

A VIEW FROM THE BRIDGE

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In July our Growth Fund celebrated its 5th Birthday. Over the five years to 31 July 2006, it has delivered a return of 50.9%, comfortably outperforming its benchmark and significantly outperforming the All-Share return of 32.5%. In terms of peer group ranking, it is top quartile and the 50.9% return compares with an average of 37.0% for the peer group (source: Trustnet).

This fund is one of three sub funds of the TY Investment Fund, an OEIC structure (to use that rather unfortunate acronym which stands for Open-Ended Investment Company). An OEIC is really a modern day unit trust but it does have the advantage that one can add further sub funds.

In June 2002 we added a Growth & Income Fund and an Equity Income Fund. These funds have been launched for the benefit of our existing clients (although they can be bought by anyone) with the intent of putting a more tax-efficient wrapper around a similar portfolio of company holdings to that which a client may have held individually. Additional client requirements are likely to result in our introducing further sub funds but more on that at a later date.

'Do Prime Ministers understand economics?' If the answer to that question is too easy - how about 'is it time to bring out your kipper ties?' Our first article provides the answer as we review the inflation debate.

As personal debt and insolvencies move more sharply into focus following the recent interest rate rise in the UK, we consider some of the influences of debt and leverage in financial markets.

To die and not pay any tax on your remaining wealth may sound very appealing but even if achieving a nil tax position is not practical there are ways of mitigating the amount of tax paid. Although probably only appropriate for a select few - AIM IHT investing is one possible avenue.

*Philip Todd
Director, Private Client and Charities*

*Peter Thomson
Chief Executive Officer*

I'll Be Back

'We used to think that you could spend your way out of a recession and increase employment by cutting taxes and boosting government spending. I tell you in all candour that this option no longer exists and, insofar as it ever did exist, it only worked on each occasion since the war by injecting a bigger dose of inflation into the economy followed by higher inflation as the next step.'

The sombre words of James Callaghan to the Labour Party Conference thirty years ago this autumn marked, in retrospect, a profound change in post-war macroeconomic policy. Up to this time, governments - both Labour and Conservative - had retained a core belief that by utilising a wide range of macroeconomic tools they would be able to control both the

unemployment rate and the level of inflation within the UK economy. If unemployment threatened to rise, then a touch on the accelerator and, by use of what was called the 'regulator', indirect taxes could be cut and economic growth stimulated. If inflation began to pick up, taxes could be increased and hence rising prices curbed. Bank Rate, the predecessor of Minimum Lending Rate, was also flexible at the whim of the Government of the day.

By the mid 1970s, however, this medicine no longer seemed to work. A sustained increase in global commodity prices, most notably the quadrupling of the oil price by the OPEC cartel in 1973/4 was combined with a rise in militancy from the Trade Union movement. Annual wage settlements for powerfully placed groups spiralled upwards and the era of 'stagflation' was ushered in - rising

unemployment and rising prices, at a time of stagnating or declining economic output.

Of course, despite the lurid headlines in the newspapers following the upward move in UK interest rates recently, the economic situation in the UK in 2006 is a good deal more comfortable than in the days of the Bay City Rollers, kipper ties and the Space Hopper. Interest rates at 4¾% and inflation at 2½% reflect economic conditions more prevalent in the 1950s than the 1970s. Unemployment, though, in absolute terms, is higher than thirty years ago and substantially so if claimants of long-term disability benefits are included as 'hidden' unemployed. The total number of those employed, however, has also risen due to an increase in the number of working women and higher levels of net immigration.

So, does the experience of what happened to the UK economy during the 1970s have any bearing on the world of 2006? What is clear is that the massive increase in the level of consumer debt, both secured and unsecured, over the past ten years has rendered the economy much more sensitive to what, in the past, would have been seen as minimal changes in interest rates. On 'Black Wednesday' - September 16 1992 - interest rates went up by 5% - twenty times more than the recent move sanctioned by the independent Bank of England. The effect of such a cataclysmic shift in rates today on consumer confidence and the housing market would be almost inconceivable. Fortunately, the prospect of 10% interest rates at the moment is very remote indeed but even a move up to the 5-5¼% range would cause significant problems for many over-extended mortgages and unsecured borrowers.

What is driving the current foreboding on rising interest rates is the reappearance, albeit in a muted way, of inflation. We have argued before that whilst the headline figures published by the Treasury reflect the 'official' inflation rate at a cost or retail price level, everybody has their own subjective view on what his or her 'personal' rate of inflation rate might be, depending on what lifestyle choices each individual elects to make. New computers, mobile telephones or clothing may have become noticeably cheaper in recent years, but taxis, underground fares and restaurants most decidedly have not. Levels of council tax, too, have risen substantially more than either prices or average earnings over the past decade. Overall, it is very doubtful that, given their own experiences, many people believe the official figures for inflation.

So could we see inflation back to the levels of the 1970s? One missing factor today is the diminished power of organised labour to press for inflationary wage increases backed by the sanction of strike action. Trade Union membership numbers peaked in 1979 at over 13.3 million and have been falling for over a quarter of a century. The NUM, the praetorian guard of the TUC, had over 200,000 members as recently as 1973, but is now a mere shadow of its former self. Another important difference for the private sector is the lack of pricing power in the marketplace - competition is undoubtedly more fierce in many areas of the retail market, driven by the pricing advantages enjoyed by the developing world and particularly China in electrical and finished goods. The internet has also empowered consumers to be significantly more price-aware without the chore of a weary slog from shop to shop.

Where inflationary pressures are becoming more evident is in the service sector, where utility and energy bills are becoming an increasingly large proportion of consumers' non-discretionary expenditure, petrol prices - exacerbated by the rising global oil price - and one new factor, rising university fees, a new and, in some quarters, a most unwelcome entrant into the 'basket' of goods and services used to calculate changes in the retail price index (RPI).

However, even the most hawkish forecasts for inflation in the future envisage, by the standards of the 1970s, only very modest levels of retail price inflation on a twelve month view. Nevertheless, were the RPI to rise by only 4% per annum - the top end of the forecast range at the moment - this would still imply that the level of UK prices would double in 18 years and significantly erode the real value of post-tax savings for most UK taxpayers.

Despite the enormous increase in public expenditure since 1997, the inflationary warning of James Callaghan has not yet come to pass in the more benign recent economic environment. To a large extent, the cyclicity of 'boom and bust' has been successfully averted thanks to the independence of the Monetary Policy Committee, one of the most effective initiatives of Gordon Brown's Chancellorship. So no return to the 1970s - as far as we can see. Inflation is stirring, but, by historical standards of the past thirty years, is still relatively dozy. The kipper ties and flared trousers can stay in the wardrobe for a while longer - the invitations to the 1970s inflation theme party aren't yet in the post.

**‘Give me a place to stand and a lever
long enough and I will move the world’**
Archimedes, c.220 BC

The level of personal debt in the UK has become a major talking point in recent weeks and is rapidly becoming a feature of media coverage. This has been particularly so following the latest move by the Monetary Policy Committee (MPC) to raise interest rates in the UK for the first time in over two years and reversing a decision to cut the rate a year ago. The cost of servicing debt is rising and this seems set to increase the levels of personal insolvency in the UK quite dramatically.

Whilst those who have outstanding credit card debt, which already carry a very burdensome rate of interest, will witness a small percentage change in the extremely high rate of interest they are being charged, the large community of mortgage payers will be more vividly impacted by this change and any subsequent upward move in interest rates. The number of households that moved into negative equity a little over 15 years ago is a stark reminder of the impact of increased interest rates on the country’s consumer base.

In the corporate sector, we have also begun to see evidence of the rising risk of loan defaults, as has been suggested in recent Standard & Poor’s reports which are very well respected sources in the monitoring of business debt dynamics. Although reservations from well respected commentators about excessive debt, particularly in the US and UK economies, have been present for many years, it is only now that Central Banks are increasing interest rates around the world that the associated risks are moving more sharply into focus.

However, the present interest rate cycle may, in time, prove to be a shallow and drawn out event, thus reducing the impact of any short term rate rises, as the associated or resultant imbalances quickly resolve themselves.

What is clear is that the MPC has a distinct lack of room for manoeuvre, with the slightest adjustment to policy likely to have a major impact on one or other side of a very finely balanced equation.

One part of the intricate equation is the prevailing level of debt and leverage that exist in the modern financial system. We have seen rather less discussion surrounding what we perceive to be a rapid increase in

(multi-structured) debt in many areas of financial markets, and in particular the levels of debt being introduced into complex financial transactions.

Gearing (in the corporate sense) is the ratio of a company’s debt to equity. A company with a high percentage of debt to equity (high gearing) is more exposed to fluctuations in commercial activity. It therefore represents higher risk for equity holders and should offer the potential for a greater return.

A small change in the price of a highly geared or leveraged instrument, in the right direction, can produce large profits in relation to the size of the investment but that also means that a small change in the wrong direction can devastate the investment.

Within this are the seeds of a fund manager’s current dilemma. On the one hand, the equity market has seen very high levels of acquisition activity and numerous bid premiums (that in many cases have been agreed) for an extremely wide range of assets, but on the other hand, the levels of debt and associated risks in the wider market place seem to be rising quite dramatically. Complicated structures and a more general lack of transparency are emerging and a high profile failure could have an impact on market ratings.

A good example of the type of complex structures that are budding can be found in the Leverage Buy Out (LBO) market. Here, the purchase of a company is completed using borrowed funds, with the company’s assets used as collateral (or as leverage) for the borrowing. The purchaser then repays the loans out of the acquired company’s cash flow, or by selling its assets. There is currently a growing trend for financiers to complete what are known as leveraged recapitalisations, thereby adding further layers of debt designed to appeal to a wider range of investor profile. Payment In Kind instruments and so called ‘Hybrid’ securities are examples of the types of structuring that can be expensive for companies to issue and which are highly subordinated, thus potentially ranking behind other forms of debt in what may ultimately be a long chain.

Leverage in itself need not necessarily be a bad thing given, for example, the tax shelter that debt can provide to profits and indeed, if Central Bankers do achieve their aims quickly through current policies and interest rates do subsequently begin to fall as we may soon begin to witness in the US, then the present concerns over the risks of excessive leverage should

diminish. However, complex structures and in particular the increasing lack of transparency must be considered undesirable.

AIM IHT

One of the characteristics of Taylor Young, which differentiates us from the bulk of our competitors, is our thematic approach to investment. One of our more well-established themes stems from a recognition that demographically, the age profile of the UK is changing. At its simplest, we have an 'ageing population'. - one in six people in the UK are 65 or over (source: Office of National Statistics - published 24/08/06).

In the same way that we view change as positive (and from an investment stand point identify potential investments such as builders of retirement homes as beneficiaries of this change), most of society also views this trend positively but it does mean that the 'old' have to be more careful about how and how quickly they dispose of their wealth. Many are keen to pass wealth down to the next generation or even straight to grandchildren and would like to do so at least 7 years before they die (to ensure that what would be deemed to be a potentially exempt transfer is exempt from inheritance tax) but for some, there is a dilemma - what happens if, for example, 'aged 70, I live for another 20 years or more: perhaps I will run out of money and I do not want to be reliant on my children who may have spouses with other priorities!'

For those of us in the UK subject to inheritance tax ('IHT'), there is a strong desire to minimise the amount paid - we might not get quite so agitated if we felt our taxes were going to be spent wisely and we tend to be more forgiving when it comes to our own children. Inheritance tax planning is something all of us should consider and professional advice should be sought.*

Rather surprisingly, the answer for a few may be to invest in AIM companies - yes, London's junior market where countless foreign companies involved in hot commodities or early stage technologies are listing but actually no, not in these companies. In amongst the over 1,500 companies listed on AIM, there are enough, just, to put together a relatively low risk portfolio.

The motive for this AIM investment is that certain AIM companies are eligible for business property

relief and if held for two years prior to death, then the value of these shares is effectively excluded from the Estate for IHT calculation purposes. With the rate of IHT at 40% once over the threshold (£285,000, for 2006/07), the uplift in value of wealth that can be passed on to the next generation is very substantial.

One of the distinct advantages of AIM investing, as opposed to gifting away your wealth, is that you retain control of the assets and if you end up needing capital to pay for that expensive nursing home then you still have control over that capital, albeit that the value may have changed.

One of the biggest risks is that the Chancellor, or a successor, may move the goal posts but if you are clear in your mind that you want to retain control then AIM investing is an avenue worth considering. Typically, one would look to invest in the larger, more liquid AIM companies that are profitable, have asset backing and pay a dividend. Sometimes a significant proportion of the shares in an AIM company are held by one family and indeed one or two companies have moved to AIM so that family shareholders can take advantage of this IHT relief.

There are too many risk warnings to go into here, but suffice to say that if you have 'spare' wealth but you are not quite sure how spare it is and control is important, then an AIM IHT portfolio might be for you. AIM IHT investing is a service we offer and if, having sought advice, you would like to discuss it further or if you would just like some background information, then please speak to your Investment Manager.

*IHT planning advice is provided by financial advisers. If you do not have a financial adviser or would like to be introduced to somebody new, then please speak to your Investment Manager.

Please send your views and comments on any of the articles above to Nick Rundle at:

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