

## Investment trusts in the spotlight

THE £460m raised by the launch of Anthony Bolton's new Fidelity investment trust based in China, though well short of the target, has been enough to restore interest in that medium which has hitherto been relatively overshadowed by investors' apparent preference for unit trusts.

In terms of performance and, particularly, of low costs there has never been any doubt that investment trusts have had the edge over units, as discerning investors know.

The crucial difference, which largely explains the massive advertising exposure enjoyed by unit trusts, has been the payment of commission to advisers.

Investment trusts do not pay commission

(though there have been exceptions, including Fidelity's China trust) so when the practice is outlawed by new legislation in 2013 they will be able to compete on equal terms with unit trusts.

Unfortunately, there remains a small but expanding cloud on the investment trusts' horizon in the European Union's Alternative Investment Fund Managers (AIFM) directive.

This is directed specifically at regulating hedge funds but its terms have been so loosely drawn that its restrictions will apply also to the investment and venture capital trust sectors.

If no amendment can be achieved the effect will be to raise the costs for investors.

CHANCELLOR of the Exchequer George Osborne's first budget bears evidence of the compromises which both sides to the coalition have had to accept.

The most significant is the proposal for major changes to Capital Gains Tax (CGT) which featured prominently in the LibDem party's election manifesto but was not mentioned by Mr Osborne's party.

The readiness of each to meet the other half-way is correct, not merely on the CGT issue but on many others as well, but it also confirms that all parties in the election were at fault in concealing the severity of the financial crisis and of the measures necessary to correct it.

Spending cuts already announced for the current fiscal year include:

\* **Scrapping of plans for ID cards** will save almost £30bn, estimated to be the eventual cost by the London School of Economics.

## Coalition plans for pensions and savings

\* **Home Information Packs** (HIPs) were suspended from May 20 but with the condition that an Energy Performance Certificate (EPC) is produced within 28 days of putting the property on the market.

\* **Child Trust Funds** are to be scrapped for all next January but after that date £20m will be provided for respite care for disabled children.

\* **Pensions**

The coalition will give priority to restoring the link between pensions

and earnings and also to abolishing the requirement to buy a compulsory annuity at age 75.

Other plans include:

\* Existing retirement ages for men and women will be phased out but not before 2016 for men and 2020 for women.

\* Basic state pension will rise by either inflation of 2.5pc whichever is the higher.

\* There will also be a review of long-term affordability of public pensions, but protecting accrued rights.

\* The parliamentary ombudsman's recommendation to make fair and transparent payments to *Equitable Life* policyholders will be implemented through an independent payment scheme.

\* The rules and regulations relating to pensions to help reinvigorate occupational pensions, are to be simplified to encourage companies to offer high quality pensions to all employees.

## Investor's Notebook

**WEALTHY** borrowers should consider switching to an offset mortgage deal as a more attractive alternative to low-interest deposit accounts.

Offset mortgages allow borrowers' savings to be set against their mortgage debt which reduces the amount of interest they pay on the net balance.

The savings must be held in an account with the mortgage provider and no interest is paid in return for the offset facility.

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**ABSOLUTE** Return Funds offer a tantalising prospect to investors: positive returns with low volatility, even in turbulent markets.

But as many investors have experienced, any fund can fail to live up to expectations and that applies to many absolute return funds.

At a recent Private Asset Management Awards ceremony all the entrants to the Absolute Return Investment category walked away empty handed.

Their citation commented: "If the wealth managers cannot match the return on cash they ought not to charge fees."

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**EUROPEAN** providers will be able to offer ETFs based on the Standard & Poor's 500 index under a new agreement with S&P.

For the past ten years iShares, the world's biggest ETF provider developed by Barclays and now managed by BlackRock, has been the sole holder in Europe of the S&P licence, the most widely followed US stock market benchmark.

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.

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## Low cost investing

**CALLS** for lower annual charges in retail investment are reaching a crescendo well ahead of the main battle which is due to escalate after 2013.

That year will introduce the government ban on commissions paid to advisers for recommending investment products to clients.

The clamour for lower charges has been influenced by the arrival in the UK of the American low-cost fund operator, Vanguard, with a wide range of index funds charging an average of 0.23pc a year which compares with the 1.5pc charged by many UK unit trust funds.

Further pressure has been added by a report for the Department of Work and Pensions which reveals that charges on some company money purchase pension schemes are as high as 1.5pc of fund value each year, compared with an annual management charge of just 0.15pc on the best-value schemes.

These developments appear to augur well for retail investors but the big investment houses are already showing signs of resisting the pressure as we report on the situation in this issue.

## Urgent business

**SINCE** the start of the global financial crisis two years ago all political parties have neglected the concerns of savers in personal financial planning schemes.

We consider the programme already announced by the new government and other measures which need to be given priority.

## Higher VAT and CGT in first moves to cut the UK deficit

**AN** emergency budget to be presented by Britain's new coalition government on June 22 will be devised to achieve a "significantly accelerated reduction in the structural deficit" with the immediate purpose, it will be hoped, of avoiding a UK sovereign debt crisis.

As the new government began work on its emergency plans it received a reminder from the ONS that the trade deficit had widened more sharply than expected in March, fuelling fears that the economy might not be in line for the export-led recovery that had been widely anticipated.

But there was also some constructive help from the International Monetary Fund (IMF).

In a regular report the IMF said that Britain could raise revenue equal to 3.3pc of GDP – more than a third of the estimated structural deficit – by eliminating exemptions and improving collection of VAT, without having to increase the standard rate.

Early reports indicated that a VAT increase, at least to 20pc, is already high on the agenda of the newly created Office for Budgetary

Responsibility.

Capital Gains Tax (CGT), currently levied at 18pc, is also scheduled for an increase for non-business assets, with new rates as high as 40pc or even 50pc.

**After vigorous protests from buy-to-let interests and others whose long-term retirement plans would be affected by the proposal the government indicated its willingness to reconsider it.**

Although there has been huge publicity given to the need to reduce UK's budget deficit of £164bn which, over the next five years, could double the overall stock of national debt from around £750bn to £1,500bn details of the likely effect of such reductions have been scarce.

In anticipation of the expected cuts in the public sector, however, *Capital Economics*, a respected think tank, reckons that 750,000 jobs will have to go over the next five years.

The *Chartered Institute of Personnel and Development* puts the figure at 500,000.

But even the loss of 150,000 jobs a year over five years, disastrous by any measure, is not unprecedented.

Between 1991 and 1997, the public sector lost 800,000 jobs, including 230,000 transfers to the private sector through outsourcing.

This did not stop total employment over the period rising as the private sector expanded.

## Life insurance cheaper than ten years ago

MONTHLY premiums for life insurance are this year as much as 30pc below those of 2000.

Policyholders who have remained loyal to their insurers could therefore be paying over the odds for their life cover.

This suggests that they should check their cover, which might need increasing, before arranging a reduction of the premium.

Among the leading insurers Legal & General reports that comparative monthly costs for

£100,000 15 year level term assurance for non-smokers aged 40 are now:

**Women** £8.10 against £10.10 in 2000, a fall of 19.8pc and  
**Men** £10.02 against £14.20, down 29.4pc.

Savings can also be made by smokers who decide to break the habit.

Typically, for £100,000 of cover a 25-year old in good health can pay between £2 and £5 less per month than a smoker.

Such reductions for

non-smokers can result in considerable savings over the full term of the policy.

HSBC Life's reduction in monthly premium £5.75 will save £1,725 and other reductions and savings include:

Fortis Life reduction £3.47 saves £1,041

Bupa (£3.19) saves £957; Bright Grey (£3.13) saves £939; Aegon Scottish Equitable (£2.68) saves £804 and Legal & General (£2.21) saves £663.

## In this issue

- Low cost investing
- Inflation mitigation
- Equity review

- Mortgage payments
- Pension loss calculator
- Investment trusts
- Coalition programme

TWO important rules of investing, which are constantly being reinforced by research, confirm that active management rarely beats the index and that the lower the fees the more money will end up in the investor's pocket.

Retail investors have been slow to accept either of these rules but evidence is growing that their message is becoming loud and clear.

The recent growth in popularity of exchange traded funds (ETFs) demonstrates that their appeal, of low charges and reliable performance, is as relevant to retail as to institutional investors.

But ten years after being made available the assets under management in the European ETF market totals

## Battle lines poised for low cost investing

only £151bn (\$234bn) – less than one-third of the assets (\$736bn) held by the US market.

This disparity is closing rapidly under the influence of Vanguard and other low-cost arrivals in the UK market.

Workplace pensions, too, are playing a part in this tendency, though there are outstanding exceptions.

A government report has found that some employers' plans are charging ten times more than the cheapest options available.

For someone with a £50,000 fund in the most expensive

schemes, that means charges of £750 every year, compared with £75 for those in the cheapest schemes.

It is never worth switching out of a money purchase company scheme if your employer is making contributions into the plan, as these will more than outweigh even the most expensive charges.

But it can make sense to switch pensions held with former employers, particularly if they run one of the growing number of schemes that impose extra charges for staff who leave.

The question of low and

high charges is merely a foretaste of what will become a major issue in the next few years.

The starting gun will be fired in 2013 following the government's ban on commissions which are paid to advisers for recommending certain funds (in fact, the majority) to their clients.

Already there is evidence of resistance to this important and necessary measure.

Many of the newly arrived ETFs are already offering commissions to advisers and some adviser networks have actually been granted permission by the authorities to continue the practice of "factoring" – effectively commissions by another name.

## Equity Review

RETAIL investors, still confused by the 50-year bull market (1958-2008), often look for the wrong signs, usually of market appreciation, before investing.

Security of income should be the aim and this is indicated by the status of a company and its dividend yield.

BP's international status is unquestioned and its yield is now about 6pc following the 35pc slump in the share price caused by the Gulf oil spill.

The quarterly dividend payment has become a legendary barometer for the City as it accounts for about £1 for every £6 paid to institutional and retail shareholders.

Although the costs of the catastrophe are likely to run to several billions chief executive Tony Hayward has assured shareholders that they are "eminently manageable" and that the dividend which costs \$10.5bn a year, at cur-

rent levels, is sustainable in future years.

This seems a good opportunity for shareholders who bought into the company at the pre-spill price of about £6.50 to average their holdings at the present price and so adjust, at least partly, to the new yield.

New shareholders might, of course, be attracted by the present yield.

Royal Dutch Shell like other oil giants has been affected by the after-shock from the Gulf spill and its Alaska operations have been temporarily suspended.

UK investors should buy the "B" class shares because dividends paid on class "A" shares have a Dutch source for tax purposes which means that they could be subject to Dutch withholding tax.

Yield on the "B" shares is 6pc which seems safe considering that Shell has a lower gearing than BP and is growing production this year.

## £65bn pensions time-bomb – and counting

THE dividend tax credit enjoyed by pension funds to compensate for the deduction of corporation tax was withdrawn in the budget of 1997 and subsequent calculations have estimated the cost since then at £5bn a year.

The cost has been shared by individual members of the schemes and their losses will have varied depending on such factors as length of service and retirement dates.

A useful calculator has been devised by Brewin Dolphin, the investment managers, which will estimate the extra contributions or weeks needed to continue at work to make up the shortfall.

The calculator can be accessed at [www.pensionstimebomb.com](http://www.pensionstimebomb.com) and by entering four figures: your current age, age at intended retirement, current value of pension fund and monthly pension contribution you will be provided with the necessary information concerning your pension shortfall.

Among the case studies the calculator shows that a 40-year old man who plans to retire at 65 and currently values his pension fund at £60,000 with monthly contributions of £250 net of basic tax will have a pension fund at retirement valued at £683,565.

If the tax credit had not been removed the calculator shows that his pension at retirement would have been £807,399 – a shortfall of £123,834.

To make up the shortfall it will be necessary either to increase the monthly contributions by £95 or to work an additional 26 months.

## RPI rise sets off inflation fears

ECONOMISTS who have warned that the government's £200bn quantitative easing (QE) programme would lead unavoidably to rising inflation are pointing to the recent figures released by the ONS in justification.

Measured by retail prices (RPI) inflation spiralled to an 18-year high by jumping from 4.4pc in March to 5.3pc in April.

The RPI is widely accepted as the truest measure of the cost of living because it includes housing costs.

This is the highest level of inflation since 1991 and follows record prices at the petrol pumps, higher phone bills, an increase in food and drink prices as well as rising mortgage rates.

While the governor of the Bank of England, Mervyn King, has written the customary letter to the new chancellor, George Osborne, to explain the rise in CPI (Consumer Price Inflation) economists are pointing out that



the UK has tripled its base money supply over the past 14 months through QE.

"Sterling," they argue, "is likely to fall even more against most currencies – making our imports more expensive while oil prices are firmly above \$80 a barrel even though most Western

economies remain on go-slow."

The view that this points to higher inflation was backed by the OECD which advised both the Bank of England and the US Federal Reserve Board to increase interest rates urgently.

For those who fear that inflation is likely to climb higher there are some means of mitigating its effect.

National Savings Index-linked Certificates offer a method of linking savings to the RPI by providing a fixed interest rate based on the RPI plus 1pc.

Index-linked (I/L) gilts also offer protection against rising RPI inflation but also pay a semi-annual interest rate of 0.5pc and the principal payment is adjusted in line with movements in the RPI.

A convenient way of investing in I/L gilts can be through an ETF provided by iShares.

Our graph shows how the price has appreciated since inception in 2006.

## Deals to mitigate higher mortgage costs

HOUSEBUYERS who are concerned that interest rates might rise this year, possibly in response to higher inflation, have a variety of deals that can protect them against higher mortgage payments.

**Split loans** HSBC are offering borrowers the option of a split loan mortgage which allows customers to fix either 25,50 or 75pc of their loan, with the remaining percentage on a lifetime tracker rate.

The fixed rate depends on the proportion of the mortgage that is fixed and the loan-to-value of the deal.

**Switch deals** Switch and fix deals allow borrowers to take out a tracker rate but then

move on to a fixed-rate deal with the same lender without any early repayment charges.

Nationwide and RBS are among the few mortgage providers that currently offer the switch and fix option.

However, Nationwide charges a reservation fee whereas RBS allows customers to switch free of charge providing they have been on the tracker for at least three months.

**Capped rates** cannot rise above a pre-set limit. Britannia/Co-op has a five-year deal at 2.99pc with a cap of 5.99pc available up to 75pc loan-to-value which comes with a £999 fee.

## Money Digest

RECENT personal finance pages have featured: I DOUBT the conventional view that there is a specifically UK fiscal crisis. The nearest thing to an impartial audit comes from the new IMF Fiscal Monitor.

This shows governments' "gross financing needs" for the UK in 2010, equivalent to 20pc of GDP. They are well below those of France, at 25.1pc of GDP, let alone the US (32.2pc) or Japan (64pc)

– Samuel Brittan, *Financial Times*

★★★★★

THE signs of high and rising UK inflation are now so stark that it is difficult even for the most ardent deflationists to deny them. Such are the vested interests involved that many will continue to do so.

– Liam Halligan, *Sunday Telegraph*

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THE EVIDENCE that clients' core exposure to the main asset classes is best obtained through low-cost passive instruments is simply too overwhelming to be ignored.

– Jonathan Davis, *Financial Times*

★★★★★

GOLDMAN Sachs has looked at three periods over the past 35 years when Britain was forced to put its economy in order. They were all associated with UK shares outperforming the world's other major markets by a significant margin.

– Tom Stevenson, *Sunday Telegraph*

★★★★★

JUST 2.6pc of the £77bn of funds bought by UK retail investors in 2009 were passive index trackers, according to the Investment Management Association, in spite of a welter of academic evidence that, thanks to their lower fees, passive funds tend to out-perform actively managed ones over the medium to long-term.

– Steve Johnson, *Financial Times*