asset class still performed the strongest of each of the sectors shown with an annual growth of 19.01%. Still, 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.

The other two stand-out performers in the past twelve months have been North America and Japan. The US market has had a strong year, and has done well to protect against significant losses in this latest downturn eroding the steady growth between October last year and April this year. Japan has seen upbeat expansion in gross domestic product, driven no doubt by the huge Quantitative Easing policy brought about through prime minister Abe’s financial reforms, which has fuelled increased confidence in its economy in the short term. We remain confident in both the US and Japanese economies but have been retracting slightly from the former and increasing the latter on valuation grounds. Meanwhile, this side of the Atlantic, UK Smaller Companies continue to lead the way, holding out better than its larger FTSE 100 peers.

UK Property continues to be a steady source of income and growth as the British economy continues to strengthen. Bonds and particularly government bonds have been sold off over the last 3 months over fears of interest rate rises, as we have been predicting over the last 3 years and highlighted in our previous newsletter. We expect this trend to continue, gradually bringing bond yields back towards historic levels.

POS	A POSITIVE outlook	UK Equity & UK Smaller Companies; European Equity, Japan & the Pacific; UK Corporate Bonds
NEU	A NEUTRAL outlook	Property, Global and UK; Emerging Markets Equities along with Brazil, Russia, India, China; International Bonds
NEG	A NEGATIVE outlook	US Equity & US Smaller Companies; UK Government Bonds (Gilts)

As you can see from the table on the left, looking forward the trends from last quarter look set to continue: Equities are looking on the whole positive as the major developed economies continue their recoveries. The feeling remains that US shares are looking 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 potentially around the corner.

As ever, we continue to recommend a diversified portfolio is held, rather than aiming to make short term gains on market sentiment.

House Rules for Inheritance Tax

Currently, Inheritance Tax (IHT) is charged at 40% on estates over the tax-free allowance (Nil Rate Band) of £325,000. This Nil Rate Band has been fixed from 2009 despite the large rise in property prices since then. Married couples and civil partners can pass any unused allowance on to one another on death, providing this is claimed by the beneficiaries on first death. This means that spouse's have a combined tax-free allowance of £650,000.

Pressure has been mounting on the government to up the Nil Rate Band to take into account the increase in property prices. The Government have finally acted under this pressure and George Osborne therefore recently announced in his latest budget that from April 2017, a new "Family Home Allowance" of £100,000 will be introduced for each parent, enabling them to pass more of the property value on to direct descendants (children and grandchildren) IHT free. This allowance will rise by £25,000 each year up to £175,000 by 2020/21, meaning that by the end of the decade couples will have a combined Nil Rate Band and "Family Home Allowance" of £1 million, enabling the vast majority of families to pass on their family home IHT free. It is worth noting that this additional allowance will be gradually withdrawn for estates worth more than £2 million, falling by £1 for every £2 over this threshold.

It has also been reported that where couples have downsized, the home allowance will still cover any released assets from the downsizing. For example, if an individual were to downsize from a home worth £500,000 to one worth £300,000 and then were to die in 2021, they would then be able to leave their home plus £200,000 of other assets with no IHT liability, when taking into account the Nil Rate Band of £325,000 and Family Home Allowance of £175,000.

Critics of the move have pointed out that the rules will not benefit the vast majority of the population, only affecting those at the wealthier end of society. The Treasury has said that the policy will not apply to 90% of estates. For those living in the South East of England however, including many readers of this newsletter, this will be welcome news. With most properties in the South East using up the majority of a Nil Rate Band, leaving little allowance if any for other cash or investment assets, this new Family Home Allowance could see many of our clients fall out of the IHT threshold altogether.

New Dividend Tax

The complicated and often misunderstood dividend tax credit is to be scrapped from April 2016 and all taxpayers will be entitled to a new tax-free Dividend Allowance of £5,000. The old 10% Tax Credit system was designed to take into account the Corporation Tax paid by companies, so that investors weren't paying tax twice (in the company and personally too). Note of course that this only applies to taxable Investment portfolios: dividend income received in pensions and ISAs will still not result in tax paid by the investor. Gordon Brown however infamously brought in legislation to stop the Tax Credit being reclaimed within pensions.

Under the new rules, from April 2016 and once the Dividend Allowance of £5,000 has been exhausted, dividends will be taxed at the following rates:

	2015-16	2016-17
Basic rate	0%	7.5%
Higher rate	25%	32.5%
Additional rate	30.6%	38.1%

The new rules will benefit *some* tax payers at the higher or additional rate, as they now can receive up to £5,000 in dividends tax free. Under the old rules they would have paid £1,250 and £1,530 respectively on £5,000 of dividends. However, once the £5,000 allowance is used up, further tax will be payable at higher rates than before (see left). So a basic rate tax payer with say £30,000 of dividend income will pay tax of £1,875 under the new rules (£30,000 minus £5,000 times 7.5%) whereas under the old rules they would have no further tax to pay. A higher rate tax payer with dividend income of £30,000 would pay £8,125 of tax (£30,000 minus £5,000 times 32.5%) under the new rules whereas they would have only paid £7,500 in tax under the old system. The tax payable on dividends does depend on the total income of the individual and dividends are the last to be taxed within a personal tax calculation.

With these new higher rates of dividend tax for some, careful use of ISAs and pensions is of greater need than ever. For most of our clients, dividends from investments were rarely subject to extra tax through careful tax planning. However, for balanced portfolios in taxable investment accounts with a value over £200,000 or so, this new Dividend Tax could come into play.

From a logistics point of view, tax will not be deducted at source above the £5,000 allowance and so taxpayers must use self-assessment to pay any tax due, which means staying on the ball.

The biggest losers from this new tax will be those with Limited Companies who are drawing a low salary to use their personal allowance and drawing the rest of their income as dividends to avoid National Insurance Contributions. This strategy will probably still be more tax efficient than taking full earnings as salary, however, this new Dividend Tax will lessen the attractiveness of this approach and help raise more for the public purse.

2015 Summer Budget Summary

Along with the major changes in Inheritance Tax and in Dividend Taxation, here are some highlights from the rest of the budget announcements:

* The Personal Allowance (the amount every UK Resident can receive in income, tax free) will increase from 2016-17 to £11,000, and for 2017-18 to £11,200.
* The plan is that by 2020 this Personal Allowance will reach £12,500, at which point a law will be introduced meaning that people working 30 hours a week on the National Minimum Wage will not pay any Income Tax at all.
* The higher rate tax threshold is to rise again next year, from £42,385 to £43,000. Whilst marginal, this will bring more people back into the basic rate tax bracket. It is set to rise further to £43,600 in 2017-18.
* A new National Living Wage is to be introduced in April 2016, giving workers over 25 a wage of £7.20 an hour, set to reach £9 an hour by 2020. This will give an estimated 2.5 million people an average pay rise of £5,000 over five years.
* The government plans to run a budget surplus by 2019-20, achieved through welfare cuts and measures to tighten up on tax loopholes and imbalances in the system, along with further efforts to crack down on tax evasion. The Chancellor claims that through these efforts £17 billion could be saved by 2019-20.
* In the March Budget it was announced that individuals were to be allowed to withdraw and replace money from their cash ISAs in a given tax year without it counting towards their annual ISA subscription limit. This already effective legislation is to be extended to include Stocks & Shares ISAs also.

2015 Budget Pension Changes

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It does seem that the Chancellor loves to tinker with pension regulations at every given opportunity these days. One of George Osborne's announcements is the alignment of Pension Input Periods with the tax year, due to take effect from April 2016. Pension Input Periods are the time period with which the maximum annual allowance of £40,000 applies. If this limit in annual pension contributions is surpassed during this period, large tax charges apply nullifying any tax relief received. However, if you had been making significant pension contributions from before the Budget announcement, there are transitional rules in place to avoid unnecessary and unpleasant retrospective tax charges!

This is all due to the adjusting of the annual pension allowance. For individuals with an income of more than £150,000, the annual allowance for tax relieved pension savings is to be reduced for 2016-17 onwards. For every £2 of income over this threshold, your annual allowance will be reduced by £1, with a maximum reduction of £30,000, allowing £10,000 as a minimum limit. It is as a result of this tapering that HMRC have stated it is necessary to align the pension input periods with the tax year.

We are now in a fixed Pension Input Period running from 9th July 2015 to 5th April 2016. We will of course aim to ensure that any clients paying in the maximum pension contributions or close to the maximum will not fall foul of these new rules.

AWFM News

As a business we've been going from strength to strength despite the moving landscape of tax planning and general financial planning. David has settled in well to his new role and is learning fast as we expected. Edward has been with the firm now for 2½ years and is working really well in the expanded team.

We're all taking some time over the summer period for holidays but we have ensured that there will always be at least a couple of us in the office throughout August.

Have a great summer!

Martin, Jon and the team.

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