KENNEDY BLACK
WEALTH MANAGEMENT

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Welcome to the latest edition of Kennedy Black's Private Client Newsletter. We hope this finds you somewhere on a beach, a world away from the ups and downs of the global economy (and the stresses of your jobs, of course). Failing that, we hope you have managed to spend some quality time away this summer (or are about to) with friends and family.

In this edition, we include some general thoughts on investment portfolio theory, and have tried to use some empirical evidence to demonstrate some important truths about investing. We also highlight some tax tips that we hope you find useful.

Are markets efficient? And why should you care?

As recently as a decade ago, the Efficient Markets Hypothesis was an unquestioned pillar of modern finance. Michael Jensen, the American economist, declared in 1978 "there is no other proposition in economics which has more solid empirical evidence supporting it."

And yet, there has been unprecedented criticism of the hypothesis in recent years following the Credit Crunch. So much so, that its author, Eugene Fama, has so far been overlooked for the Nobel Prize in Economics as a result.

In short, the Efficient Markets Hypothesis states that current prices incorporate all available information and expectations. Price changes are therefore due to unforeseen events.

Much of modern finance is built on this premise, and its validity has far-reaching consequences for active fund managers who exist because they believe that they can exploit market inefficiencies with a level of consistency that is worth paying for.

More relevant for investors, it also helps remove the temptation to react to movements in share prices, such as the recent correction in equity markets.

Recent criticism has been focused on two apparent limitations of the hypothesis:

1. Its inability to explain asset bubbles, such as the dot com boom;

2. Its inability to explain irrational behaviour (see the Behavioural Finance article in issue 4 of this newsletter). Over-confidence as prices rise followed by irrational risk aversion as they fall both exaggerate potential inefficiencies.

Yet, bubbles are not easy to spot, even by the experts and even the ones that look particularly daft with hindsight (in 2000, according to Forbes magazine, there were 59 internet companies worth over $5 billion with revenues of less than $100 million). If bubbles were really that easy to spot, then surely everyone would be lining up to profit from them bursting? Yet very few people manage to do so successfully. In fact, in our view, the more people call it a bubble, the less likely it is to be one.

However, we at Kennedy Black do have a soft spot for Behavioural Finance. We enjoy understanding the human psyche and the limitations it creates for investors. However, we struggle to believe that Behavioural Finance necessarily deems markets to be inefficient.

A recent book ("Beyond Mechanical Markets" by Frydman and Goldberg) has suggested that the two schools of thought can be reconciled if you believe John Maynard Keynes's assertion that the factors governing the success of any future investment are too complex to be calculable. Not only do investors have to be correct about all of the fundamentals, they need to anticipate correctly the future concerns of fellow investors. To achieve both involves a great degree of intellect and an even larger dose of good fortune.

In our view, the Efficient Markets Hypothesis has emerged from the criticism all the stronger. Hence, we continue to favour a passive investment strategy for our clients' investments, and would caution against panicking in the face of the recent market volatility. And a fitting reward would surely be a Nobel Prize for Eugene Fama, who has had to wait longer than he deserves to be proven right.

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The value of dividends

An interesting statistic presented in this year's Equity Gilt Study from Barclays helps shed some light on the origin of long-term equity market returns.

Barclays calculates that £100 invested in the stock market in 1899 would now be worth £12,655 (or £180 in 1899 prices).

However, by reinvesting the dividends over the same period, that £100 would now be worth £1.7 million (£24,133 in 1899 prices).

The difference is stark and illustrates the value of dividends against capital growth. And in terms of conclusions, it leads us seriously to question the long-term value of any financial product that offers capital returns without any entitlement to dividends (e.g. structured products).

Top tips for reducing your tax bill

Speculation is mounting that the government may reduce the 50% top rate of income tax. (Even so, Danny Alexander, Chief Secretary to the Treasury, thinks those who want to scrap it are "living in cloud cuckoo land.")

Either way, higher and additional rate taxpayers are focusing on their tax bills like never before. Here are some simple tips to help optimise your tax position.

1. Use your ISA allowance.
2. Use your Capital Gains Tax exemption.
3. Make pension contributions.
   Up to £50,000 can be contributed to a pension every year, with full tax relief at your marginal rate of income tax.
4. Use your spouse's allowances.
   Even if your spouse doesn't pay income tax, he or she can still contribute £3,600 gross to a pension and still receive basic rate income tax relief.
5. Make sure income-producing assets are in the name of the lower taxpayer.
6. Pay CGT rather than income tax wherever possible.
   Higher and additional rate tax-payers should aim to pay 28% CGT rather than 40 or 50% income tax.
7. Invest in VCTs and EIS investments.
   VCT and EIS investments offer income tax relief of up to 30%. However, these are high-risk investments so you must understand the risks.
8. Invest offshore.
   If you anticipate paying a lower rate of income tax at some point in the future (e.g. in retirement or moving abroad) then offshore bonds could make sense to help defer tax until a later date.
9. Give assets to family members.
   If family members pay a lower rate of tax, think about passing assets on sooner rather than later. Not only with their tax treatment be more favourable than yours, but if you live for seven years or more then no Inheritance Tax is payable on the gifts.
10. Make gifts to charity.
    Gifts to charity not only benefit from income tax relief via Gift Aid, but under rules announced in the latest Budget, they are soon to help reduce the overall rate of Inheritance Tax due on an estate.

Investment Rule #7:

"Avoid chasing returns"

The Economist recently conducted some research as to whether retail investment flows are influenced by past performance and, if so, whether their returns were better or worse for it ("The Foolishness of Crowds," 7th April 2011).

Their conclusions: the most popular sectors were indeed those that had outperformed in the preceding 12 months (by 2% on average). And performance over the following 12 months ended up being 3% below the sector average.

Similarly, a recent report from Cass Business School ("Do UK Investors Buy at the Top and Sell at the Bottom?") has estimated that market-timing errors erode the average retail portfolio by 1.2% per annum. Over 18 years, that would leave the portfolio 20% lower than where it would have been through doing absolutely nothing.

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