# KENNEDY BLACK
## WEALTH MANAGEMENT

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**Welcome to the latest Kennedy Black Private Client Newsletter.**

**Now that we're well into a new tax year, I thought I'd shift the focus in this edition from tax and Budget-related topics to investment-related topics. I have spent a significant amount of time recently investigating whether active or passive fund management is preferable. Furthermore, I am often asked 'how much should I be putting aside for retirement?' so I have tried to use a case study to highlight a few 'rules of thumb' to ensure a comfortable retirement.**

## ACTIVE OR PASSIVE INVESTMENT STRATEGIES?

There is considerable debate at the moment about the relative merits of active versus passive investment strategies. So which really offers the best opportunity for investment performance?

To summarise the debate, active funds pick stocks in the hope that they will generate outperformance, whereas passive funds simply track an underlying benchmark but at much lower cost. Charges can have a significant impact when compounded over many years.

The cynic in me tells me that beating the financial markets on a consistent basis is extremely difficult, and someone who can do it will undoubtedly be doing it for themselves, probably from the back of a rather large yacht. However, there are plenty of skilled fund managers out there who will argue the contrary: that they truly can pick well-managed companies that translate into rising share prices; and that a passive fund holding all of the shares within an index means having to own a lot of poor performing stocks too.

However, what I found is that even the longest-standing, most consistent outperformers have not necessarily continued to outperform.

I based my analysis on the funds that Lipper (an independent fund research company owned by Thomson Reuters) gave its 2006 UK Lipper Fund Awards for "consistently strong risk-adjusted performance" in each sector. I chose the 2006 awards since that was the year the awards started (or at least, as far back as I could find).

I then built a portfolio using those funds and rated their performance *since* the awards were given, and compared that to the weighted sector averages over the same timeframe (i.e. how would a portfolio have performed if selected by monkeys). By doing this, I have attempted to remove any benefit of hindsight, which often biases the analysis of actively-managed funds.

Interestingly, the portfolio of Lipper Award-winning funds returned +0.99% to the beginning of August 2010, while the weighted sector average portfolio returned +2.75%.

In this instance, therefore, there was no ongoing consistent out-performance and an investor would have been much better off picking tracker funds at much lower cost.

While I fully acknowledge that this is far from conclusive, and that my analysis is far from perfect, this should at least pose a serious question about the value generated by award-winning fund managers. For the time being, I remain to be convinced that active managers are worth paying for, but if anyone would like to demonstrate otherwise, I am all ears.

## ETFS OR TRACKER FUNDS – A COST COMPARISON

When it comes to building a passive investment strategy, there is often a choice between passive tracker funds and exchange traded funds (ETFs).

ETFs offer a number of benefits, and there has been growing publicity recently around the sector (e.g. Morningstar recently launched a new online 'ETF Centre'). However, I'd like to demonstrate here that ETFs are not necessarily the best value for money.

For instance, if you're looking for a fund to track the broad UK market, there are a number of choices. Focusing just on the FTSE All Share Index, there are traditional tracker funds with total expense ratios of 0.24% per annum. One manager even offers a TER of 0.15%, although they also charge stamp duty of 0.50% as an upfront fee, rather than having it taken out of the fund.

On the other hand, ETFs that track the same benchmark start at 0.35%. So in this instance, unless you definitely want the intra-day liquidity offered by an ETF (even though that can be a double-edged sword when liquidity dries up in a crisis), then a passive fund invariably makes more sense.

## Are you contributing 20% of salary towards retirement?

Pensions are a very topical subject, with plenty in the news in the past few days about the age of retirement as well as public sector pension schemes.

A pension is usually an individual's second largest asset after a house, and yet there is considerable confusion and misunderstanding about how they work and what they can achieve.

Perhaps the most common question I receive relates to how much a client should be saving for retirement. There are clearly a lot of variables, but a helpful rule of thumb is that you should be thinking about contributing 20% or more of your income in order to sustain a lifestyle on a par with what you are experiencing today.
Let's use the example of Mr Black, who is 35 and has a money-purchase company pension that both he and his employer contribute towards. For the sake of round numbers, let's say Mr Black earns £100,000 a year, and he contributes 5% towards his pension which is matched by his employer. His current pension pot is valued at £100,000.

It would be a fair assumption to think that Mr Black's expenses should drop when he retires aged 65. For example, he intends to use his lump sum at retirement to pay off his mortgage. However, he would like to balance this with a round-the-world holiday and plenty of spoiling of grandchildren.

Having conducted a thorough analysis of Mr Black's expenditure patterns, we might conclude that Mr Black enjoys his current standard of living and would require an income of two-thirds of his current income to support such a standard in retirement.

In today's prices (i.e. zero inflation) and assuming *real* (i.e. after inflation and fees) investment returns of 3% per annum, Mr Black could expect a pre-tax income in retirement of £29,000 – after taking a tax-free lump sum on retirement of £175,000.

This annual income is well short of the required £67,000. To make up this shortfall, Mr Black would need to contribute an additional £1,100 per month – equivalent to 13% of gross salary.

Or to put it another way, in total, Mr Black needs to be contributing approx 23% of his salary in total towards his retirement.

20-25% of salary is a pretty good rule of thumb when it comes to retirement planning, particularly as people tend to have lofty aspirations when it comes to their retirement income requirements. It is common to underestimate the required level of monthly contribution, hence this is an important area of financial planning.

If you would like a personalised review of your own retirement plans, don't hesitate to get in touch.

### Investment Rule #3:

"Diversify to spread your risk"

In today's investment world, asset allocation is the only free lunch.

That is, a well-diversified portfolio costs no more than an undiversified portfolio, and yet diversity can sharply reduce risk, thereby optimising the portfolio's risk/return payout. Hence it pays to ensure that your portfolio is properly diversified across asset class, industry and geography.

Kennedy Black Wealth Management uses sophisticated portfolio modelling tools to ensure that your investment portfolio is diversified in relation to the efficient portfolio frontier – and appropriate for your personal level of risk appetite.



Kennedy Black Wealth Management Ltd • 10 Nelson Terrace • London • N1 8DG
Tel: 020 7250 3862 • email: enquiries@kennedyblack.com • web: www.kennedyblack.com