Wealth Management Update

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Message From Anita

Some office news to begin:

After 10 months in her role Diane has decided to move on to pastures new.

We are fortunate that an ex colleague of Jacqui's, Dave Canning is stepping into the role after a period of handover and we are looking forward to his contribution within the team. Dave brings with him much experience of work-flow systems and has a love of figures, which will prove very handy! I am sure you will find him very helpful and knowledgeable when you come in to contact with him.

We all wish Diane the very best in the future.

Sadly, I seem to have reached that age where I hear of people I have grown up with being hit by health challenges. It does make one aware of the fragility of good health and with that thought we should all ask some questions:

When you review your life, will you say "I'm glad I did it" or "I wish I had"?

With those questions in mind will you change anything?

Just as a planning assumption, shall we assume you only have one life?

Just a thought ………..

Get Real

I went to the garage yesterday to fill my car with diesel and it cost me £82. Your first response might be - "you need to get a smaller car". That certainly ran through my mind. Recently it seems that every time I fill up the cost increases substantially. At the beginning of the year a full tank cost about £65.

Wikipedia, the online encyclopaedia, states "inflation can be thought of as a decrease in the value of a unit of currency" it also describes it as a "rise in the general level of prices of goods and services over time". By that definition my fuel inflation has been 26% in a little under 6 months.

"We are told inflation is currently 3% but it doesn't feel like that to me"

Back in the days when our Prime Minister was still the "Iron Chancellor" he was fond of telling us how he had put an end to the damaging cycle of the "boom and bust" economy. Other politicians have made similar claims both in the UK and internationally over the years but none have so far been able to tame the twin beasts of inflation and the stock market bubbles. Both have a life of their own that is far beyond the control of any Government.

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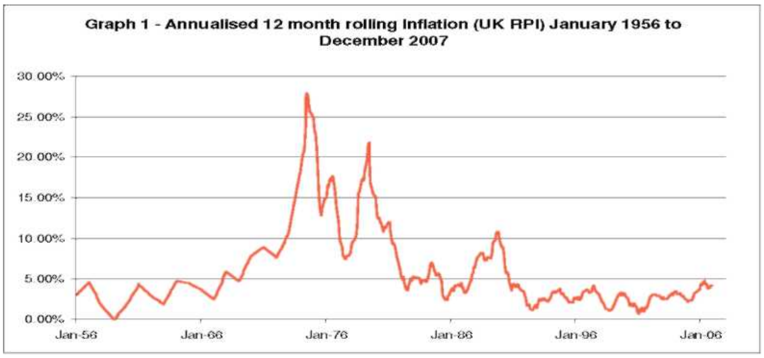
The Government's stated target for inflation is 2%pa but anything within the range 1% -3% is acceptable. The Government's measure of inflation is currently Consumer Price Index (CPI) which doesn't include things like mortgage interest and other housing costs and is running at 3% as at the end of April 2008. Another measure of Inflation is the Retail Price Index (RPI) which is currently running at 4.2%. Both of these fall well short of the 26% I recently experienced at the pumps although the two figures are not directly comparable due to different time periods. The Government's statistics department the Office for National Statistics (ONS) reported that the increase in petrol costs for the twelve months to 28th April was 17.9%. Heating Oils were up 59.3% over the same period. If, like me, you eat a lot of pasta (up 81%) and rice (up 61%) the real rise in the cost of living is an awful lot higher than the 3% or even 4.2% the Government want us to believe.

Graph 1



You can see from Graph 1 above, that we haven't experienced inflation at the current *implied* levels since the early 1970's at which point we had a three day week and petrol rationing. However, even these numbers pale into insignificance compared to the plight of Germany in the 1920's. In 1922 German inflation was 3,442%. In January 1923, there were 20,000 marks to the dollar; this increased to 630 million marks to the dollar by early November. During this period 300 paper mills and 150 printing works with 2,000 presses worked day and night to keep up with demand for bank notes. In 1923 inflation in Germany was 209 billion percent. The German hyper inflation had devastating consequences, wiping out all internal debts almost overnight, and ruining a substantial portion of Germany's middle class. Savings, bank balances, mortgages, annuities, pensions, bills, bonds and other paper investments all became worthless. This remains as a dreadful warning that government bonds and even bills (cash) can, under extreme circumstances, experience a real return of -100%.

Although Germany suffered the worst inflation of the twentieth century other countries weren't immune to periods of high inflation. In their book Triumph of the Optimists professors Dimson, Marsh and Staunton analysed inflation in 16 countries over the 101 years between January 1900 and December 2000. Table 1 below, shows the average annual rate of inflation for a few of the countries surveyed along with the highest and lowest rates for each.

Table 1

Country	Average Inflation 1900-2000	Highest Inflation	Year	Lowest Deflation	Year
UK	4.1%	24.9%	1975	-26%	1921
US	3.2%	20.4%	1918	-10.80%	1921
France	7.9%	74.0%	1946	-23.80%	1921
Italy	9.1%	344.4%	1944	-9.70%	1931
Japan	7.6%	317.1%	1946	-18.70%	1930
Sweden	3.7%	35.7%	1918	-25.20%	1921

In most countries inflation has been a bit of "a game of two halves" some countries such as Germany and France experienced much higher inflation in the period up to 1950 but subsequently managed to contain it while others such as the UK and the US experienced much lower inflation during the first 50 years but this increased substantially in the second half of the 20th century.

So there you have it, a nice little history lesson and possibly even a few facts that may come in useful at the local pub quiz but what does it really mean for investors? Well, clearly it is essential for investors to think of investment returns in "real terms" (i.e. adjusted for inflation) rather than simply focus on "nominal returns".

Table 2 shows the nominal and real returns for Cash, UK equities and US Equities between January 1956 and December 2007. During this period inflation in the UK averaged 5.8%pa while cash returned 7.81%pa or a "real return" of 1.9%pa[1].

Table2

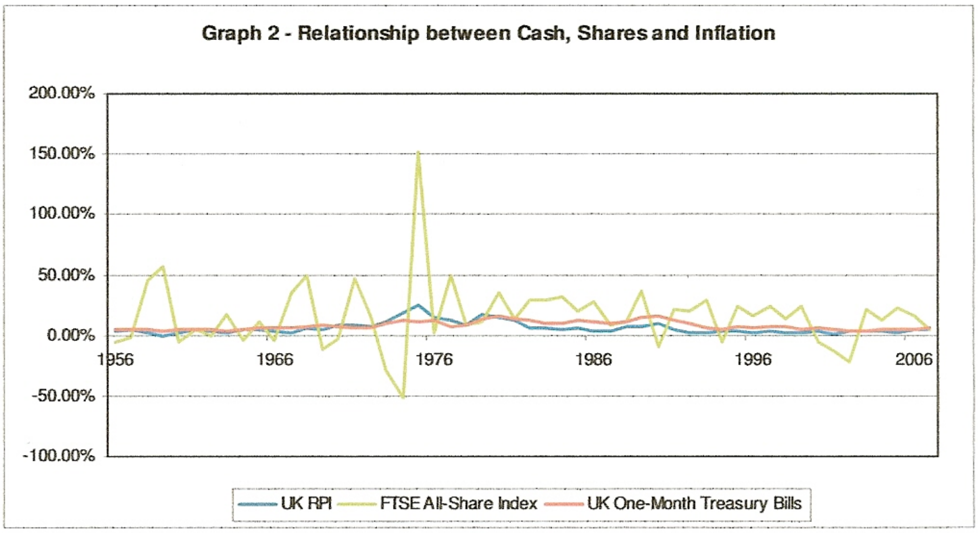
Asst Class	Nominal Returns	Real Returns
UK T Bills	7.81%	1.90%
FSTE All Share	12.77%	6.60%
S&P 500	11.17%	5.60%

While it is comforting to think of cash returning nearly 8% or UK shares returning almost 13% it is more helpful to think in real terms. If cash can provide a real return of 2% pa and shares provide a real return of around 6%pa there is a "risk premium" for owning shares of around 4% pa after inflation. This is the type of methodology we use when building client portfolios and setting assumptions for individuals' cash flow projections.

We also need to consider the relationship between various investments and inflation as well as the relationship between different investment assets. For example, do some investments do well in high or low inflation environments? Do some assets do well when certain others are doing badly?

"There is only a very weak relationship between equity returns and inflation"

Graph 2 shows there was very little discernable relationship between the returns of either cash or equities and inflation. This is borne out by the correlation coefficient which shows a moderately strong relationship between cash and inflation but a weak relationship between equities and inflation. More importantly it shows a very weak relationship between cash and equities. Therefore, a diversified strategy that owns both cash and equities stands the best chance of performing reasonably well in all market conditions. In reality a balanced portfolio would be expected to consist of more than simply these two asset classes.



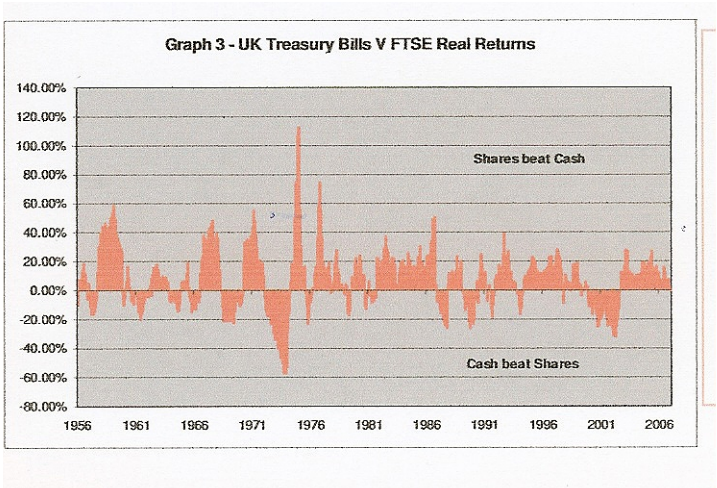
[1] Due to the compounding of returns you must divide the figures rather than simply subtract in order to arrive at a real rate of return. You must also use decimal figures rather than percentages. So, if an investment returns 8% and inflation is 3% the real rate of return is not 5% (8-3) but 4.85% ((1.08/1.05)-1) times 100 to convert to percentages

Table 3 shows the correlation between the inflation, cash and equities. A correlation of 1.00 means that the two assets perform in exactly the same way while a figure of -1.00 means they do exactly the opposite (the ultimate diversifier of risk). A figure of 0.00 means there was no relationship at all. You can see that the correlation between inflation and equities was 0.24 and between cash and equities was 0.09 so it is simply not possible to say that periods of high inflation result in either high or low returns from either asset class. However, it is possible to say that high inflation can completely decimate cash and bond investments whereas only equities and to a certain extent property can keep preserve an investors long term spending power.

Table 3

Data Series	UK Inflation (RPI)	FSTE All-Share Index	UK One-Month Treasury Bills
UK Inflation (RPI)	1.00		
FTSE All-Share Index	0.24	1.00	
UK One-Month Treasury Bills	0.63	0.09	1.00

The next consideration is whether equities beat cash on a regular basis. If so, by how much and how often? Graph 3 shows that on a rolling 12 month basis equities outperform cash in "real terms" around two thirds of the time. In our survey, equities gave a positive return in "real terms" 69% of the time and lost money 31% of the time. Cash on the other hand provided positive real returns 82% of the time and only lost money 18% of the time. However, the range of returns was markedly different. Equities provided a maximum real loss of -62.7% but a maximum real gain of 101.3%. Cash on the other hand lost 13.5% in the worst year but made only 9.1% in real terms in the best year.



There is no doubt that, over the longer term, equities offer the greatest protection against inflation. Companies producing the goods and services that are rising in price can raise prices or squeeze costs to preserve profit margins. Eventually this allows company shares to increase in value and provide "real returns" to investors. However, there is no fixed relationship between rising or falling inflation and equity market returns. The returns from equities can be extremely large and are often highly concentrated therefore it is more important to be in the market when it goes up than it is to be out when it goes down.

Rather than trying to pick the best asset class to invest in at any given time it is much more important to think in terms of the role of each asset within an overall portfolio. While cash and fixed interest investments are helpful in reducing volatility and protecting against loss of capital from stock market falls this comes at the very real risk of erosion during periods of high inflation. On the other hand equities are volatile and at risk of substantial capital loss in the short term but provide the fuel to power the engine that takes us forward on our financial journey in the long run.

Clearly, rather than worry about how inflation affects individual asset classes with a view to devising a strategy that exploits the current market conditions, the best solution is simply to diversify across multiple asset classes and sit tight for the long term. We have been through periods of extreme inflation before and lived to tell the tale why should this current market storm be any different? If anything, the current state of world markets should be an opportunity to invest.

Pre-nups up!

Research by Grant Thornton shows that the number of pre-nuptial agreements drawn up in England and Wales has increased dramatically. Their figures show an increase of 67% over the last 12 months. All very strange when you consider that pre-nuptial agreements are not enforceable under English law.

Clarification on Nil Rate Band

As we mentioned in previous updates, the changes to the Inheritance Tax (IHT) rules mean that the executors of a second-to-die spouse can claim any unused Nil Rate Band from the first spouse to die. This claim is made via an IHT 214 form during probate on second death.

This does **not** mean that you have an allowance of £624,000. It means that you have an allowance of £312,000 and can make a claim for any unused allowance, left over from the first of the marriage to die which may be up to £312,000 in this tax year. This may be semantics, but we have seen people trying to claim £624,000 when they only have an allowance of £312,000. We have also seen people who think that the allowance is now £624,000 per person, which clearly it is not.

Book of the Month

So you really think it would be great to be seriously wealthy? Well, you may think again after reading this.

Painfully Rich: the Outrageous Fortune and Misfortune of the Heirs of J. Paul Getty (ISBN: 0312135793) by John Pearson. The book is a hefty 270 pages, but is easy and entertaining to read. It tells the story of the generations following John Paul Getty and how thoroughly horrible their lives all seemed to end up. There are lessons for us all, but most of all it simply shows us that we are either happy or unhappy, and that money just amplifies what we already are.

Best Savings Selection

To get the best from your deposit based savings you often need to move the money around. Use these rates to help you with your arrangements.

Top Three No Notice Accounts

Name	Contact	£1 Gross %	£500 Gross %	£1,000 Gross %
Heritable Bank	0845 607 1212	N/A	N/A	6.21
West Bromwich BS	0845 330 0622	N/A	N/A	6.20
Manchester BS	0161 923 8000	N/A	N/A	6.12

Top Three Monthly Interest Accounts

Name	Contact	£1 Gross %	£500 Gross %	£1,000 Gross %
Birmingham Midshires	0845 602 2828	6.33	6.33	6.33
Bradford & Bingley	0845 600 8885	6.32	6.32	6.32
Kaupthing Edge	0845 1313233	N/A	N/A	6.31

Top Three Cash ISA's

Name	Contact	£1 Gross %	£500 Gross %	£3,000 Gross %
Teachers BS	0800 783 2367	N/A	N/A	6.25
Ruffler Bank	01372 736 700	N/A	N/A	6.11
Icesave	Www.icesave.co.uk	N/A	N/A	6.10

(All figures are correct for date 24/06/2008. Information taken from www.moneyfactsgroup.co.uk. Due to current market trends these figures are likely to fluctuate. Please check with the terms and conditions before opening any account. If in doubt consult with us directly as the above are for information only.)