financial focus

Winter 2009

rosan helmsley

Farewell 2009!

As we approach the end of another year, it is worth reflecting on one of the most volatile periods in financial history while looking for signs of optimism ahead.

The market downturn of last autumn, that extended through to the end of February this year, pushed many investors into a position of capitulation as far as their equity-based investments were concerned. Of course the depths of doom are never the time to sell shares and those who chose to realise losses probably regret that decision now.

The run-up in share prices since March has been spectacular by any yardstick with the FTSE 100 up over 40%. The FTSE World Emerging index is up over 90% over the same period. With the benefit of hindsight, we can certainly conclude that fortune favours the brave. It is very interesting to see how some of the world’s smartest investors are behaving. While most investors were unloading financial stocks last year, Warren Buffet was buying into Goldman Sachs – he is now the largest shareholder and has seen a return of over 227% on this investment over the last twelve months. Buffett’s reputation as the world’s most successful investor hangs on his ability to buy a good business when most other investors dislike or are at best indifferent to it.

Buffet has just concluded the acquisition of Burlington Northern, which could be another inspired piece of contrarian thinking. Buffett’s gamble is that the railways will be seen as a low-cost, environmentally friendly alternative to the roads if the oil price continues its upward trend. He has also conceded this is an “all-in wager” on America’s future.

So where might investors look for a Buffet-style contrarian geographic investment in 2010?

According to the Investment Management Association the biggest net outflows from funds in September were once again from assets invested in Japan – the country that liked the lost decade so much it decided to repeat it. The Nikkei index, at around 10,000, still stands about 75% lower than it did 20 years ago, when it peaked just below 39,000. Predicting an end to the slow strangulation of the Japanese stock market has been a mug's game for nearly a generation.

The numbers don’t lie, but the almost total lack of investor interest in what remains a stable and prosperous economy, the world's second largest, is a good sign for Buffett-style contrarians. With a new government offering the prospect of political change and structural reform, a unique position as a backyard exporter to the world’s fastest-growing region and share prices which have finally shaken off the overvaluation that made them so unattractive two decades ago, perhaps Japan is the Burlington Northern of Asia. It is certainly, on most yardsticks, one of the world’s cheapest stock markets.

Japan is not an investment area for ‘widows and orphans’, but for those looking for growth in 2010 and prepared to accept the inherent risks, Japan looks interesting. Contact us if you wish to discuss our preferred Japanese investment funds or for information on any of the articles in this newsletter. Have a wonderful Christmas and New Year.

Start planning early if you want to retire early

Experience shows that turning a pension fund into retirement benefits can be a slow process ...

Many people yearn to retire early – well before their 60s if possible. The trouble is that this is hard to achieve without careful preparation; relatively few people achieve a comfortable early retirement, and it may be getting even harder.

Only about one in 25 women and one in 12 men between the age of 50 and State Pension Age (SPA) (currently 60 and 65) were 'economically inactive' because they had retired, according to National Statistics. In fact, the proportion of people in work between the age of 50 and SPA increased in the dozen years between 1996 and 2008.[1] One of the main reasons for this growth in employment is that early retirement has become increasingly expensive because:

- Many employers with final salary pension schemes are facing substantial deficits and can no longer afford to offer generous early retirement terms as a way to soften redundancy.
- Life expectancy has continued to rise, increasing the period over which pensions are paid and therefore their cost.
- Annuity rates have fallen since the turn of the century, because of rising life expectancy and also generally lower long-term interest rates.[2]
- Increases in the basic state pension have generally been linked to prices rather than earnings, with the result that the basic state pension has shrunk as a proportion of earnings immediately before retirement.

There are also two important changes that are due to take place from 6 April 2010 and will have the effect of constraining your early retirement options even more:

- The normal minimum age at which you can draw pension benefits will rise from 50 to 55. If you were born between 5 April 1955 and 6 April 1960, this change will affect you, although it may be of little relevance. In practice, retirement before age 55 is usually too costly: for example, at current annuity rates a 52 year-old man would need a pension fund of nearly £220,000 to provide a level pension of £1,000 a month before tax. Add inflation protection to the pension and the cost nearly doubles.[3]

  If you are in the affected birth date range and are considering drawing your pension benefits (including tax-free cash) now rather than at age 55 or later, you should contact us as soon as possible. Experience shows that turning a pension fund into retirement benefits can be a slow process, particularly if your pension fund is spread across several providers.
- The SPA for women begins a phased increase that will see men and women have an equal SPA of 65 by 6 April 2020. Four years later, a further phased increase of one year will be introduced, raising the SPA to 66 by 6 April 2026. Another year will be added in 2034–2036 and 2044–2046, so that by 6 April 2046, the SPA will be 68.

If you want to retire before the state thinks you should, your starting point should be to arrange an initial discussion with us. We can then assess what would be required to meet your retirement objective, taking into account your existing pension provision and investments. Even if the result is that you need to rethink your retirement age – not an uncommon outcome – you will be better informed about when you can realistically stop work.

Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

1. *Office for National Statistics, 24 September 2009.*
2. *Office for National Statistics, 21 October 2009 and www.employeebenefits.co.uk, 18 November 2009.*
3. *FSA comparative tables, 10 November 2009.*

Were You Born Before 6 April 1960?

If the answer is Yes, you can now take advantage of the new individual savings account (ISA) investment limits announced in the 2009 Budget:

- Your maximum ISA investment is now £10,200 per tax year – a £3,000 increase over the previous limit.
- Up to £5,100 of your new limit may be invested in a cash ISA.

The new limits took effect from 6 October 2009 and will apply to all eligible ISA investors from 6 April 2010.

Some ISA providers will not be operating the new limits until 6 April 2010 and are refusing top-ups beyond the old £7,200/£3,600 ceilings. To complicate matters further, you are only allowed to invest in one cash ISA and one stocks & shares ISA per tax year, so you may not be able start another ISA just for the top up. However, there are ways around this restriction which we can explain to you.

The value of investments and income from them can go down as well as up, and you may not get back the original amount invested. Levels and bases of, and reliefs from, taxation are subject to change and their value depends on individual circumstances.

Investor interest is growing in commercial property funds

Interest rates remain at their lowest on record,[1] making the returns available on commercial property look attractive. The most convenient way for most people to invest in property is through specialist, open-ended investment funds.

Broadly speaking, there are three kinds of property funds, and each brings its own drawbacks and opportunities. But remember, investing in property involves a lot more risk than holding cash does. The investment could fall and you might not then get back the amount you put in. Past performance is not a reliable guide to future performance.

Bricks and mortar funds

Funds specialising in investing directly into property are also termed 'bricks and mortar funds'. They are typically structured to pay an income which is derived from the rental streams of the properties held in the fund. Eventually, when investors withdraw capital, they should receive their investment, plus any capital growth (or less any loss) in the value of the properties themselves.

One of the problems with these types of property funds can be their illiquidity, as the past 24 months or so have shown. In other words, there can be a delay in getting access to your capital. But they do provide returns which are closely linked to the commercial property market in terms of their capital growth and income. Their assets are not publicly traded and so are sometimes hard to value on a day-to-day basis.

Property-focused share funds

A less direct way to access the property market is to buy shares in large builders or property management companies that are listed on the stock market – typically through specialist funds. When the market is flourishing, so will such businesses. Investors receive an income based on the dividends from the companies, and – when they withdraw cash – any capital growth is based on the traded value of the shares.

These shares are normally very easy to buy and sell, and so the liquidity of such funds is excellent. However, they provide only a limited link to the property market – the price of the shares is normally closely tied to share prices generally.

REITS – a modern development

One of the most popular investment routes is now through a fund investing in the shares of real estate investment trust schemes (REITS). Launched in the UK in January 2007 to mimic their US counterparts, these investments were expressly designed to make investment in property easier. They are generally businesses that are listed on the stock exchange and whose primary function is managing a portfolio of income-producing properties. They typically distribute most of their profits in the form of dividends, and so their share price is normally closely linked to the value of the portfolio of underlying properties.

REITS are designed to offer the best of both worlds: the liquidity of stocks, coupled with extremely close ties to rental income and property prices. In practice, they score well but not perfectly on both counts. However, the market is new and therefore somewhat untried, and offers limited investment choice.

UK commercial property has shed up to 40% of its value in the past two years,[2] but if the worst is over, and you are thinking of investing, it is important that you take advice.

1. *Bank of England, 08/10/09*.
2. *Financial Times, 21/08/09.*

Instead of the latest gadget, why not give your grandchild an investment in a unit trust or other fund for Christmas? Within a month the latest gizmo may be out of favour, but an investment could help fund university fees in later life. For a young child, tax would usually not be an issue.

Asset allocation is the key to successful investment planning

Asset allocation took a beating in 2007 and 2008, largely because investors found they seemed to be losing money no matter what securities they favoured. That has led to some doubt about whether it is really the best way to invest. So it is worth taking a fresh look at this approach to investment portfolio design in the light of the past two years' performance.

Asset allocation is based on the theory that the choice of assets you invest in will have by far the biggest impact on the level of returns you make – rather than the selection of the individual funds. A considerable amount of research by Paul Merriman supports the view that a very high proportion of investment returns come from the choice of underlying assets – shares, fixed-interest securities, property and other assets.

The first step in the investment planning process is to assess your risk profile. This is followed by recommending how your investments should be deployed across the main asset classes and only then are the individual funds selected to fine tune the portfolio – the reverse of the traditional approach.

The idea is that different asset classes normally move in broadly different ways; so, for example, apart from the last few years, property has often tended to rise or stay roughly level when shares have fallen. In theory, you can increase performance and smooth out the ups and downs of a portfolio of investments by combining different asset classes – described as 'diversification'.

A simple analysis of the numbers shows that the model largely held up in the market mayhem of 2007, 2008 and so far in 2009, although there have been times when all three main asset classes fell together. In 2004, 2005 and 2006, all three assets classes made positive returns for investors, but property was the best performing asset by far, followed by shares, and fixed-interest securities were the laggard. 2007 and 2008 saw that order reversed, with property posting losses while fixed-interest securities and shares made very small gains. So far in 2009, the trend of 2004–2006 has been restored.[1] This demonstrates amply that no one asset class is always a winner and that over time, diversifying really can smooth out returns.

Building your risk profile is the first hurdle to overcome by assessing how much risk you can really afford to take on. Here are a few of the key questions to consider:

- Can you afford to take substantial losses? People close to retirement, for example, probably cannot afford to take this chance, and generally have a low-risk profile.
- Are you investing for the long term? On average, most assets available to investors perform well in the long term, because short-term price swings should be ironed out. Hence, the longer your investment horizon, the more risk you may be willing to add to your portfolio.

- Can you be flexible about when you take out your money? If the answer to this is No, and you will need access to your funds reasonably soon, you have a very low-risk profile: in the event of a dip in markets, you will not be able to wait for a rebound before withdrawing.

With your risk profile determined, asset allocation can be optimised. Remember, with all these asset classes, the value of your investments and the income from them can go down as well as up; you may not get back the amounts you have invested and past performance is not a reliable guide to future performance. It is always important to take advice.

1. *www.castlestonemanagement.com, 12 November 2009.*

Your retirement income choice could have a lifelong impact

Making the right choice is not easy when it comes to turning your pension fund into a retirement income. Get it wrong and you, and possibly your dependants, could spend many years regretting an irreversible error.

It is a decision that needs great care. For a start, the information your existing pension provider supplies shortly before your retirement date will rarely spell out all of your options in detail. If an annuity rate is quoted, it may not be competitive. Insurance companies are required to quote a rate, even if they do not actively market annuities. An added complexity is that the retirement income market is far from static. Annuity rates can – and do – change daily, while in the last year the terms for some of the alternative income products have been altered significantly. In summary, your main options at present are:

Annuities An annuity is the most popular way of producing a regular income from a pension fund. Its key attraction is that once payments start, they continue throughout your life – however long that is. Payments are guaranteed, unless you choose an investment-linked annuity. The main drawback of lifetime annuities is that they are inflexible; once they have been started they normally cannot be changed.

A number of major insurance companies actively compete in the annuity market, but some only quote rates for their own pension policyholders. This makes it vital that you check with us what is available in the market place before accepting your pension plan provider's offer. Even among those companies quoting public rates, differences of 16% are possible.

If your health is not perfect or you are a smoker, you may qualify for an enhanced annuity rate. These specialised annuities have become more common in recent years, but even so an enhanced rate from one company may not beat the standard rate from a more competitive insurer.

Income drawdown Income drawdown (a type of 'unsecured pension') is a higher risk, more complex approach, generally only suitable if you have a variety of other income sources in retirement and can afford to dispense with the security offered by an annuity. Under income drawdown, withdrawals from your pension fund provide your retirement income. The maximum initial withdrawal level is set by HM Revenue & Customs – there is no minimum – and withdrawals must stop by age 75. Thereafter you must either switch to a so-called alternatively secured pension or buy an annuity.

Income drawdown has a number of important advantages over annuities, which need to be weighed against the reduced security and additional running costs:

- The value of your remaining fund can be paid out as a lump sum if you die before reaching age 75. A flat 35% tax charge would apply, but normally inheritance tax would not.
- You can vary your income at any time, so long as you stay within the HMRC maximum. However, the higher the income you choose, the greater the chance that it may not be sustainable.
- Your pension fund investments remain under your control.

'Third way' annuities 'Third way' annuities are not annuities, but specialised retirement investments designed to offer some of the security of conventional annuities alongside the flexibility of income drawdown. This has been the area of most innovation in recent times and further developments are expected in the coming months. However, they also have drawbacks: they are complex and can be costly, and they involve more investment risk than fixed annuities.

We can provide you with detailed advice on all these and other options and help you in making that all-important retirement choice. Past performance is not a guide to future returns. The value of investments and income from them can go down as well as up, and you may not get back the original amount invested.

Did you know that the final date for online filing of tax returns for the 2008/09 tax year is 31 January 2010? On the same day, any balance payments owed are due, as are the first 2009/10 payments on account. If these balance payments are not settled with HM Revenue & Customs by 31 January 2010, an automatic 5% surcharge will be added to the outstanding amount – in addition to any interest payments that may be owed. The FSA does not regulate tax advice.

Absolute return funds are increasingly attracting investors

The concept of an absolute return fund is disarmingly attractive. Branded as able to make money in good times and bad, these funds generally provide a lower but steadier average return than many of their more conventionally managed competitors.

The idea behind such funds is that they should outstrip conventional equity or bond funds when markets drop, but the flipside is they are likely to lag behind their rivals when the markets rally.

They come in a variety of types. Some allocate their investments across a very diverse range of assets with the aim of smoothing out returns. Many are indistinguishable from hedge funds, and typically use unconventional investment techniques or complex financial products to try to generate positive returns in both rising and falling markets.

The key word here is 'try': absolute return funds can no more guarantee you a positive return than any other open-ended investment fund. More to the point, many failed to achieve exactly this during the meltdown unleashed on markets by the credit crunch.

Some absolute return funds coped with 2007's and 2008's volatile trading conditions, but others failed completely, losing up to 25% of savers' cash in a single year.[1] The strategies they had carefully constructed to accrue modest returns in all market conditions simply did not work in extreme conditions. It is a warning to investors: if your investment scheme aims to achieve something, but does not guarantee it, you may not get back what you expect.

The good news is that the challenges of 2007 and 2008 highlighted those absolute return funds whose strategies coped well in extraordinarily trying times. They have demonstrated that there are some funds that have been able to produce positive returns in both good times and bad. If you are still keen to add an absolute return fund to your portfolio, the credit crunch has pointed to a selection of candidates to choose from.

But do not forget: the value of your investment can go down as well as up and that past performance is not a reliable guide to future performance.

1. *Standard & Poor's, 13/07/09, Bloomberg, 31/08/09.*

What inflation really means

Inflation erodes the value of your savings because, as prices rise, the same money buys you less. So unless your investments are growing faster than prices, you are losing money in real terms.

It is hard to open a newspaper or magazine without being told of strange inflation behaviour. Whether inflation is slowing down or speeding up, is too high or too low, there have been plenty of doom-laden headlines in recent months. One measure struck 5.2% a year ago in October 2008, its highest for 16 years and more than twice the Bank of England's target of 2%. Since then it has dropped right back down, and was just 1.8% in July.[1]

While that is reassuring, it is also important to remember that there is more than one way to measure inflation, and that the rate favoured by the Bank of England today is not the one most of us are used to. In 2003, the Bank switched from targeting the RPIX measure of retail prices minus mortgage costs to using CPI, or consumer price inflation.[2] At time of writing, RPIX is running at just 1.2%.

The most relevant measure of inflation for you is the one that most closely matches your expenditure, and for many of us, that is neither of the above: it is the RPI measure of retail prices, also known as 'cost-of-living inflation'. RPI includes many expenses that are really relevant to day-to-day living, such as council tax. The good news for your savings is that RPI is, at time of writing (October), negative at -0.8%.

Independent control

Also worth remembering is the Bank of England's remarkably consistent record for hitting its 2% inflation target. Since the Bank gained independence from political tinkering in 1997, inflation has been extremely stable. The fluctuations triggered by the credit crunch, while alarming, represent the first really volatile period seen since politicians were barred from interfering with interest rates.[4]

1. *Bank of England inflation report, August 2009 and Guardian, October 2008.*
2. *Office for National Statistics, August 2009.*
3. *Office for National Statistics, November 2009.*
4. *www.commonsleader.gov.uk, 18 November 2009.*

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As life changes ... check your cover

Why did you take out life insurance? The spur is often to provide financial protection for a partner or children, by arranging a big enough lump sum to pay off a mortgage and to cover living costs.

Few people want to spend much time thinking about their life or health insurance protection, and the result is that policy documents are often stashed away in drawers and forgotten about. However, it is certainly worth checking regularly that your current life insurance is fit for purpose. There are no rules as to when you need a review, but there are several factors that could affect your cover:

Family matters

Since your last review, you may have added to your family or perhaps you or your partner have changed jobs (or are no longer working at all). School fees or other future expenses may have become an issue, and you could now need insurance for a larger amount.

Property ladder

There are some signs of improvement in the property market after the recent slump in prices. Is your life cover enough to cover your mortgage or other loans? Some people have switched to an interest-only mortgage where the capital value remains static, and so cover may now be insufficient. If you have bought a second property with a mortgage since you last reviewed your cover, it could be wise to consider extending your life cover.

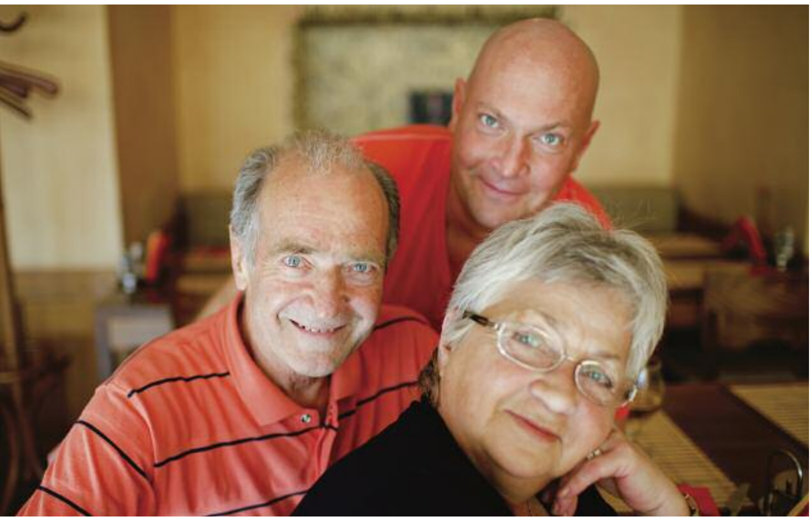
Added value?

The cost of life insurance is very competitive, so there is no need to pay over the odds. Even if you have a medical condition we may be able to find specialist insurers to provide cover. If you have given up smoking since you arranged a policy, it might well be possible to reduce the premiums you pay.

Remember, life assurance is not the only financial protection you should be considering. If you were too ill or disabled to work, you would probably have grave difficulty paying all your bills. The state benefits for long-term illness are much lower than most people think. The answer could be an income protection policy that would pay out an income in these circumstances.

A parent's job is never done

Just as you thought your adult children were off your hands and earning their own living at last, you wake up to the fact that they still need your continuing financial support.



Your help may just amount to advice and a sympathetic ear. But it could easily extend to financial help with their buying a home or starting a business – so much depends on your circumstances and their needs and aspirations.

So just imagine what would happen if your adult child were to fall seriously ill and could no longer afford to pay their bills. Remember, state benefits will probably cover just a small proportion of their financial needs. In the end, who do you think will pick up those bills, or else be concerned that there is simply not enough money to go round? Yes, probably you.

Fortunately, there is an insurance policy that everyone in work should consider, and it is called 'income protection'. The policy pays out if the insured person is unable to work and continues paying out until they are well enough to return to work. It is in your interests that your adult children should look into it as a matter of urgency.

Rob Sandwith, Chief Executive

independent financial advice

Rosan Helmsley Limited, 3000 Cathedral Hill, Guildford, Surrey GU2 7YB

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