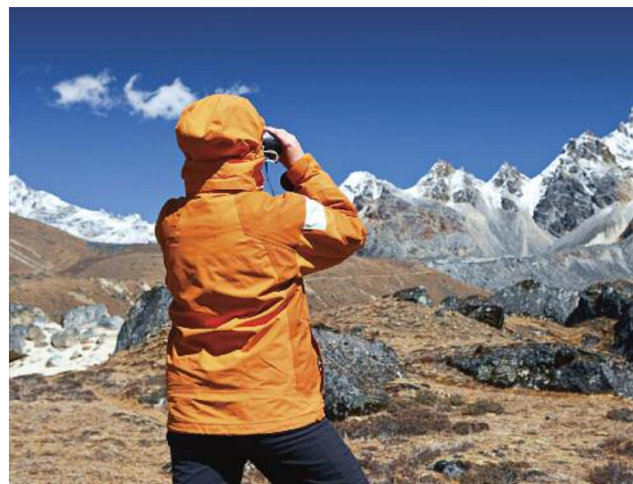
financial focus

Summer 2010

anthony, bryant

The rewarding long view of investments

What are the chances that an investment in UK shares will outperform deposits over a ten calendar-year period?



Over the last ten years – from 31 December 1999 to 31 December 2009 – cash was a clear winner, according to the authoritative Barclays Capital Equity Gilt Study (EGS) 2010. UK equities or shares produced a gross return of –1.2% a year, once reinvestment of dividends and inflation are both taken into account. In other words, if you had invested £1 in shares at the start of the decade, by the end of it your investment would have had 88.6p buying power. Cash, on the other hand, offered a post-inflation return of +1.8% a year. However, there are two key factors to note:

- These figures make no adjustment for tax, which means they are primarily applicable to pension and ISA investments. If tax is taken into account, the gap narrows because UK dividends are effectively paid free of basic rate tax whereas interest is fully taxable. Capital gains – when they occur – are also currently more generously taxed than income, although the new coalition government has indicated that it intends to increase CGT rates to 'similar' levels to those for income.
- More importantly, the 'Noughties' were one of the worst ten-year periods for share investment on record. The EGS says that in the 101 periods of ten calendar years between 1899 and 2009, shares outperformed cash on 92 occasions. One reason for the disappointing 1999–2009 share returns was that the end of the millennium marked the peak of the technology boom for the UK stock market: the FTSE 100 began 2000 at 6930.2. Less than ten months before the end of the decade, the index was languishing at a post credit crisis low of 3460.7 – almost exactly half its starting level.

The EGS shows that the longer the period under review, the more likely it is that shares will have outperformed cash. For example, across five-year periods, shares outperformed cash 75% of the time, but measured over 18-year periods, cash only outperformed 1% of the time. The better historic performance over lengthier timeframes makes sense: the longer you hold investments, the less significant short-term fluctuations become. Viewed over the full 110 years of the EGS data, shares outpaced cash by 4% a year on average after allowing for inflation.

A point to remember when comparing returns in the EGS is that no allowance is made for investment costs (eg commissions, stamp duty and management fees), which can all have an impact on the performance of investments, especially those based on shares. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and your financial circumstances. Share investments do not include the same security of capital which is afforded with a deposit account. The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.

In this issue: Many spring Budget tax changes survive into law • Retiring abroad – the tax pitfalls • New investment opportunities • Looking beyond the pound • Complaints about cash ISAs • Annuity rates looking up?

This newsletter is for general information only and is not intended to be advice to any specific person. You are recommended to seek competent professional advice before taking or refraining from taking any action on the basis of the contents of this publication. The FSA does not regulate tax advice, so it is outside the investment protection rules of the Financial Services and Markets Act and the Financial Services Compensation Scheme. The newsletter represents our understanding of law and HM Revenue & Customs practice as at 17 May 2010.

Many Spring Budget tax changes survive into law

The new coalition government has said that CGT rates for non-business assets are set to be 'similar or close to those applied to income'.

The March 2010 Budget contained little to frighten the voters. The June Budget could well be rather different.

Alistair Darling's final Budget was predictably heavy on politics and rather light on new measures. The timing – just over six weeks before the General Election – was one reason why there were few fireworks. The other was that the Chancellor had already put in train a variety of tax increases, including the new 50% income tax rate and the phasing out of personal allowances from £100,000 of income.

For all its pre-election caution, the Budget still produced a raft of detailed proposals, although not all became law before Parliament was dissolved and the Finance Act received Royal Assent on 8 April. There were 71 separate HM Revenue & Customs Budget Notes on tax law changes, covering everything from tackling tobacco smuggling in the post to bank payroll tax. The more interesting and less obscure included:

Capital gains tax (CGT)

The Chancellor made one change to CGT: he doubled the lifetime limit for entrepreneurs' relief to £2 million. This relief reduces the effective tax rate to 10% on gains made on the disposal of certain business assets, such as shares in a private company. The Chancellor pointedly said that he was not making any other revisions to CGT, but that is only a temporary stay of execution. The new coalition government has said that CGT rates for non-business assets are set to be 'similar or close to those applied to income'.

Inheritance tax (IHT)

In last December's Pre-Budget Report the Chancellor announced that he would be reversing the £25,000 increase in the IHT nil rate band due for 2010/11. In March, Mr Darling went further and said that the nil rate band would be frozen at £325,000 until 5 April 2015. This particular measure was passed in the 'wash-up' Finance Act, rushed through in early April in Parliament's dying days. The Conservative manifesto pledge of a £1 million nil rate band has been put on the back burner: the coalition government says increasing the personal allowance 'should take priority'.

ISA increases

The overall investment limit for ISAs was £7,000 at launch in April 1999 and remained there until April 2008, when it increased by a paltry £200. In the 2009 Budget, the Chancellor announced a rise to £10,200, but staggered its introduction. Mr Darling decided that from 2011/12, the ISA limit will at last be index-linked each year, with each rise rounded to the nearest £120.

Stamp duty land tax (SDLT)

At the end of last year, the SDLT 0% threshold fell back to £125,000 after the temporary increase to £175,000 expired. Less than three months later, Mr Darling raised the threshold to £250,000, but only for first time buyers. This is also a temporary increase, in this instance for two years. It will be funded by a rise to 5% in SDLT on residential properties worth over £1 million, due to take effect from 6 April 2011 (with no end date) and legislated for in the Finance Act 2010.

Annual investment allowance (AIA)

The AIA was introduced in 2008 and gave a 100% initial capital allowance to the first £50,000 a business invests in plant and machinery. The Chancellor doubled that figure to £100,000 in his Budget, although the rise came at the same time as a temporary 40% first year allowance disappeared.

The next Budget on 22 June may contain more surprises than March's, including some unwelcome tax increases. After all, the next election is now some way off and the Treasury has forecast a £163 billion Budget deficit for this year. The FSA does not regulate tax advice.

The grey plastic package

Did your 2009/10 tax return arrive in early April?

In 2008/09 HM Revenue & Customs (HMRC) managed to answer only a little more than half of the 103 million calls to its main tax helplines, according to a House of Commons report issued recently. However, HMRC is much more efficient when it comes to issuing tax returns to its 'customers'. No sooner had Easter and 5 April passed than the nation's doormats were being blighted with weighty grey plastic packages containing 2010 tax returns.

You have until 31 October 2010 to send back your paper return, although if you choose to file online, HMRC gives you an extra three months' leeway. If the recession meant that your income fell in 2009/10, you may want to act more quickly. Your second payment on account for 2009/10 is due on 31 July 2010, and if your projected 2009/10 tax bill is lower than that for 2008/09, you could reduce or even eliminate that payment. If you cannot get the information together and complete your return in time, you can still make a claim to reduce payments, but you will be charged interest if it subsequently transpires that you have underpaid. The FSA does not regulate tax advice.

Retiring abroad – the tax pitfalls

If you are thinking of retiring abroad to enjoy a better climate and escape the UK tax system, you might find it harder than you expect, especially after a recent well publicised tax case in the Court of Appeal concerning Mr Robert Gaines-Cooper, who retired to the Seychelles.

Mr Gaines-Cooper thought that he had kept to all HM Revenue & Customs (HMRC) rules about non-residence. For many years, he meticulously monitored the days he spent in the UK, making sure that he was here for fewer than 91 days in a tax year, closely following the guidance set down in HMRC's guidance leaflet on the subject called 'IR20'. Unfortunately, an analysis of the number of days in the UK revealed that he had spent considerably more time in the UK when days of departure and arrival were included.

HMRC argued that whatever the leaflet said, it only amounted to guidance and they could depart from it over such matters as the rules on days of arrival and departure.

HMRC also argued that Mr Gaines-Cooper's ties with the UK continued to be so strong that, in any case, he had not ceased to be a UK resident in the first place.

The Court of Appeal ruled in favour of HMRC on both counts, agreeing that he had remained a UK resident. So what are the implications of this judgment for people who want to leave the UK and escape HMRC's net on most of their income and gains?

There was one piece of good news for some would-be expatriates. The Court ruled that those who leave the UK to work abroad under a full-time contract of employment are subject to very different rules from those who leave the UK 'permanently or indefinitely' for retirement or some other purpose.

It is now clear that individuals can become non-resident from the day after departure if they leave the UK and work under a full-time contract of employment that will last at least one complete tax year, provided return visits are limited to fewer than 91 days per tax year.

For those who retire abroad or are leaving for some other reason, it is essential that there is a demonstrable change in a person's normal pattern of living that clearly shows a break from UK residence. This means that, in future, would-be non-residents should ensure that they can demonstrate that they have cut meaningful ties with the UK. In particular it is important to:

- Cut all business, social and family ties with the UK. For example, resign from employment, close bank accounts, take their family with them, cancel membership of clubs etc.
- Sell any accommodation, or at the very least let it out on a long lease (even then, HMRC will want a good explanation as to why the property is being retained).
- Create meaningful ties with the new country of residence – for example, buy a property, register to vote, make a will there or have children educated there.

So if you are going to live abroad, but not under a full-time contract of employment, you will need to take care to sever your ties with the UK. Even if you manage to achieve non-resident status, remember that when you are counting days in the UK, any day in which you are here at midnight is considered to be a day in the UK. The FSA does not regulate tax advice.

New investment opportunities

Investors now have access to a much wider range of investment funds than in the past and they can provide some really valuable new opportunities. These funds go under the unpromising name of UCITS (Undertakings for Collective Investment in Transferable Securities). It has taken years for UCITS funds to grow and develop in popularity, but they are finally bringing the offshore market to onshore UK savers.

UCITS were designed to break down border restrictions for investors and fund managers. It made no sense, EU legislators ruled, that international 'onshore' funds were not available to retail savers from more than one country. Instead, fund managers had to open a separate fund in any nation they wanted to sell into, increasing the administration costs that would be passed on to savers. It became just one more reason for funds to base themselves offshore. The EU decided its members needed to harmonise their investment regimes, and in 1985, 'UCITS I' was enacted.

The scheme was slow to find fans, partly because the initial rules needed so much revision to make them workable, and partly because individual regulators had to work out how these new international onshore funds should be handled. But it is now massively successful: around 40,000 UCITS funds manage in the region of 5 trillion euros, or about three-quarters of Europe's investment fund market.

European funds tend to be much smaller than their US peers – seven times smaller on average. The discrepancy means higher costs to the individual investor, putting UK savers at a disadvantage. Ironing out that divergence is one of the main reasons for the new 'UCITS IV' regulations, which come into effect next year. They contain provisions that aim to make consolidation easier, and encourage 'master feeder' fund structures, to promote the efficient pooling of assets. Fewer but larger funds mean more competitively priced opportunities for savers, with a smaller proportion of invested money needed to finance the running of the fund itself.

For the UK saver, a key benefit has been access to absolute return funds, also known as hedge funds. With the flexibility on investable assets that version III of the legislation now permits, hedge fund managers are discovering that it's simple, and not prohibitively expensive, to launch a UCITS-compatible 'clone' of their existing funds, which they can then offer to retail investors.

A further 24 UCITS 'clone' funds were launched in 2009 alone, and there are now more than 200 UCITS III hedge funds out there, with more than £35 billion of savers' funds under their wings. The *Financial Times* recently reported that 80% of alternative fund managers plan a UCITS launch within the next 12 months. As more fund managers adopt UCITS III, investors have been granted access to a wider pool of securities, including not only hedge funds but asset classes such as internationally-traded commodities. There's some doubt, however, over whether these increasingly volatile and complex investments are what UCITS was designed for.

UCITS have opened up a wealth of alternative assets to retail investors, but they come with their own risks. Moreover, with version IV just around the corner, some savers might want to hold off entering the UCITS investment universe until it's clear what changes are on their way.

These investments may not be suitable for everyone, so you should seek independent advice before making any decisions. Returns may go down as well as up, and you may not get back the full amount you originally invested. Not all UCITS funds are regulated in the UK, so may not be covered by the Financial Services Compensation Scheme.

Could you live on the basic state pension? The basic state pension rose by 2.5% in April, to £97.65 a week for a single person and £156.15 a week for married couples. Other state pensions, such as the old graduated pension, were frozen. The previous government knew that the basic state pension is inadequate, which is why the means-tested Pension Credit standard minimum guarantee is £132.60 a week for a single person and £202.40 for a couple. If none of these numbers look adequate to you, then make sure that you discuss your retirement planning options with us.

Looking beyond the pound

The pound has had a rough time of late, but for some investors that has been good news.

It was not so long ago – December 2007 – that the pound would buy you over US$2 or €1.40. Since those heady days, sterling has come under a credit-crunch inspired cloud. The Bank of England has maintained interest rates at low levels seemingly without being too concerned about the impact on the currency. The weakness of the pound has even been seen as a benefit because it makes exporters more competitive and discourages imports, both of which should bolster the economy. The most obvious flip side has been that foreign holidays have become more expensive, as you may soon discover.

A fall in sterling is not necessarily bad news from an investment viewpoint. If you hold overseas assets or investments, their sterling value will rise, even if the home-currency value remains unchanged. Some Spanish second homeowners have found that the pound's fall against the euro has more than counterbalanced the decline in property prices on the Costas: it has been possible to sell at a euro loss, but still make a sterling profit. Of course if sterling appreciates, the reverse is also true and you should remember that the value of assets can fall.

Overseas investment not only provides currency diversification, but it can also give you access to a greater range of investment opportunities. For example, there are no UK companies to match US software businesses such as Microsoft and Google. Similarly, the scope for economic growth in China and India is on a different level from the UK's.

If you want to add overseas exposure to your investment portfolio, there is a wide variety of opportunities available. There are two particularly significant areas.

Funds investing in major UK companies

Investing in UK companies to gain overseas exposure may sound counter-intuitive, but it makes sound financial sense. Many of the largest companies listed on the London Stock Exchange – for example HSBC, BP, Vodafone – operate on a global basis. It is estimated that over 70% of the earnings of the FTSE 100 companies now comes from abroad. A falling pound means that those foreign earnings become more valuable when they are converted back into sterling. A low pound can also make UK companies look cheap to their acquisitive overseas competitors – witness the recent takeover of Cadbury by Kraft.

Companies outside the FTSE 100 tend to be more domestically oriented and some may suffer if they are reliant upon imported supplies.

Funds investing in overseas companies

There is now an extensive choice of funds investing outside the UK. These can be broken down into three main categories:

- **Global funds**, where you can leave the fund manager to decide in which countries to invest.
- **Regional funds,** the next tier down, covering broad geographic areas such as Europe or the Far East.
- **Single country funds**, which let you choose the country in which to invest.

Overseas funds have traditionally had a growth focus, but this has changed of late. If you are investing for income, there is now a selection of global and regional equity funds with an income focus. These can, of course, come with increased risk to your capital, so always take specialist advice.

Exchange rate changes may cause the value of overseas investments and the income from them to fall as well as rise. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances. The value of your investment can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance.

Complaints about cash ISAs

Consumer Focus has made a 'super-complaint' to the Office of Fair Trading about cash ISAs. There is a good case to answer.

If you have a cash ISA, you are not alone. There are 15 million cash ISA holders with a total of around £158 billion invested according to Consumer Focus, a statutory organisation campaigning for consumer rights. Consumer Focus says that the average interest rate being paid on these ISAs is under 0.5%: one major provider pays just 0.05%.

These rates look nothing like those which you may have seen in the personal finance pages of the national press recently, but that is because of what Consumer Focus calls 'bait pricing'. This practice involves offering a high initial interest rate – typically above 3% in the current market – based on a temporary bonus which then lapses, leaving a low rate. It may not be easy to discover what that rate is: often there are many old closed accounts with similar names. In theory you can usually switch to another ISA cash provider to avoid the low rate, but in practice Consumer Focus says people face 'unnecessary and costly delays' when switching accounts.

Cash ISAs can make a sensible home for rainy day savings, but there are potentially more rewarding alternatives for longer term investment. Fortunately, you can now transfer between a cash ISA and a stocks and shares ISA (but not vice versa). Such a transfer would mean that you lose the capital security of a deposit-based investment, but the additional risk comes with potentially higher overall returns. If you are looking for income from your ISA, a move from cash to a corporate bond fund or UK equity income fund could give you an immediate uplift.

The value of your investment and the income from it can go down as well as up and you may not get back the full amount you invested. Past performance is not a reliable indicator of future performance. Investing in shares should be regarded as a long-term investment and should fit in with your overall attitude to risk and financial circumstances. The value of tax reliefs depends on your individual circumstances. Tax laws can change.

Trust accumulation rules change

Legal changes will boost the earning potential of trusts – but those trusts already in existence generally won't benefit.

The Perpetuities and Accumulations Act 2009 came into effect on 6 April this year, and finally abolished the 21-year limit that previously restricted how long income could accumulate for. New trusts can now build up income for their entire 125-year lifespan, bringing them more in line with popular offshore structures.

The limits were intended to prevent assets from being tied up for too long, preventing beneficiaries from actually profiting from accrued capital and income. But they also generated unwanted side effects, like trustees being forced to distribute income to minors, who would be better off if the assets continued to accumulate capital.

To take advantage of this enhancement, it will need to be properly incorporated into a trust – the longer accumulation period isn't automatic. Moreover, existing trusts won't retrospectively become eligible, so it's worth reviewing anything you may have already established. With the Act in force, live trusts can be varied and wills can be republished to benefit.

Now that the changes have come into effect, check to see if you and your family could benefit from making changes to planned or existing trusts. The FSA does not regulate tax advice, will writing and some forms of estate planning.

In a world of 50% tax, the personal allowance has become more valuable. Independent tax for married couples opened up a variety of tax planning opportunities when it was introduced in 1990. New opportunities have now appeared with the arrival of 50% income tax and the phasing out of personal allowances in 2010/11. For instance, it is possible that a switch of £10,000 of income between you and your spouse or civil partner – for example by transferring investments – could save over £5,500 in tax during 2010/11. If you have not reviewed your independent tax plans recently, now is definitely the time to do so. The FSA does not regulate tax advice.

Annuity rates looking up?

Annuity rates are mired at ultra-low levels. But could this be about to change?

At about 6.5% (for a man aged 65), it is many decades since UK annuity rates appeared so unattractive. In 1990, a 65 year old man would have received more than 15% from an annuity. The massive decline means today's retirees see their hard-earned retirement savings converted to annuities that produce income levels similar to late 1990s bank base rates.

Historically, annuity rates were closely linked to the yield on longer term UK government debt (gilts). This is no longer the case, as most annuities are now underpinned by corporate bonds, which generally offer higher yields than gilts. At the peak of the credit crisis, the gap between corporate bond yields and gilt yields widened substantially, pushing up annuity rates. However, over 2009 the reverse happened as corporate bond yields tumbled and the credit crisis abated. Annuity rates came back down in their wake.

With economic uncertainty, weak sterling and sharply rising inflation, there is a possibility that long-term interest rates will rise soon. However, a return to 15% annuity rates is most unlikely. One simple reason is growing life expectancy. The man who reached 65 in 1990 was expected to live for another 15.8 years, according to the Government Actuary's Department. The 65 year old in 2010 has 21.3 years ahead of him – over a third more. Perhaps that 6.5% guaranteed for life is not such a bad deal, after all…

Lifetime allowance limit reached

Two of the main pension limits are now frozen until at least April 2016.

The lifetime allowance effectively fixes an upper tax-efficient limit on the value of your pension benefits, unless you opted for transitional protection before 6 April 2009. The lifetime allowance limit was set at £1.5 million in April 2006 and has gradually increased to £1.8 million now. However, in his 2008 Pre-Budget Report Mr Darling announced that the 2010/11 figure would remain unchanged for at least six years. The legislation bringing this into force was presented to Parliament on Budget day in March.

£1.8 million may sound an excessive amount, but for a man aged 60 buying an index-linked pension today, it would provide little more than £50,000 a year initial income, once the cost of widow's benefits are allowed for.

The freezing of the allowance means that you are likely to be caught by the lifetime allowance charge, currently at a rate of 55% if benefits are drawn as cash and 25% if a taxable income is taken. For example, if your pension value was £1.25 million as at 5 April 2010, should it grow by more than 6.27% a year then by 5 April 2016 it will be over the lifetime allowance, even if no further contributions are made.

The annual allowance (which generally caps the level of tax-efficient contributions) has also been frozen for six years. In practice, this pension ice age has been rendered somewhat academic by the announcement of restrictions on pension contribution tax relief that now apply at income levels of £130,000 and above.

Unless you have already built up substantial pension benefits, these restrictions mean that loss of full tax relief on contributions is going to be more of a threat than the likelihood of exceeding the annual allowance or lifetime allowance limits.

If you think that the allowance freezes or tax relief restrictions could affect you, then you should review your retirement planning as soon as possible. You could find that there are more tax-efficient ways than the traditional pension plan to fund your retirement.

The value of tax reliefs depends on your individual circumstances. Tax laws can change. The FSA does not regulate tax advice.

anthony,bryant

Anthony, Bryant
Independent Financial Advisers
25 Eccleston Square
London SW1V 1NS
Telephone: 020 7630 9696
Fax: 020 7630 5761
Email: info@anthonybryant.com
Web: www.anthonybryant.com

Authorised and regulated by the Financial Services Authority
Anthony, Bryant & Company (Investment Consultants) Limited. Registered Office as above. Registered in England No 1225777