



Spring 2008 Newsletter

## The Same Mistakes

"To err is human" said Alexander Pope - but in investment, this costs money. Better to learn from others and try to avoid the problems, which others have already faced.

Investors make many mistakes but none so common as following the herd. Despite the reassurance and the desire not to miss out, any fallout is always costly. The most recent example is the dot com boom which convinced millions of ordinary investors to part with their savings - and sadly, many are left even today with only a fraction intact.

Investors can also be scared of volatility. Stories of booms and busts make them nervous and some sell their shares at the smallest sign of trouble. This can leave them crystallising a loss and missing out on what could have been much greater long-term benefits. If such short-term movements scare you, perhaps equities are not for you.

Finally, some know-it-alls think they can time markets, but if this were possible, we would all be millionaires. Profit chasing is really no different to gambling and should be avoided unless you are prepared to lose your investment.

Investment should never be gone into lightly. Be clear about your objectives, your timelines and your risks - and make sure you build the portfolio which is right for you.



### Investment bonds


Investment bonds are investment products offered by life companies which offer you a choice of how that money is invested. The most popular funds used to be with-profits, managed and distribution funds which combine different assets within the one fund. Today, however, more options are available, as life companies also offer external links to fund management houses. For an onshore bond, the fund automatically pays tax on the income and gains which is deemed equivalent to the savings rate of income tax. Basic rate taxpayers therefore pay nothing more on any profits and higher rate taxpayers simply pay an additional 20%.



Welcome to the latest edition of Grapevine, our update on developments in the world of financial services.

We hope you find the contents of interest. If you have any questions, or would like to discuss any of the points raised, please give us a call.

Please call us if you require any information on anything contained in this Newsletter.



## What to do about property


After three years of startling returns for commercial property, the bottom seemed to fall out of the market towards the end of 2007. Rising interest rates did the early damage and the credit crunch finished things off. Property funds that had attracted billions following changes in the ISA rules were forced to devalue and impose penalties for investors selling out. So what now for investors who still have property holdings?

Funds invested in property shares were the first to be hit. Arbitrageurs who had entered the property sector to make quick money on the introduction to REITs, exited promptly afterwards, dragging property shares down – and, along with them, the value of funds invested in those shares.

However, much of the retail money went into direct commercial property funds. In this case, as commercial property values started to fall, nervous investors scrambled to get their money out of the funds. Because direct property is illiquid, many providers kept a holding of cash and property shares to manage such redemptions. However, for some, this money ran out and many were in danger of becoming forced sellers of the buildings in their portfolio.

Forced sales risk a lower selling price and thereby penalise existing holders of the fund. In an attempt to prevent such redemptions and protect values, therefore, some funds imposed exit restrictions - including six month notice periods, giving the fund time to either accumulate the amount necessary or at least have the chance to sell on property at the right price. Despite this, however, some popular fund values are down between 15 and 20% in the last six months\* (source: Financial Express Analytics, to 1st January 2008).

So what do you do now? For investors who still have property holdings, now is probably the worst time to sell out. Analysts believe the market has reached the bottom – although a steady recovery is more likely than any quick turnaround so there is still worry ahead. Having said all that, it is up to each individual to decide why they hold property in the first place. Its diversification properties have not changed and there is no reason why it should not get back to its return profile, providing long-term yields, once this phase is over. Like any other asset class it will have its ups and downs over time – but this is exactly the reason why experts suggest you spread your portfolio around. Long-term, well diversified investors should be more than able to weather this storm.



### Finding help in an emergency

An overlooked peril of the ageing population is the greater need for healthcare. And the costs of long term care are rising. There are two ways to fund long-term care: a pre-funded policy (based on risk) or, if the situation has already arisen, by using an immediate care plan. At the moment, people tend not to be thinking ahead to long-term care, so the vast majority do not have any pre-funding option. But then, this might not be a problem if costs can be met out of income or existing savings.

In the case of short term requirements, this could indeed be the most appropriate course. However, in the longer term, what happens if payments for care increase? How long will the savings last? What if you live longer than expected? An 'immediate care plan' guarantees to cover any shortfall between what you can pay and the actual care fees for life – or for as long as you need them, whichever is sooner. These 'immediate care' plans balance the risk that you will live longer than expected and need more money than you invest, with the fact you may die earlier than expected and lose more money than you would have done just paying the fees.

Finding a lump sum may be difficult but thanks to house price rises, releasing equity from the family home may also be an option. This brings its own considerations, but such a move could also help with estate planning. Make sure you considered all the options don't give up your house without the full facts.

## Avoid last minute surprises



Investing money in a pension scheme requires careful thought as the decisions made will have a significant impact on your net wealth in retirement. In occupational schemes, the investment decisions are usually made by the plan provider, but for money purchase (defined contribution) and personal pension plans, the burden is on the investor.

The range of options offered by pension providers is widening. However, the main decision remains how to blend the four main asset classes – equities, property, bonds and cash – to best advantage. Equities have been the highest returning asset class over the long term, but carry the most risk; property fluctuates with the ability of companies to buy or rent premises; bonds are influenced by interest rates; and cash ensures capital preservation – but there is no chance of any capital gain and income is at the mercy of interest rates.

It is common to start with a greater proportion in equities, to maximise the growth potential, but to move into more secure assets as retirement approaches. This helps to lock in any gains, removing the risk that the pension will eroded by a last minute downturn in markets. Investing too heavily in one asset class means if that asset does badly, the whole fund will suffer. Chasing attractive looking performance is always risky. But being too cautious early on may mean you miss out on valuable growth.

## ISAs from 2008

In the last Budget, the Chancellor announced changes to ISAs which became effective at the start of this new tax year. The highest profile has been the change to investment limits as the Government eliminated the mini and maxi components. Now, there are just two types of ISA - the Cash ISA and the Stocks and Shares ISA - and your overall allowance for both in 2008/09 is £7,200. Within this, for limit for Cash ISAs - or for the cash element within a Stocks and Shares ISA - is £3,600.

Within the limits, there is flexibility. You can, for example, now put the maximum £3,600 in a cash account and £3,600 in a stocks and shares account. Alternatively, if you place just £2,000 in cash, you can use the entire remaining balance – £5,200 - to invest in stocks and shares. If you don't need cash at all, you can put the full £7,200 into stocks and shares. You can also transfer existing Cash ISA holdings to a Stocks and Shares ISA without impacting on your current tax year allowance. So, if you have £10,000 already sitting in existing ISA plans then this amount can be moved to a Stocks and Shares ISA, yet leave your allowance of £7,200 still available.

The only other change is we have finally seen the back of PEPs. Although no new money has been invested in PEPs since 1999, the distinction remained. Now, the Government has allowed providers to consolidate the plans under one product wrapper. Existing PEP holders should actually see no difference, but do check with your adviser if you are unsure.



## Chinese Promise

China now has one of the world's fastest growing economies, making it one of the most influential investment regions globally. As it develops, the appetite for commodities grows – and its demand for oil, among others, has consistently pushed prices to new highs. However, China's outstanding economic progress has not been fully reflected in the performance of the Chinese stock market which has remained in line with the world average. There is still a lack of transparency in business, and shareholders are not given the same consideration as in Western markets. There could be opportunities, but you need to be careful of the risks.

## Using your ISA allocation wisely

While ISAs are well known for being tax-efficient, from a tax perspective it matters what kind of investments you decide to put into them. Using your ISA allocation wisely does not just mean picking a reliable and successful destination or provider, but it also entails giving careful consideration to the actual assets themselves. The reason for this is, within an ISA wrapper, not all asset classes receive the same tax benefits, which can be confusing.

Cash ISAs for instance, are free of income tax, and if you decide to invest in bonds through your ISA, you still get the tax benefits. For example, if you choose a corporate bond ISA, you'll have the considerable advantage that income (whether paid as income or re-invested) is totally tax-free, because interest-paying bond funds qualify for a tax credit of 20%. However, if you do decide to opt for such a scheme, despite the potential for regular monthly income, your capital can be at risk.

Some corporate bond funds also have exposure to UK government bonds (known as gilts), which are also free from income tax, and are even lower risk – the chances of the government defaulting on its loans are negligible. In addition, you can find a gilt fund which only invests in government bonds, though if you choose to invest in gilts directly, you'll need to ensure the bonds have at least five years to run until maturity. With any bond ISA investment, the hope is that income payments will be supplemented by capital growth, but remember, there is no guarantee this will occur.

When compared with bonds, using your ISA to invest in stocks and shares is a little less effective from a tax relief perspective. This is because, since April 2004, the rules have changed slightly. Basic rate taxpayers currently pay 10% tax on dividend income, which is taken before any dividend is received and can't be refunded, even within an ISA. Higher rate taxpayers, however, who would normally pay tax on dividend income at 32.5% outside an ISA, won't get back the 10% dividend tax credit element, but will save the remaining 22.5%.

Having said this, it is worth noting that although stocks and shares are seen as higher risk investments, the asset class has performed relatively robustly over the long term, when compared with bonds or cash. Before making a decision you should weigh up any tax advantages against the potential risks and likely returns of your prospective ISA holdings and speak to your adviser, who can help you plan for your personal circumstances.



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