360

from **AW Financial Management LLP** **April 2018**

Welcome to our Easter 2018 edition of 360 — which, despite thoughts of Spring, follows shortly after various bouts of positively wintry snow-showers.

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Definitely Not a Budget

The Chancellor's Spring Statement on 13th March, we were reminded, is no longer the Budget that advisers await with a mix of optimism and pessimism—and so it proved. The most notable announcement was his plan to consult on the potential scrapping of our copper coins. Apparently, as a nation around 8% of them are thrown away and the Government's consultation paper pointed to the surge in digital and contactless payment.

However, amid concerns about the inevitable rounding up of retail prices and a tabloid campaign to "save the penny" the PM announced the following day that the coppers were safe. So, not too dissimilar from a Budget Statement after all!

The New Tax Year

Whilst the Spring Statement had no fiscal implications, we take this opportunity to remind our clients of the previously announced tax-related measures which take effect *in England, Wales & Northern Ireland* on 6th April. Most notably:

- Personal Allowance (unless income exceeds £100,000) increased to £11,850 (£11,500)
- Basic Rate Tax Band increased to £34,500 (£33,500)
- Marriage Allowance increased to £1,190 (£1,150)
- Dividend Allowance reduced to £2,000 (£5,000)
- Pensions Standard Lifetime Allowance increased to £1,030,000 (£1,000,000)
- Junior ISA Limit increased to £4,260 (£4,128)
- Capital Gains Tax Annual Exempt Amount for individuals increased to £11,700 (£11,300)

Global Markets and Your Portfolio

It is pleasing to see positive returns from almost all portfolios over the last year, despite the recent market falls. Global markets are recovering well, for the most part, with China, Asia and the Emerging Markets leading the way. US markets have bounced back stronger than their European peers. This largely explains the strong performance of the higher risk portfolios which have a much greater weighting to overseas Equity assets.

We have been particularly pleased with the performance of our Strategy 5 unrestricted portfolio, which has benefited from very strong stock picking and a greater weighting to smaller companies, which have benefited from positive global economic data.

Our lower risk unrestricted portfolios have struggled a little this year ironically due to their more defensive positioning. This year investors have generally favoured riskier assets and shunned lower risk assets. However, we feel it more appropriate to keep our lower risk portfolios just that, "low risk"! This positioning will look much more attractive if we see more aggressive losses in equity markets particularly.

Description	AWFM Risk Model	Ethical		Unrestricted	
		3m	1yr	3m	1yr
Cautious Risk	1	-1.82%	1.74%	-1.80%	-0.10%
Cautious to Moderate Risk	2	-2.36%	3.88%	-2.88%	-0.26%
Moderate Risk	3	-2.42%	4.32%	-2.71%	1.62%
Moderate to Adventurous Risk	4	-2.14%	5.64%	-1.89%	4.74%
Adventurous Risk	5	-1.96%	7.43%	0.62%	12.15%

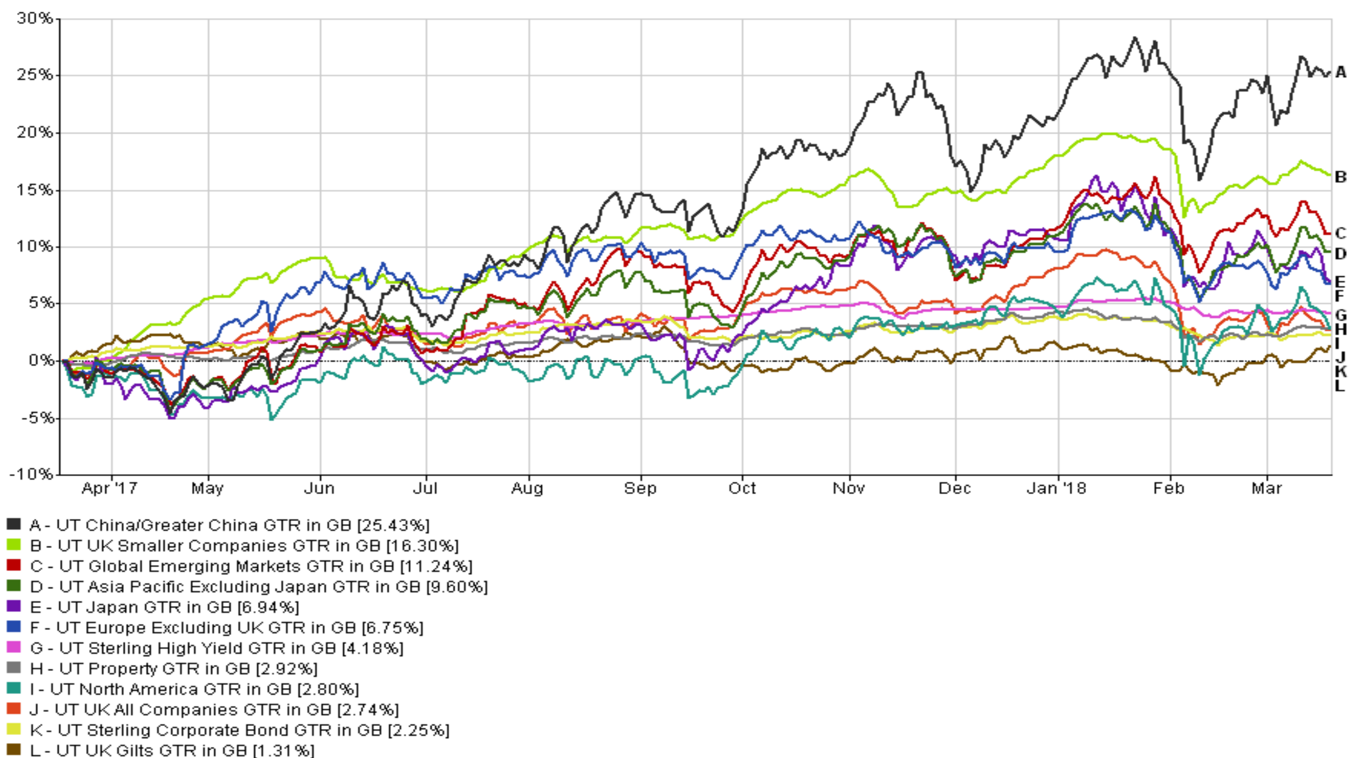
Lastly, we note the strong outperformance from our ethical portfolios this year, driven largely by strong stock picking from the managers and their typical bias towards medium and smaller sized companies, which have performed strongly.

"He is not here; he has risen! Remember how he told you, while he was still with you in Galilee: 'The Son of Man must be delivered over to the hands of sinners, be crucified and on the third day be raised again. " - Luke 24:6-7

Investment Returns & Outlook

We wrote to you all in February this year, following the short lived but rather sharp fall in global stock markets. Since then global markets have broadly recovered well and particularly Chinese equities, which have continued their strong performance and are now well ahead of peers. We continue with our cautious view to China, allocating a small portion of client portfolios to this region (to a greater extent for higher risk portfolios). It would be hard to ignore China as the largest economy in the world now and with the potential for very strong gains clearly evident. However, we remain mindful of the equally strong potential for loss, through poor corporate governance, corruption, political issues, high levels of debt and most importantly China's attempts to 'rebalance' its economy away from being investment driven to consumer led.

European and UK stock markets remain at their lower levels, following the "sell-off" in February this year. Brexit worries and more recently Russia/UK relations continue to weigh on some UK asset prices, as well as the fear of reduced consumer spending (the main driver of economic growth in the UK). However, we have seen some positive steps both in the Brexit negotiations and in UK economic data recently, with wage growth picking up, inflation reducing slightly as the Pound regains ground. We hope this trend continues as this will provide a boost to client portfolios, which are, generally speaking, overweight UK and Sterling assets.



20/03/2017 - 20/03/2018 Data from FE 2018

UK Government Bonds (Gilts) have continued their expected decline following the first interest rate rise in the UK in around 10 years. This rate rise, coupled with high inflation, makes the already low yields on Gilts look unattractive. Fears that interest rates are set to increase further, as the UK economy strengthens, will weigh further on Gilt prices we believe and so we continue to allocate a low weighting to these assets, preferring instead Corporate Bonds (loans to companies) including High Yield Bonds, which as you can see have performed much stronger this year.

As usual, we now report on the consensus view on various regional markets from a wide selection of investment houses. The main change since our last report in October 2017 is that UK Equity markets have moved from having a negative outlook to a neutral one. We remain quite positive on UK Equity Markets for now but are keeping a watchful eye on UK wage growth and inflation, which obviously has a large affect on the spending patterns of the UK consumer and in turn company profits.

POS	A POSITIVE outlook	European Equity, Pacific Basin (ex-Japan) Japan & Emerging Markets
NEU	A NEUTRAL outlook	UK Equity; UK Smaller Companies and Global Property
NEG	A NEGATIVE outlook	US Equity; US Smaller Companies; UK and Global Corporate Bonds and UK Gilts

Whilst we would tend to agree with the negative outlook for Fixed Interest assets generally (Corporate Bonds & Gilts) we generally look more favourably on US Equities, particularly following the tax cuts pushed through by Trump's administration late last year. However, we retain an underweight position in portfolios, mindful of US Equities' strong performance to date and historically high prices.

Overall, we retain a positive outlook, given robust economic data globally and high levels of company profitability. However, we are ever wary that things can change quickly in investment markets and so, whilst we are hopeful for returns to come, we continue to allocate to defensive assets in portfolios in case we see a downturn.

MiFID II and What it Means for You

As previously reported, the revised version of the Markets in Financial Instruments Directive— MiFID II— came into effect on 3rd January. This legislation—seven years in the making— was drafted by the European Securities and Markets Authority on the instigation of the European Commission and is intended to give investors more transparency. Perhaps reassuring then that its measures will remain with us irrespective of our impending separation from the European Union.

In practice it means that fund management groups are obliged now to provide greater granularity in relation to the cost of investing. In turn, advisers are required to illustrate clearly all costs —including those related to their advice. As you will be aware, regardless of MiFID II, cost analysis has always been an integral component of recommendations prepared for our clients and those calculations are, in part, dependant on the detail provided by our chosen fund managers but now we are obliged to remind you of these costs at least once a year.

You will notice, therefore, in our review letters that all costs incurred during the preceding year will be set out for you. As the directive only took effect three months ago, the fund managers haven't yet accumulated a year's worth of data and so for the time being we are estimating the ongoing costs incurred by their funds as part of that calculation.

However, at first sight it may appear that the costs have increased since we provided our initial recommendation to you and this warrants explanation! In reality, managers have not introduced a raft of new costs but, they are now expected to incorporate certain charges in the ongoing costs figure ('OCF') of a fund which, hitherto have not formed part of that calculation. For example, transaction or trading costs now have to be included and, where charged, performance related fees are also included. This has attracted much attention in the financial press as the hitherto 'hidden' costs have in a number of cases almost doubled and in extreme examples increased the cost by four times the pre-MiFID II stated figure. Naturally, some consumers will be alarmed or confused at any disparities but, as stated above, these are costs which have always been incurred by the fund managers and, in our view, are not a cause for immediate concern.

However, we welcome the new clarity which will aid us in our independent assessment of funds which may or may not be included in our recommendations and which will be revisited as part of our regular asset allocation reviews. Nevertheless, you should not hesitate to let us know if this development gives rise to any questions.

A Reminder For Property Investors

Whilst most of our clients have exposure to commercial property which we believe to be an important diversifier in the portfolios we manage, some are also holding property directly. Whilst there are disadvantages of holding individual properties, one of the benefits often cited is the tax relief available to investors who have borrowed for this purpose. Indeed, if structured correctly, the borrowing need not be secured against the investment itself in order to qualify for the relief.

Whether incorporated or owned individually, the business of owning and letting property has enabled some or all of the rental income to be offset for tax purposes against expenses such as for the maintenance and management of the property. Included in the allowable expenditure is *interest* (as opposed to any capital repayment element) on loans directly associated with the letting business. This allows leveraged property investors to, in effect, fund some or all of the associated loan interest out untaxed rental income. Until 2017, the amount of loan interest relievable was limited only by the capital value of property acquired—potentially making it a very tax-efficient form of investment.

However, in the Summer 2015 budget statement, the then Chancellor George Osborne, announced a limitation on the extent of tax relief to be phased in over four tax years starting in 2017/18. Over that time the tax relief will become limited to the Basic Rate—meaning that the impact will be felt mainly by those paying tax at the Higher or Additional Rate of tax. In practice, the proportion of the total finance cost to the letting business allowable at Higher or Additional Rate has been reduced year by year such that in 2018/19 only 50% of this cost will be allowable at these rates (where applicable to the tax-payer's circumstances) with tax relief on the other half limited to Basic Rate Tax relief. In the years 2019/20 and 2020/21 the Basic Rate element will increase to 75% and ultimately 100% respectively—meaning that at that point tax relief on all finance-related cost will be at the Basis Rate only.

Inevitably, the changes have added another layer of complexity to the tax affairs of those letting property and for some this may be their sole source of income. Nevertheless, it is also incumbent on landlords to ensure that rental income—however small— and any allowable expenses are accounted for under Self Assessment. This obviously incurs additional cost in terms of time or Accountancy fees - factors sometimes overlooked by the first-time property investor.

Gifting to Children and/or Grandchildren

We are often asked how much you are allowed to give away to children. The short answer is – as much as you like – there is no restriction. The question is of course pertinent and relevant only if your estate is caught by the Inheritance Tax (IHT) net. By April 2020 if you are leaving your estate to direct descendants on death, (and you own or have owned a residential property) a full £500,000 each can be inherited by children or grandchildren without paying IHT. So a married couple can pass on an estate valued at £1m without it being subject to IHT with effect from April 2020.

In scenarios where the assets are worth less than the combined nil rate band(s) there is no problem at all in giving away any amount at any time – there will be no repercussions. However, where assets are worth more than the nil rate band(s) any amount can be given away but in order for the gift to be exempt from IHT, it must be outright to the child or grand-child (rather than in Trust) and the donor must survive for a full seven years from the date of the gift. In a situation where a married couple with an asset value of £1.2m give away £200,000, the gift is known as a Potentially Exempt Transfer (PET) until the seven years have elapsed. If death occurs in the meantime, the value of the gift is deducted from the available nil rate band and so in this case, although the value of the estate at date of death has been reduced by £200,000 to £1m, the then available nil rate band has also reduced by £200,000 meaning that only £800,000 is IHT free and so exposing £200,000 of the remaining estate to inheritance tax.

If donors can make the gifting strategy “regular and habitual” and “out of excess income” and “not impacting on their standard of living” the gift is not a PET but it an exempt transfer. So if our same clients had say £30,000 of excess income that they didn’t spend each year (perhaps increasing income from investments even) they could give this excess away each year. After 7 years, they would have given away £210,000 and none of it would be written back into the estate for IHT purposes.

Often gifts to children or grandchildren are used for property purchase, home improvements, cars or driving lessons etc. In situations where clients are wishing to establish their wider family in the ways of investing, whilst also achieving the objective of keeping future IHT liabilities under control, financial products such as ISAs (for those who are reasonably well established), Lifetime ISAs (for those between the ages of 18 and 40 who have yet to purchase a property) or indeed Junior ISAs (for those aged under 18) can be a useful tool in helping to achieve the overall goal.

Finally, it should also be remembered that individually you are permitted to give away £3,000 of gifts in each tax year to anyone and a further (up to) £2,500 for a grandchild or £5,000 for a child (£1,000) for any other person on the occasion of a wedding (or civil ceremony) and these will be immediately outside your estate for IHT purposes.

House Prices to Average Earnings

House prices are always a hot topic of conversation. With the prospect that Interest Rates are on the gradual rise and with tax measures (see page 3) making property investment less attractive, we thought we’d delve into the latest House Price Index report published on the 7th March 2018 by Halifax. This index has been running since 1983.

The headline is that house price growth has slowed to 1.8% which of course in theory means that house prices have not kept pace with inflation over the last 12 months. It also states that the average house price of £224,353 in February was down from the high of £226,408 in November.

The number of homes for sale peaked in January 2008 around the time of the credit crunch of course. At that time, the average house price was just over 5½ times the average earnings. It subsequently fell to about 4½ times average earnings but over the last 5 years has crept up back to about 5½ times again. Rising interest rates, increased tax burdens and lack of affordability will all potentially put downward pressure on property values. It is only the current very low (by historical standards) numbers of properties on the market at the present time which is the positive factor for maintaining current values.

AWFM News

- Congratulations to Jack on passing the first paper towards his Diploma of Regulated Financial Planning.
- Some will have encountered the disruption occasioned by a temporary and unintended water feature recently in Foots Cray High Street—coming as it did not that long after the structural work to The Seven Stars. We’re pleased to say that traffic is once again flowing almost as freely as the Cray beneath it!
- Whilst on the subject of the local environment, we’re sorry to say no more sightings of the Kingfisher of late although the odd Egret and Wagtail have been in residence.

If you have any questions about this newsletter or your existing investments, please contact us to discuss your situation further.

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