360

from AW Financial Management

July 2019

Welcome to our Summer 2019 edition of 360. We thank you for your continued support and hope that the British summer sunshine proves to be a reason to relax. For those getting away we hope you enjoy your travels—and make the very most of those frictionless borders whilst they last!

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England Expects

This time last year it was Gareth Southgate and the England team whose progress we followed with raised expectations through the men's football World Cup.

Whilst we're sure that the words of Admiral Nelson did not form part of Phil Neville's team talks, football has nevertheless captured our imagination as the women's team put on a series of great performances only to be edged out by the current holders and tournament favourites who, some would say, were not especially gracious in victory. It was fantastic to see, generally (with a notable exception being our quarter final against Cameroon) levels of sportsmanship and respect for both opponents and officials which often seem to be in short supply in the men's game. And how heartening not to have heard any talk of antisocial behaviour – from English or other 'fans'. Well done to the Lionesses and, as a result of England's progress in the tournament, we can look forward to more football and Team GB in Tokyo for the Olympics around this time next year.

In the meantime, Phil's sister, Tracey equalled her brother's feat as her netball team were also edged out –again to the tournament's eventual winner. The Roses were beaten by the Silver Ferns of New Zealand in a very close semi final tie. Saving the best to last: the men's cricket team, staked a strong claim to the 'Team of the Year' accolade. In a fantastically thrilling final they eventually won after both the innings and resultant 'Super Over' were tied. England showed their resilience after some early setbacks in the tournament this time turning the tables and defeating the Black Caps also of New Zealand to be Cricket World Champions for the first time.

The cricketers' successful run incorporated a semi-final win over Australia and we now hope that in the Ashes series to come that success can transfer from white to red ball. For those of you not in the least entertained by Test cricket we hope that the weather holds out so that you enjoy the summer for other reasons!

In finance (just in case it seems that AWFM have been focussed only on the sport!) we watch with interest as the newly selected party leader and, ipso facto , PM, drops a number of his predecessor's key players. In what some journalists have described as "cabinet carnage", 'BoJo' has surrounded himself with a team that is 'energised' and also signed up to his gameplan. Let's hope that the promised "no ifs and buts" Brexit on 31 October leads to greater (or at least some) certainty and that expectations are not, once again, raised unrealistically.

Global Markets and Your Portfolio

Description	AWFM Risk Model	Ethical 3m	Ethical 1yr	Unrestricted 3m	Unrestricted 1yr
Low Risk	1	2.66%	4.61%	2.46%	4.30%
Low to Medium Risk	2	4.46%	6.68%	3.72%	5.44%
Medium Risk	3	5.63%	7.99%	4.50%	4.86%
Medium to High Risk	4	6.08%	6.85%	4.78%	3.21%
High Risk	5	7.46%	8.76%	5.54%	3.71%

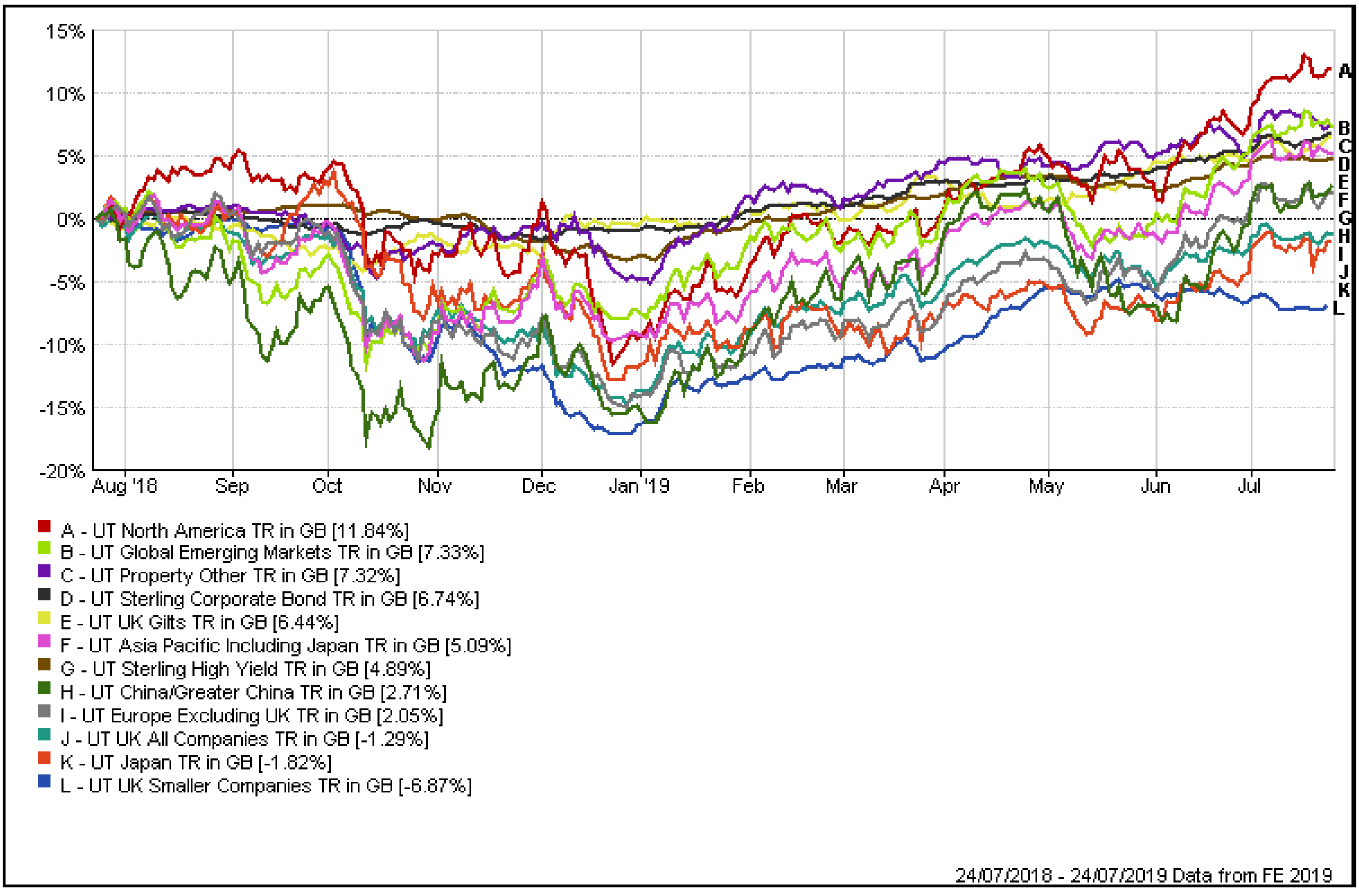
At the half-year, all portfolio profiles—both ethical and unrestricted remain in positive territory on both 3 and 12 month measures. Whilst of course, carrying little or no risk, cash would have returned you less than even the most cautious of these portfolios but it would have been making you a loss in real terms over these (in investment terms) very short time horizons—so in one sense not a risk-free return.

Another misconception which is highlighted by this data is that ethical investors must always sacrifice a degree of investment return in order to be constrained by ethical parameters of investment. As you see from the table here, relative to mainstream funds, those parameters do not appear to have hindered those managers we selected in to our ethical strategies over the last year. Although due in part to good stock selection, certain sectors avoided by ethical funds –such as tobacco and oil have fared less well than technology for example. Nevertheless, whilst we will always want to know about any preferences or exclusions our clients want to impose on the investment strategy, such limitations do, to an extent of course, reduce scope for diversification (more about that later) and so will be incorporated into the plan with a 'health warning'!

"Therefore, my dear brothers and sisters, stand firm. Let nothing move you. Always give yourselves fully to the work of the Lord, because you know that your labour in the Lord is not in vain. " - 1 Corinthians 15 verse 58

Investment Returns & Outlook

As in past editions of 360, we are regularly talking both with clients and fund managers about the prospects of a 'Brexit' deal being agreed with the EU and, latterly, the outcome of the Tory leadership vote and as the graph shows, uncertainty has clearly weighed on UK-centric businesses. The first impression one gains from investment managers is that there are fewer concerns for the impact of 'no deal' on a diversified portfolio than, for example, the possibility of unresolved trade tensions between China and the US. Perversely, a fall in sterling of, say 20%, which some economists are predicting in the event of 'no deal' would be positive for many of the businesses to which our clients' portfolios are exposed as such a large proportion of their revenues are earned in currencies other than sterling. A falling pound would inflate that element of profits when translated back to sterling which is why, invariably, on days when sterling falls we generally are tending to see a rise in the FTSE (index of our top 100 companies by market capitalisation) which generate around 70% of their revenues in non-sterling currency.



If a 'soft' Brexit occurred or ultimately the UK remained in the EU, we would probably see sterling appreciate which of course would diminish the value of non-sterling earnings and potentially be negative for portfolios in the short term. However, the greater certainty (at last!) for UK business might, to a certain extent, counteract the detrimental effect on foreign earnings.

The political situation continues to be fluid and it's impossible to know whether Boris Johnson will seek a 'snap' general election and much will depend on whether popular sentiment seems to be in his favour. Having said this, no doubt his advisers will be wary of his predecessor's attempt to secure a mandate after her arrival at Number 10 via a similar route. If he takes the plunge - and if successful at the polls- this might improve the prospects for UK-centric companies and of his policies being approved by Parliament. As ever in recent times, too many 'ifs' to be certain in the short term and of course the default position remains that, for better or worse, the UK leaves EU on 31 October!

Nevertheless, the majority of most portfolios under our advice, are international-looking - and so, it seems, are the economists who follow with interest President Trump's Twitter feed – if not his official policy statements! The noise from the G20 summit turned out to be more positive than was previously feared although he is likely to continue to play the "America First" card for the time being with one eye on his 2020 re-election campaign. However, as we have seen, a proposed increase in tariffs against Chinese imports was deferred after the G20 meeting and he may be mindful of the impact which retaliatory measures against US-made goods could have on the financial wellbeing of US voters. The seemingly inexorable rise in US corporate earnings continues to make that the strongest performing element of most portfolios.

POS	**A POSITIVE outlook**	Japan equity, Pacific Basin equity, and Emerging Markets equity.
NEU	**A NEUTRAL outlook**	UK equity, UK Smaller Cos equity, US equity, US Smaller Cos equity, Europe equity, Property, Global and Bonds.
NEG	**A NEGATIVE outlook**	UK government bonds and UK Corporate bonds.

We are conscious that there has been no recession since the 2008/09 financial crisis and so it is reasonable to expect a downturn – albeit some of the managers with whom we regularly meet think this unlikely before late next year. We may see a reduction in risk and in the equity (company shares) content with the 'underweight' element added to more stable assets such as cash and fixed interest securities (loans to corporations or governments).

We have recently seen an 'about turn' on expectations for interest rates and now, the Fed is using more dovish language so markets expect at least one rate *cut* possibly as soon as late July. This would typically be viewed as supportive of (more risky) equity markets and negative for (more cautious) fixed interest assets to which most of our clients have varying exposures dependant on their investment aims and risk appetite.

The consensus amongst investment mangers shown here is unchanged since we last reported - perhaps reflecting a 'wait and see' attitude.

The Case for Diversification

Much has been written recently—at least in the financial press — about the startling fall from grace of fund manager, Neil Woodford. He became known as one of the industry's star investment managers acquiring his reputation by virtue of the stellar performance enjoyed by investors in the fund he managed for Invesco Perpetual from 1988. After leaving his long term employer in 2013, he launched in 2014 the eponymous Woodford Equity Income fund which in relatively short order was managing around £10bn of investors' money — many, one assumes, motivated by the manager's previously consistent and strong performance.

If you listen for long enough at regular review meetings with your AWFM adviser, you will definitely have heard the "past performance is no guide to future investment performance" refrain and so it has proved in this case. Despite making loyal investors at Invesco Perpetual around 23 times their money during his 25 year tenure at Invesco Perpetual, the story since going it alone has been a little different .

Early on, as the chart below shows, the fund (blue line) performed well ahead of both its (FTSE UK All Companies Retail—green line) sector of the funds market and against its (FTSE All Share—red line) benchmark. You are, of course, paying the fund manager for his or her stock-picking skill and since early 2017, Woodford backed his preference for UK-focussed companies whilst many managers were selecting a greater proportion of companies with international currency exposure as the Brexit referendum result weighed heavily on Sterling.

He has also favoured financial companies with (currently) 39% exposed to this sector against an average of 19% for the fund's peer group. Performance, as you see, has lagged from late 2017, investors begun to have their doubts and some were prompted to liquidate their holdings. Some will have kept faith in the manager and his strong-held convictions and his views may, in the long term, be proven to be well-founded. In the meantime, it's hard for any manager to retain investor loyalty when consistently underperforming the peer group and the, often irrational, herd mentality will probably prevail.

Liquidity

By May this year redemptions had accelerated and, at around that time, Kent County Council was reportedly considering selling the (£263m) investment held in its pension fund. Before they could do so, Woodford had been forced (perhaps because of the news from Maidstone) to suspend all dealing in the fund. Such action is extremely rare but for the time being leaves investors in this fund with no means of liquidating any of the shares they hold despite the suspension being intended (ironically) to protect those who remain invested. Typically, managers will hold the majority (if not all) of their underlying investments in assets which are relatively easy to trade and turn into cash and, as such, can readily respond to requests from investors to redeem their holdings. In this case, the manager holds a relatively high proportion (for a fund like this) of its investments in unquoted companies which are much less easy to liquidate as there is no recognised exchange making a market in such shares. So when large numbers of investors in the fund ask for their money back but the manager does not have enough available cash and cannot quickly raise it there is a risk that, without limiting or suspending dealing in their shares, the manager is forced in to a 'fire sale' of its more illiquid investments—thereby devaluing shares in the fund and disadvantaging those who continue to stay invested.

At the time of writing, the fund's Authorised Corporate Director has extended the fund's suspension for a further month whilst negotiations are ongoing for the disposal of selected investments. It seems likely that, whenever dealings re-commence, there will be another rush for the door but the manager will hope to have provided for this with the currently ongoing sales. At that point, the fund manager will hope to be able to make investment decisions based purely on economic fundamentals and without being forced into disposals of assets.

Lessons

We are not questioning the skill of the investment manager of the validity of his stock picking decisions but this experience reminds us of the risks which can be associated with a (seemingly liquid) fund that holds positions in illiquid assets. This is something which is more common with property funds such as that held by many of our clients as part of a broadly diversified portfolio. Other lessons to be learned are the importance of monitoring performance— after exceptional returns in its first year, the fund was rated a fourth quartile performer in each of the succeeding three and, so, plenty of opportunity to reconsider its value as part of an investment strategy. And, lastly, perhaps stating the obvious but having all of the "eggs in one basket" - whether that be in terms of the underlying assets *or* the selected fund — will magnify both prospective gains *and* losses.

Ornithology Corner

The latest in an occasional series from AWFM: we were surprised to encounter a (according to our resident 'twitcher') juvenile Chiffchaff at our place of work—not least as it had somehow found its way in to the Reception area at River House!

We are pleased to report that both our Receptionist and feathered friend survived un-scathed.

Inheritance Tax Simplification?

Early July, saw publication of a long awaited report, *Simplifying the Design of Inheritance Tax*, from the Office of Tax Simplification. This report had been commissioned by the (now 'former') Chancellor, Philip Hammond who described the tax as "particularly complex". This is perhaps, evidenced by the report's length —107 pages — and, like other financial planners we would tend to concur with Mr Hammond!

Amongst feedback which informed their recommendations, much centred around the fairness of the Residence nil-rate Band ('RNRB') - which was introduced by Mr Hammond's predecessor only in April 2017! This relief facilitates, on death, an additional £150,000 of IHT-free gifting over and above the standard £325,000 nil rate band ('NRB'). One of the key provisos is that this can only be claimed where the value of the main (or former main) residence passes to direct descendants—i.e. children or grandchildren. Consequently, those who have never owned their own home *and* / or have had no children will never benefit.

Although the tax take is less than 1% of HMRC's total revenues, IHT regularly features in our client conversations and related planning. We instinctively, advocate steering clear of complex and / or artificial planning strategies where possible and in many cases a Potentially Exempt Transfer ('PET') is the most tax-efficient and cost-effective solution. Essentially, this boils down to giving away an asset and surviving a full seven years from the date of that gift. Where cumulative gifts exceed the nil rate band and death occurs within that timescale but after four or more years have elapsed, the rate of tax is tapered. Herein lies one of those elements of complexity which can also lead to an unexpected tax liability for the gift's beneficiary—possibly some years after the donor's demise.

The OTS has recommended, therefore, that PETs fall out of the estate after only five years and that any liability arising on gifts made within that timescale should no longer fall on the donee.

Another key observation relates to the value of the NRB which has been set at its current level since April 2009. Had it been increased in line with inflation the NRB would now be at around £500,000—for everyone. As already mentioned, the RNRB is available to some and, from April, will be worth £175,000 to those eligible—making a total allowance, by coincidence, of £500,000. In contrast to the NRB, the RNRB will increase in subsequent years in line with the Consumer Prices Index ('CPI' - the less generous measure of inflation typically used by the Government where impacting on reliefs or benefits available to tax-payers!)

Another allowance which has remained unchanged for some time is that relating to annual gifts. These fall out of the estate for IHT purposes immediately on gifting but the annual gifts allowance has stuck at £3,000 since 1981. Inflation linked increases since that date would have lifted this allowance to £13,000 and, some say, may have encouraged wealth to be passed on earlier.

Another very effective mechanism which is often overlooked but which we have recommended to clients with net income that exceeds their outgoings, is making gifts out of normal expenditure. In essence, although no statutory definition exists, this allows gifts which are habitual and which do not affect the donor's lifestyle to immediately fall outside the IHT net. However, the OTS view this as complex to monitor as donors need to maintain comprehensive records of their income, expenditure and gifting. Consequently, the suggestion for a higher annual gifts allowance goes hand-in-hand with another—to scrap the gifts out of normal expenditure rule.

Whilst we agree with the sentiments behind the proposals we cannot help thinking that, in common with virtually all other matters of state, it will be some way down the new Government's 'to do' - at least until (but probably well beyond) 31st October.

News in Brief

- In an era which has seen the emergence of cryptocurrencies and, now, Facebook launching a digital currency it was, perhaps surprising to learn that the 1p piece has escaped the axe. The Treasury had previously announced that producing copper coins is uneconomical as about 60% are used in only one transaction before ending up lost, in piggy banks or the bin. However, it seems that the decision was challenged, amongst others, by charities who feared an impact on bucket collections and, in so doing, these objections appear to have preserved our right to spend a penny.

AWFM News

- As in other recent editions of 360, we are again pleased to welcome a new team member this month. Harin Fernando (no relation to Diran) joins us from a career in accounting and business management. He is keen now to become acquainted with the financial services industry and is currently 'learning the ropes' with a view ultimately to helping the Partners manage the operational side of AWFM. It is quite possible you will meet Harin in person as we aim to introduce him to the client relationship element of our business.
- Another seemingly regular and encouraging news item has been progress in professional qualifications—something which we are keen to support. Jack recently sat the final paper towards the CII's Diploma in Financial Planning. He's worked hard and we wish him every success as he looks forward to a summer without text books and to news of a 'pass'!
- Such is the expansion in our team here at AWFM, we have outgrown our desk capacity and so, for the time being when he is not meeting clients, Martin is making use of his office at home more regularly.

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