

Bond funds hedge

SPECULATORS who have sought the higher yields offered by bond funds could be heading for disappointment as the EU sovereign debt crisis continues.

One reason is that index-based strategies employed by such funds have the unintended effect of making life easier for the most heavily indebted borrowers.

As a consequence, some of the least creditworthy borrowers in the system will enjoy ready access to funds regardless of their actual credit rating.

Inflation-linked bond funds are a good example of the relentless marketing energy which characterises the fund industry.

Vanguard's UK Inflation-linked Gilt Index fund holds 16 I/L gilts with the aim of tracking the Barclays Capital UK government I/L float adjusted Bond Index.

Swiss & Global's Julius Baer Emerging Markets I/L fund invests in an actively managed portfolio of I/L bonds issued by nine countries.

M&G's I/L corporate bond fund, holds bonds issued by UK companies as well as conventional bonds and derivatives.

While the annual charges, 0.15pc, 1.00pc and 1.30pc respectively, seem fairly attractive they alone do not justify the existence of these funds.

As one City bond market veteran commented: "The UK ten-year breakeven rate for inflation-linked bonds is currently 3.21pc.

"So, if you believe that inflation will be higher than 3.21pc over the next ten years you should buy – otherwise you may be wasting your money."

Timber shelter

FRONT page reports of the government's plan to sell off 250,000 hectares of forestry will have reminded some of the availability of a useful move to mitigate Inheritance Tax (IHT) which is levied at 40pc.

An investment in woodland qualifies for full exemption from IHT if it has been held for at least two years at the time of death.

There is no Capital Gains Tax (CGT) and heirs inheriting the woodland receive it with the CGT base value at that time.

Prices vary. Currently, £50,000 or thereabouts will secure a decent copse of about 5 hectares (12 acres) or for £355,000 a larger wood of 32 hectares with lots available from £70,000.

ANNUITY RULE DROPPED

NEW rules for retirement pensions to become effective on April 6 will include:

(1) Pensioners will no longer be required to buy an annuity on reaching 75.

(2) For those whose pension contributions in any recent input periods have been less than £50,000 then they can pay in up to £50,000 plus any unused part of the £50,000 allowance in the three years ending in the 2011-12 tax years.

(3) From October your retirement age will be your choice. The new freedom from the annuity rule, which has been an annual source of frustration for thousands of pension savers, will only apply to pensioners who can show that they have a separate pension income of at least £20,000 a year.

Inheritance Notes

UK INTEREST rates will need to be raised soon if Mr Mervyn King, Governor of the Bank of England, is to avoid an uncontrollable inflation explosion coinciding with the loss of production capacity caused by the credit crunch.

The decision will be welcomed by savers but not by house buyers and other borrowers. Bond investors could lose some capital value.

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FRIENDS Provident Life and Pensions group is facing calls to review hundreds of transfers out of its with-profits pension plans after it was found that crucial details about bonus guarantees had been omitted from customers' statements.

Bonus guarantees can add thousands of pounds to the value of a pension fund.

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GOLD ONLINE dealers have been told by the Office for Fair Trading to polish up their marketing after it had found abuses including forcing sellers to accept low payments unless rejected within a short time frame.

Tesco which began buying gold last November, pays £8 per gram for 9 carat gold but some dealers have offered as little as £5.13.

Clients will appreciate that life assurance and pension plans are generally long-term investments and there may be penalties for terminating such plans prematurely; that past investment performance is no indication of future prospects and values can fluctuate; that in relation to house purchase their home is at risk if they do not keep up the payments on a mortgage or other loan secured on it. Some of the products and services mentioned in Money Planner might not be among those regulated by the Financial Services and Markets Act 2000.

The information in Money Planner is for guidance only and our expert advice should be obtained before any action based on it is taken.

Bank cast-offs welcome

WITHDRAWAL of investment advice by Barclays Bank, announced in January, is likely to be of profound significance for the future of the financial services sector.

The bank explained that its decision was not linked to its recent mis-selling offences, which attracted a fine of £7.7m, so it seems reasonable to assume that the other big banks will be forced to make similar decisions.

Rising staff training and other costs are cited as the cause of falling returns from Barclays Financial Products (BFP) and further costs would have been incurred by the implementation of the Retail Distribution Review which will ban the payment of commission after 2012.

Barclays will now provide investment advice only to the wealthier of its million BFP customers.

With at least some other UK banks likely to adopt the same course as Barclays over the next two years the cumulative effect will leave many bank customers in need of sound financial advice at fees they can afford.

Those who have an opportunity to read this and future issues of Money Planner are likely to be interested in the long-term advantages of low-cost products which are expected to become the default media for retail investors over the next few years.

NIC increase

THE full impact of April's NIC increase can be mitigated by salary sacrifice arrangements which we feature in this issue.

Oil prices prospect revives recovery fears in UK and US

ENCOURAGING statistics at the beginning of February transformed the outlook for both the UK and the USA but events in the Middle East raised a new question about the future of oil prices which will affect the outcome.

After their adoption of diametrically different policies to solve their basically similar economic problems the early signs indicated that the UK was nearer than the US to reaching its long-term target.

While the UK doggedly pursued a policy of reducing its sovereign debt and cutting spending, the US enthusiastically went ahead with increased Keynesian spending, overseas borrowing and tax cuts.

Although that policy succeeded in reviving the American economy it also attracted a stern warning from the International Monetary Fund (IMF) to rein in its economy.

The IMF also offered its general support for the UK's plans to cut spending and borrowing.

Even so, the score by year's end suggested that the UK's long-game was only just beginning but the US unemployment figures remained unacceptably high even as the indicators fell from 9.4pc to 9pc in December.

This picture seemed to be radically

challenged by the UK and global manufacturing figures published by the Purchasing Managers' Index at the end of January.

Surveys of purchasing managers in all leading economies showed strong manufacturing

activity, order books and hiring intentions. The composite global PMI index, compiled by JPMorgan and Markit economics, stood at 57.2 in January – up from 55.6 in December – and the highest reading on this measure since the series began in 1998.

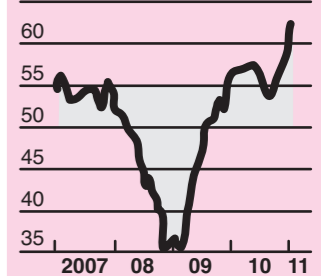
Satisfactory though these figures were, taken by themselves, they inevitably strengthened fears of worsening inflation.

The interest rate futures market, which reflects expectations of how rates will move, went from calculating a 50pc chance of a quarter-point rise in bank rate in May to a 75pc chance after the numbers were released.

The market's calculations found some support when the Bank's governor hinted that the rate would increase, though in three stages instead of one.

UK manufacturing purchasing managers' index

CIPS/Markit index, above 50 indicates expansion



Source: Markit

"Pension charges should be clear....."

A CALL for greater clarity by pension providers to enable savers to see their charges as a percentage of investment returns has been made by the new watchdog, Mr Michael O'Higgins, who took over as UK Pensions Regulator last year.

We report the poor performance and high charges of some life companies' long-term pension plans in this issue.

Mr O'Higgins, speaking to the Financial Times, said that among his first priorities would be to make sure that not only could individual pension savers know what they were paying, they would also be able to assess whether

those charges were sensible, given the returns they were earning.

"Linking the payment to the return is something that is sensible to me," he said.

This year the regulator issued a consultation document on a range of issues including the presentation of charges which, research has shown, can make a significant dent in lump sums earned at retirement.

"Individuals must understand what they are paying for as the UK experiences a tectonic shift in the nature of occupational pension provision, to defined contribution individual plans

and away from defined benefit schemes."

Mr O'Higgins's views drew a sharp retort from Mr Richard Saunders, the chief executive of the Investment Management Association, whose members control funds valued at £3.4trn in the UK and Overseas.

Obviously hurt by Mr O'Higgins's remarks Mr Saunders "failed to see how the disclosure of funds' charges as a percentage of returns would help investors".

Maybe the approaching confrontation between the two sides will make the issues clearer.

A manual for investors, from the coalface

"MOST investors make some classic mistakes which prevent them from capturing the best investment performance they could obtain. "In general, investors are also too active or they buy funds run by managers who are too active."

With these cautionary words Terry Smith launches the Owner's Manual for investors in his Fundsmith low-cost fund which opened for business in December last year.

Characteristically, Smith has produced something more than that: the text offers all who peruse it a rare guide to the intricacies of fund investment which are seldom, if ever, discovered

by retail investors.

It is what those who are familiar with Smith's reputation, as the author of Accounting for Growth which exposed some of the City's dodgiest practices, would have expected.

"Investment activity in the form of buying and selling shares," Smith explains, "has a frictional cost in terms of the commissions and the difference between the bid-offer spread which dealers charge.

"The more we can minimise these costs the better."

Smith's opinion of investors' habits and fund managements is not high.

"The required low level of investor activity needs

the deceptively simple task of buying the right shares in the first place and holding onto them for a long time.

"Investors buy the wrong type of funds. But this is hardly surprising as the average equity fund manager owns far too many stocks and, in effect, tracks the index.

"Why do fund managers do this? Because, for them, the greatest risk is not underperforming the index with your money, it is stepping out of line with their peers.

"Most fund management groups also manage a proliferation of funds. A myriad of funds covering growth and income, large compa-

nies and small companies, international and domestic equities, emerging markets funds, long only and long/short funds, funds covering particular sectors, and that's just in equities.

"At Fundsmith, we only have one equity fund, because in active management we think that's all you will ever need.

"The name of our fund is simple. It doesn't say it's a growth fund or an income fund because we regard the distinction between income and growth as artificial."

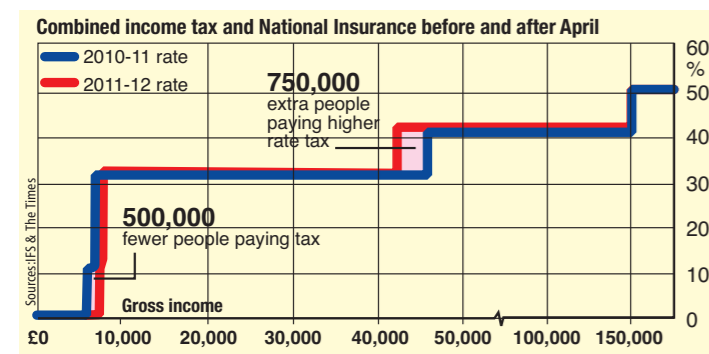
April tax hits top earners

NEW measures to be introduced in April will bring an estimated 750,000 more people into the higher rate tax (HRT) bracket.

This will be the result of a reduction in the level of income at which the HRT will start to bite.

The reduction accompanies an increase of £1,000 in the tax allowance which itself will take 500,000 other people out of tax payment altogether.

These are among the findings of a new analysis by the Institute for Fiscal Studies.



Losses from the new measures in April will hit the higher income households hardest.

They will lose from the NIC increase and will not gain from the increased income tax allowance with a minority losing from the restriction in the amount that can be contributed tax-free to a pension.

Those with the highest incomes have already been hit by the new 50p tax rate on income above £150,000 and the loss of the personal tax allowance for all those with incomes over £100,000.

At the other end of the scale those dependent on means tested benefits will be affected by the decision to raise inflation affected benefits in line with the CPI rate of 3.1pc in contrast with the higher RPI of 4.6pc.

ETF review: Quarterly Income

WHILE low-cost index funds are deservedly receiving most public attention just now it is important to notice the ground-breaking influence of Exchange Traded Funds (ETFs) in the UK low-cost story ten years ago.

The UK's first ETFs were iShares launched in 2000 by Barclays Global Investors which was acquired last year by BlackRock, the global US investment management group.

iShares now has about half of the world's ETF market under management and offers 430 ETFs across 19 exchanges worldwide.

Most of the iShares offer a low annual cost in the range between 0.20pc and 0.80pc.

With one exception All iShares replicate the relevant indices through direct physical investment but there is a growing development of "synthetic" ETFs which track an index through credit default swaps which involve an extra counterparty risk.

In addition to their low

annual cost the main characteristic of all ETFs, is their liquidity: they can be bought and sold like other quoted stocks during normal daily hours.

Retail investors can buy ETFs easily through a broker or an execution only platform and for those seeking income iShares provide several, the two most popular being UK Dividend Plus (exchange ticker IUKD) with net assets of £450.5m and £ Corporate Bond (SLXX) with assets of £1,100m. The top ten in the IUKD portfolio includes Man Group, RSA, Royal Dutch Shell, Aviva, Balfour Beatty, Aberdeen Asset, Home Retail, Drax, Standard Life and Intermediate Capital.

The SLXX portfolio includes UK bonds issued by Barclays Bank, Imperial Tobacco, Lloyds TSB and HSBC.

Both IUKD and SLXX pay quarterly dividends in the 5-6pc range.

Low-cost fundamentals

AFTER pioneering the low-cost fund concept in the USA and dominating the sector there for the last 30 years it seems exactly right that the Vanguard Fund should become the first of its kind to be established in the UK.

That was just two years ago and Jack Bogle, the founder, whose US group has \$1.4trn (£79bn) under management globally means to expand in the UK and then expand some more.

His success has been built on a simple idea: "Since all investors collectively own the entire stock market, if passive investors holding all stock for ever, can match the gross return of the market, then active investors, as a group, can do no better.

"Since the management fees and dealing costs incurred by active investors are clearly greater than those of passive investors, then passive investors must earn higher net returns."

This is how Jack Bogle's idea works:

Fund	Gross retn	Expenses	Net return	One year	Ten years
Low cost	12pc	0.6pc	11.4pc	£1,340	£19,400
High cost	12pc	2.5pc	9.5pc	£950	£14,800

In ten years this low cost fund would achieve 31pc more pounds than the high cost fund.

At present Vanguard has 14 indexed funds in the UK with annual expense ratios averaging well below 0.80pc.

Last December saw the launch of another low-cost fund by Terry Smith, a well-known City figure who is also a dedicated advocate of the concept.

"Fundsmith", says Smith, "is aimed at buy-and-hold investors for the long term.

"We seek to own only stocks that will compound in value over the years. We believe that we do not have a good investment idea every day, or indeed, not even every year.

"We should treat our investment career like one of those tickets you get for a tram which is spent once it's been punched 20 times, as that's the number of great investment ideas we are likely to be able to find at a price we can justify investing in them."

Take a tax cut from higher NICs

SALARY sacrifice arrangements have become popular in recent years as NI contributions have steadily increased for both employers and employees.

By making a special arrangement with their employer to forgo a monthly salary cut staff and other workers have been able to avoid the NIC and some income tax while their employer pays an equivalent sum into the individual's company pension scheme.

This results in no change in the take-home pay but an increase in the participants' pension contributions.

From April 6 the sacrifice schemes are

Funds that mislead

THE £7.7m fine imposed on Barclays Bank for allowing investors to be misled by the description of its funds is not likely to remain the only instance.

The Investment Management Association (IMA) which administers the mutual fund industry says it is to investigate the problem and promises some action by the end of this year.

Cautious was the word that let Barclays down although the IMA's own definition allows funds to use that description even if as much as 60pc is invested in equities.

More than 12,000 investors put money into funds described as Global Balanced Income and Global Cautious Income but both lost more than 40pc of their value.

The basic problem is that these and many others are concepts of the active marketing which has been an essential feature of the IMA's growth over the last five decades.

This marketing drive clearly contributes to fund managements' incorrigible optimism.

What other explanation could there be for the recent announcement by Royal Bank of Scotland, the taxpayer backed lender, which recently announced the launch of two funds named "Cautious" and "Balanced" which they claim will "tame volatility yet still deliver decent returns"?

Money Digest

RECENT personal finance pages have featured:

HAVING believed at the start of 2011 that there was little chance of a rate rise this year, the markets are now betting heavily that the Bank will simply have to act by May.

— Liam Halligan, *Sunday Telegraph*

★★★★★

AFTER improving in 2009, Britain's trade position took a decided turn for the worse last year.

The great rebalancing of the economy, sustained export-led growth on the back of a low pound, is not happening.

— David Smith, *Sunday Times*

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ACTIVE funds have no future unless they cut the fees.

— Headline, *Sunday Times Money*

★★★★★

SOME recent messages take the view that equities are cheap: we think they are good value and there is good dividend support; in particular that quality companies are the ones to hold.

— Sarah Arkle, *Vice Chairman, Threadneedle Asset Management*

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THE YEAR of the rabbit which began in February, is a pivotal one for China. It will determine whether the world's most populous nation can achieve a successful balance between sustaining growth and containing inflation. The days of China as a low-cost workshop of the world are gone.

— Anthony Bolton, *Fidelity International*

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THE best buying opportunities for investors who have time horizons of more than five, or even fifteen months — those investors who are more focused on building wealth for the long term as opposed to trying to make recurring short term trading profits — will happen when we see the payback period.

— David Rosenberg, *Chief Economist, Gluskin Sheff*