

# KENNEDY BLACK

## WEALTH MANAGEMENT

QUARTERLY PRIVATE CLIENT NEWSLETTER

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Welcome to the 15th edition of Kennedy Black Wealth Management's Private Client Newsletter.

In this edition, we have highlighted why we think the Equity Income sector is wrought with structural problems and could be a crisis in the making.

We also include some recent thinking about the nature of planning for retirement and the impact that wealth (at least relative to your peers) could have when it comes to your retirement. Not so much 'Get Rich Quick' as 'Get Rich Slow.'

Finally, we continue our series of Behavioural sins, with a look at one of the less obvious irrational behaviours: mental accounting. The brain is a devious investment partner, and there are traps aplenty when it comes to investing. Compartmentalising and post-event rationalisation are both destructive forces when it comes to trying to implement a successful investment experience. Be on your guard.

### INVESTING FOR (EQUITY) INCOME? BEWARE.

We regularly read about the concept of "investing for income," often in articles aimed at do-it-yourself investors who seem hung up on the fact that all they need is yield, yield and more yield.

What we mean by "investing for income" is investing in stocks that pay out high dividends as a percentage of their share price (their 'yield').

This concerns us for a number of reasons, and we would like to highlight here some of the risks and unintended consequences and to explain why we think it's a potential accident waiting to happen:

- The argument is that reinvested dividends is where the bulk of investment returns come from and hence, by maxing out the dividends you receive, you improve your overall expected return.
- We've even heard people claim it is a 'lower risk' strategy because you are less

reliant on capital gains and therefore are likely to get your original investment back over a shorter period of time.

We don't deny that the power of reinvested dividends is substantial. As we've pointed out in previous editions of this newsletter, according to Barclays, £100 in invested in 1899 would be worth £180 now (adjusted for inflation) with no reinvesting of dividends whereas it would be worth £24,133 with dividends reinvested.

What this does not prove, though, is cause and effect. There is no proven link between high dividends and better overall returns.

However, the problems don't stop there. By focusing on higher-yielding stocks, investors end up concentrating their exposure in a limited number of stocks. In the FTSE-100 for instance, the top 15 dividend-paying companies made up 68% of the total dividend payments in Q3 2012, according to Aberdeen Asset Management.

In fact, research from Société Générale (entitled "Popular Delusions") shows that an abnormally high dividend yield tends to be a

sign of distress. Either the company is inflating its dividend in a desperate attempt to attract investors, or the market is expecting the share price to fall. That is certainly not a "lower risk" strategy in our view.

In the end, what one ends up with is greater exposure towards a handful of out-of-favour 'mega-cap' stocks (think Microsoft, which has been shoring up its dividend to mask a business in decline). Under our investment process we prefer tilting exposure towards small-cap and value stocks, since research suggests they offer a better risk/return trade-off.

It is reasonable to assume if the Equity Income sector keeps on growing, that a sharp correction in this part of the market could see huge retail volumes rush for the door very quickly, with disastrous results.

And yet all of this overlooks perhaps the most important factor when it comes to effective investment: tax.

ISAs and pensions aside, an investor who pays 40 or 45% tax should surely favour a

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low-yielding portfolio because the income tax he pays on dividends far exceeds the Capital Gains Tax he pays on capital gains. Plus, don't forget the first £10,900 of capital gains is exempt from CGT.

All in all, we favour a 'Total Return' approach, accompanied by up-to-date tax planning and effective diversification.

Please get in touch if you'd like a free, no-obligation review of your investments.

### WANT TO BE WEALTHY?

Various studies have shown that wealth is a relative concept. That is, we tend to feel more or less wealthy when we are richer/poorer than those around us.

A famous Harvard University study (by economists Hemenway and Solnick in 1998) demonstrates this quite clearly. Students were asked whether they would prefer an income of \$50,000 a year if their neighbour earned \$25,000 – or \$100,000 a year if their neighbour earned \$200,000. About half opted for the lower real income, confounding expectations around 'rational' economic thought.

This idea got us thinking.

Given the UK population is fundamentally failing to make the necessary provisions for retirement, there is a clear and relatively cost-effective opportunity for anyone to make themselves far wealthier than their peers when they reach retirement. All that is required is to do what most people are failing to do – plan effectively for retirement.

While today's generation of retirees may benefit from final salary pensions and

stratospheric rises in property prices, the next two or three generations won't necessarily have the level of same support and are likely to be far poorer as a result.

Hence there is unlikely to be the same sort of fall-back provision, despite many who think their property or their business is their pension (a strategy often wrought with risks).

Taking personal responsibility for one's retirement can be liberating, and we would argue it could be "wealth-creating" too, relatively speaking.

Modest provisions now may end up giving rise to greater relative wealth in later life. It could even result in you becoming the envy of your fellow retirees, while you go on a round-the-world trip and everyone else has to keep working (a generation of "Nevetirees" as they are now called).

Why not take it a step further and ask us to calculate your "Number" (as Lee Eisenberg refers to it in his book, "The Number"): that is, how much money you would need to retire *NOW* and still afford your current lifestyle? It may not be as much as you think.

### IRRATIONAL BEHAVIOUR #5:

#### *"Mental Accounting"*

When it comes to complicated issues, humans have a natural tendency to compartmentalise. The brain likes to deal within defined boundaries, and when a problem is dealt with it can be metaphorically packed up and stowed away so the brain can move onto the next one.

This is good for dealing with difficult problems, but not so good when it comes to successful investing and effective financial planning.

For instance, it is very tempting to divide up one's financial affairs into different pots on the basis that, for example: "this pot is for my retirement," or perhaps more tellingly: "this is just play money."

While that may not sound too problematic at first, it can create issues. A clear example is having savings in the bank but a credit card that isn't always paid off.

Mental accounting can also lead to unnecessary panic in the face of a crisis. If one investment doesn't do very well, it is tempting to write it off and focus on better performing investments. This often leads to investors hanging onto losers for longer than they should.

A far better strategy is to view everything as one part of a complicated whole, where equal focus is required on each and every element. Only then can the required level of discipline be maintained and sensible, consistent decisions be made.

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