KENNEDY BLACK
WEALTH MANAGEMENT

QUARTERLY PRIVATE CLIENT NEWSLETTER — ISSUE 9: FEBRUARY 2012

Welcome to the latest edition of Kennedy Black Wealth Management's Private Client Newsletter. A lot has happened in the three months since the last edition, which is amazing given how quickly these newsletters seem to come around.

Firstly, and among our proudest achievements so far, we have received independent recognition from two sources. We have been shortlisted for Small Company IFA of the Year at the prestigious Money Marketing Awards 2012, and have been picked by Citywire New Model Adviser® magazine as one of the "top ten young firms to watch out for."

Secondly, on the back of rapid growth over the past couple of years, we have started to expand. I am pleased to welcome Cathi Harrison to the team as a dedicated paraplanner. Cathi will help support the business behind the scenes, ensuring we can continue to provide a first class, personal service to our clients. Cathi has been a paraplanner for six years and is qualified to the highest level.

As for this edition, we touch upon some investment topics and highlight some tax areas worth thinking about as we approach the end of the tax year. Hope you enjoy it. Feedback welcome as always.

How to make use of your CGT exemption

A large part of financial planning for our clients involves using various tax allowances. As well as the more obvious tools (pensions, ISAs, offshore bonds etc), we regularly recommend that clients make use of their annual Capital Gains Tax exemption. We attempt here to summarise how it works and what difference it makes.

In a nutshell, every UK resident has an annual exemption from CGT. In 2011/12, the first £10,600 of gains are tax-free.

Yet even for gains above this threshold, CGT is typically payable at a lower rate than if income tax applied (i.e. 18% for basic-rate taxpayers or 28% for higher- and additional-rate taxpayers). This can make CGT-based investments particularly attractive for high earners.

By constructing a portfolio of low-yielding investments, the income tax liability can be minimised. And by crystallising any gains in a careful manner, it should be possible to ensure that no CGT becomes payable. Hence, a portfolio that is very tax-efficient.

The impact that this can have is stark.

Let's take an example (and thanks to Fidelity for helping calculate these figures). Take an additional-rate taxpayer with a £200,000 portfolio that delivers an annual dividend/ interest yield of 2% and capital gains of 5% (i.e. a total return of 7%). After ten years, if no CGT management has taken place, the after-tax portfolio could be worth £303,626 (assuming 1.5% p.a. of fees and charges).

By making use of the client's CGT exemption every year, the after-tax portfolio could instead be worth £332,332 on the same assumptions – an improvement of more than 10% simply through more effective tax management. This could be improved further by holding the account in joint names.

If you would like to discuss this further, do not hesitate to get in touch in advance of the end of the tax year.

Stop self-destructing!

Retail investors have a habit of getting it wrong. It doesn't matter who you are, even if you work in high finance, the temptations of the market can be universally damaging.

According to the Investment Managers Association (IMA), retail sales of equity funds halved in 2011 as investor confidence took a beating following the market slump in August.

And yet, at the time of writing, equity markets are making fresh six-month highs.

Kennedy Black advocates a disciplined investment approach that helps our clients resist these destructive temptations – and hopefully deliver better investment returns as a result.

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How to get 60% tax relief on pension contributions

Another trick to consider at the end of the tax year applies to people earning over £100,000 per annum in the 2011/12 tax year.

For every £2 earned over £100,000, UK taxpayers lose £1 of their Personal Allowance (the first £7,475 of income that is completely free of income tax). This continues until earnings reach £114,950 at which point the whole Personal Allowance has been lost.

The net effect is that every £1 earned between £100,000 and £114,950 increases take-home pay by a rather paltry 40p.

Hence, a well-timed pension contribution will achieve two benefits: income tax relief at a marginal rate of 40% plus gradual restoration of the Personal Allowance. Together, this gives effective tax relief of 60%.

For example, if you stand to earn £110,000 this tax year (check your monthly payslip for a running total of your earnings over the year), then a £10,000 pension contribution would reduce your take-home pay by just £4,000. There is no more tax-efficient way of investing in the UK at the moment.

R.I.P. active fund managers?

As our readers may have gathered, Kennedy Black treats 'star' fund managers with a healthy dose of scepticism. One school of thought says it is impossible for an individual to outwit the market on a consistent basis. The other says maybe they're out there, it is just impossible to identify them in advance from those who are simply fortuitous. Either way, we don't believe it is worth bothering trying to find (and pay for) these so-called stars.

One recent event and two recent research reports have helped reinforce this thinking.

Firstly, the darling of US fund management, Bill Miller, has retired from thirty years of managing the Legg Mason Value Trust Fund. Mr Miller became famous for outperforming the S&P 500 for fifteen years in a row.

A recent book ("*The Drunkard's Walk*," by Leonard Mlodinow) has suggested that Mr Miller's winning streak could be more down to luck. Mr Mlodinow calculates the odds of one fund manager beating the market over 15 years in the modern era as 3 out of 4.

Since his winning streak ended five years ago, Mr Miller ranked 840th out of 840 funds in his sector (according to the FT) and has decided to step down.

Secondly, two recent research reports have highlighted the poor returns achieved by investors who have backed those sparkliest of 'star' managers, hedge funds. It turns out that only the best funds report returns, meaning the statistics are riddled with the benefits of hindsight.

Once adjusted for those funds that don't report returns (or go bust), a US report from Clifford, Aiken and Ellis ("*Out of the Dark: Hedge Fund Reporting Biases and Commercial Databases*") suggests that "the average excess return of hedge funds does not differ markedly from zero."

In another book out recently, "*The Hedge Fund Mirage: The Illusion of Big Money and Why It's Too Good to Be True*," Simon Lack comes to a similar conclusion: that the effective investor return since 1998 has been just 2.1% (far below both equities and Treasury bills). Mr Lack's research highlights the impact of survivor bias, but also includes the effect of investors piling into hedge funds *after* they have performed well. Both ensure that the average investor misses out in the long term.

Investment Rule #9:

"Rebalance regularly and diligently"

Part of our disciplined investment approach involves rebalancing our portfolios every year.

This achieves two things: firstly, it ensures that the portfolio returns to the risk profile that it started with. Secondly, it gets our clients in the habit of selling those funds that have performed well and buying more of those that haven't.

Better this than buying high and selling low, which is the typical retail investor tendency (see the 'Stop self-destructing' section above).

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