



## Where is Britain's 'sovereign wealth fund'?

In our first article we consider how disciplined the UK has been with its own finances and where we stand at a time when recessionary economic influences are starting to emerge. It is perhaps not surprising that although life may be more challenging for those of us who live in the UK, for overseas investors the UK provides opportunities.

Our second article is a summary of one of the presentations at our last private client seminar. It is full of large numbers, but even if only half the billions that are talked about are actually spent over the next ten years on the world's infrastructure, it is a tremendous backdrop for many of the UK-quoted international consultancy companies.

Our third article looks at how the Capital Gains Tax system will change with effect from 6 April 2008, and also the changes to PEPs and ISAs. At a time when many are forecasting inflation rates to rise in the UK it seems ironic that the CGT system is saying goodbye to indexation – a recognition that it is fair only to tax the real increase in value (or to put it another way, the increase in value over and above inflation). Although taper relief – introduced ten years ago – was not an exact replacement, there was at least recognition that a lower level of tax was appropriate for assets held over longer periods. Although 18% is a lower headline rate, the amount of tax actually paid on disposals of pre-1998 assets may increase on 6 April 2008.

There is also a reminder that there are only a few weeks left to consider inter-spousal transfers – it is often forgotten that for assets acquired before April 1998 the book cost going forward for the receiving spouse does include indexation. But you must act quickly.

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## Debt in the modern world

**'The problem is the explosive growth of debt in all its forms in most of the developed nations and the overwhelming majority of developing countries. Of course, the existence of debt and the tendency for debt to grow through time are not new. Evidence of legally enforceable contracts in ancient Egypt and Assyria has been found by archaeologists.'**

The words of Tim Congdon, a member of the Shadow Monetary Policy committee, have a resonance with a great deal of what we read in the media today. Interestingly, though, this is a quotation from a book he wrote, called *The*

*Debt Threat*, published as long ago as 1988. Do we perhaps infer that we have grown complacent about the existence of debt in all its forms in the modern global economy, or should we now properly acknowledge that debt, and the obligations that surround its acceptance and servicing, are a crucial and necessary part of the global growth pattern of the past fifteen years? The facts are that some economies have been disciplined about debt and have been prudent and circumspect about their national finances over the economic cycles that have occurred recently. Others have not and, unfortunately, the United Kingdom is in the latter category.

## Debt in the modern world continued

One of the most fascinating aspects of economic development in the global economy in the past century, to take a longer term perspective, is how certain economies and areas of the world have managed to prosper, both in relative and absolute terms, whilst other less fortunate countries have suffered relative and absolute declines.

In the 19th Century, for example, South America was seen as a key growth area in the world and, indeed, it was an over-ambitious view of growth prospects in this area which led to the rescue of Barings Bank – which had over-extended itself through an imprudent expansion of its loan book – as long ago as 1890. African economies, too, backed by large-scale agricultural and mining interests, were seen as reliable backers of long-term debt, whilst smaller countries in the Far East, still in their development phase, were seen as risky and unreliable.

Today, though, the debt of economies such as Singapore, South Korea and Taiwan is highly rated, yet that of economies rich in natural resources in Africa and South America are accorded a significantly lower risk rating. This is clearly indicative of a massive shift of economic and political power in the modern world. A great deal of this shift has occurred in the last ten years. At the time of the crisis in world credit markets in 1997/8 (initiated by the convertibility issues surrounding the Thai baht and culminating in the effective liquidation of the assets of LTCM, the leveraged global hedge fund), many Pacific Rim economies were exposed to debt de-rating through the inadequacy of their capital reserves.

Over the last ten years, though, a key factor in world economic development has been the massive strengthening of the currency reserve bases of the so-called 'emerging' or 'developing' economies, and a substantial relative weakening of the reserve positions of the countries of the developed world. Today, the Bank of England is effectively a global pauper, not aided in the least by the decision of the former Chancellor of the Exchequer and current Prime Minister to initiate a fire sale of the country's gold holdings at below \$300 per ounce. It is indeed a sorry indictment of the economic policies of the past ten years that the combined fiscal, trade and budgetary positions of the UK economy are at such a low ebb just at the time when recessionary economic influences are starting to emerge. There is a good deal of media attention at the moment about the so-called 'sovereign wealth funds' of governments of the Gulf States

and the Far East. Even Norway has one. Where is Britain's? The sad reality is that we can't afford one.

To return to Tim Congdon's initial point, debt in the UK economy is a massively bigger issue than it was in 1988. A complacent faith in the inevitability of rising house prices accompanied and fostered by a lax policy of credit availability has created an unstable illusion of paper wealth in the United Kingdom. This is extraordinary in the sense that memories of the house-price deflation between 1989 and 1993 seem so short lived. The danger for the nation is that in having been effectively 'living beyond its means' for so long, a transition to a more stable fiscal and budgetary platform will necessarily require some form of repricing or sale of domestic assets to maintain economic confidence in the economy. This is already being seen in the effective devaluation of sterling against most major currencies and, particularly, against commodities not subject to government influence, such as gold. The great advantages that the domestic economy does retain, however, are its geographical position in the time zone between the United States and the Far East, a free-floating currency and the lingua franca for global commerce. Putting these factors together, it is reasonable to expect that – provided the UK can maintain its position as a commercial and financial entrepot between America and the Far East, and provided that capital flows are not unduly inhibited by onerous regulation or red-tape – the current indebted nature of the domestic economy in Britain may yet be propped up and bolstered by overseas investment.

This returns us to a key point about our investment policy at Taylor Young. If foreign investors are going to seek to grow their businesses and interest in the UK, and in domestically listed companies, where are they most likely to place their capital? One possible answer is in so-called 'trophy assets' within the market, and particularly in companies with asset bases not easily replicated. Real estate companies with estates built up over many years feature in this screening process, as do companies involved in the management and operation of port and infrastructure facilities. It is also hard to see entities such as National Grid or BG Group being duplicated in the near future, either. For overseas investors with a long-term time horizon, the perception of an indebted economy with a falling currency, but still possessing a number of highly valuable assets, is an opportunity for the future. But, make no mistake, it is for their future benefit and not necessarily ours. We must beware of letting such assets be sold 'on the cheap' in volatile markets for essentially short-term reasons.

## The importance of global infrastructure spend

As a thematic house, we continually look to identify trends and developments that give rise to investment opportunities. One such theme, which we discussed at our last client seminar, is that of global infrastructure spend.

Infrastructure systems across the globe are proving to be inadequate. Sustained periods of underinvestment have led

to outdated infrastructure systems in developed countries and a lack of provision in developing ones. China's logistics industry lags 2–3 decades behind that of advanced nations; yet its position in the global economy is rising dramatically, with its contribution to global growth more than doubling from 12% in 2006 to around 30% in 2008, and its presence

in international trade expanding, with a share of about 6% and 5.5% of imports. Transportation systems must keep pace as more and more Chinese people travel overseas and visitors to China increase significantly, as expected during and after the Beijing Olympic Games.

Other examples include underinvestment in the US's ageing and decaying steam-pipe systems, which have been responsible for dangerous accidents of late, and the current power crisis in South Africa, which has led to severe disruptions in the mining industry, with underinvestment evident in both maintenance and new capacity. The liquid fuel infrastructure is also under pressure, as are road, water and sanitation systems. As populations grow and their aspirations rise, such issues are likely to be exacerbated and so are expected to attract considerable fiscal and investment spend in coming years.

Infrastructure encompasses a broad range of assets, including transportation, in the form of airports, roads, rail and ports; property, including residential, commercial and social; natural resources, such as water supply, oil and gas, nuclear power and basic materials; and those associated with the environment and climate change. In short, assets which provide essential services and enhance the productive capacity of a nation's economy.

A surge in demand has been prompted by a number of factors. As populations grow and economies move away from more traditional rural industries, urbanisation and the emergence of 'mega-towns' increases demand for infrastructure. Today around half of the world's 6.5 billion population live in cities. By 2020, this is forecast to increase to 75% and by 2050 global population is expected to reach 9.2 billion – placing further strain on facilities such as energy distribution, water supply, roads, hospitals and schools. In the UK alone, Government statisticians believe the population could rise to 90 million by 2056. In capacity terms, such growth would require a city the size of Sheffield to be built every year, although we are more likely to find cities becoming larger and more sprawling as semi-rural towns and villages become engulfed. Therefore, the trend to regenerate cities, such as the King's Cross and St Pancras basin in London, will continue.

Globalisation at an industrial, financial, economic and logistical level has enabled greater participation in world markets – particularly on the part of the emerging economies. This new-found wealth has led to an identifiable

power-shift towards the emerging economies, stimulating an exponential growth in demand for infrastructure systems to support both international trade and the increasing wealth of their growing populations. Indeed the estimated infrastructure spend of MENA (Middle East and North Africa) is expected to be as high as \$300 billion in the next 10 years. India spends 5% of GDP on infrastructure, and to sustain India's future growth it is expected that \$50 billion will be spent on roads, \$70 billion on railways, \$11 billion on ports and \$10 billion on civil aviation.

Greater demand for finite resources coupled with the shifting global power balance and concerns regarding the environment have led to increased interest in energy efficiency and the development and sourcing of alternative energies. Global energy demand is expected to increase by more than 50% by 2030 if current policies remain in place and more than 60% of this is expected to come from emerging economies. The 'costs' of such demands are significant: greenhouse gases increased by 70% between 1970 and 2004 and the past decade was the hottest for 150 years. However, there has been some success in mitigating these effects. Between 1990 and 2005 a 4% reduction in carbon emissions was achieved. Set alongside 43% economic growth this can be seen as an accomplishment, but both 2020 and 2050 targets are substantially more challenging and in the UK, for example, CO2 emissions in 2006 were 1.25% greater than those in 2005.

In summary, annual infrastructure expenditure is projected to rise by nearly 50% each decade at a cost of \$30 trillion through to 2030, with greater concentration in the emerging economies, which could exceed \$1 trillion over three years. Central and Eastern Europe is expected to spend \$45 billion whilst the US will continue to under invest, with an investment shortfall of \$1.6 billion over 5 years. It is evident that there is desperate need for infrastructure spend. We therefore continue to believe that both in developed markets and emerging economies, there is considerable scope for a number of the UK-quoted international consultancy companies to participate, particularly in the key areas of transport specialisation, project management, town planning, building design/architecture, waste management, engineering, surveying, energy and environmental efficiency. Likewise, natural resources should remain in strong demand and we can expect the large infrastructure investment vehicles to play an important part in funding such spend around the world.

## Tax changes in the private client world

In the last edition of 'A View From The Bridge' we made some comments on the Chancellor's October 2007 pre-budget report, which included significant changes affecting Capital Gains Tax and the taxation of non-UK domiciled persons living in the UK, both of which take effect on 6 April 2008.\* On the subject of 'non-doms', the delays in

guidance and clarification have made planning extremely difficult and those involved in advising non-doms are likely to have their work cut out in the run-up to 5 April 2008.

On the Capital Gains Tax side, despite industry representations, the only real concession the Chancellor has agreed to is an Entrepreneurs' Relief. This relief will

## Tax changes in the private client world

continued

potentially apply if the self-employed are selling businesses or if employees and Directors, who own more than 5% of the shares in the trading company or group of companies for which they work, make a disposal on or after 6 April 2008. The relief only applies on the first £1m of lifetime gains. If a disposal or a potential disposal meets these criteria then specialist advice should be sought, but for most other chargeable disposals, the rules from 6 April 2008 are now reasonably clear. It is fair to say that calculations will generally be much simpler and the main points are as follows:

- All assets owned as at 31 March 1982 will have a base value calculated using that day's price.
- There will be no indexation relief or taper relief.
- The identification rules for which shares you are deemed to be selling will be
  - 1 Acquisitions made on the same day.
  - 2 Acquisitions made within the following 30 days (to prevent old-fashioned bed and breakfasting).
  - 3 All previous acquisitions which will go into a single un-indexed pooled holding.

In most private client sale situations the 'last in first out' rules fall away so that if you sell 40% of your holdings which were bought in tranches then you are deemed to be selling 40% of the pooled holding. The book cost of the pool is the sum of all the book costs of the various tranches, including rights issues, and if you sell 40% of the holding then the chargeable gain is the proceeds less 40% of the holding's book cost.

As we said in our last newsletter, if there are sales to be made in the near future and tax really is the most important consideration, then there are calculations to be made to decide whether to sell using existing rules before 5 April 2008 or to sell after 5 April using the new rules. But there is one course of action which should be

considered for immediate action, and that is inter-spousal transfers and transfers between civil partners of any assets acquired before April 1998 which you do not want to sell this tax year. If these transfers are made before 5 April 2008 then there are tax advantages for subsequent disposals under the new rules. Such transfers are 'deemed to have been transferred at such consideration as gives rise to neither a gain nor a loss on the disposal' – importantly the book cost going forward for the receiving spouse or partner includes indexation. So if for example a wife bought shares for £10,000 in 1982 and sells them for £40,000 in May 2010 she is likely to pay tax at 18% on a £30,000 gain, which is £5,400 (assuming her CGT allowance has been used in full). If she transfers these shares to her husband before 5 April 2008 and he then sells them in May 2010 for £40,000 he will pay tax on a £20,000 gain which at 18% would be £3,600 (because his book cost will be £10,000 + an additional £10,000 due to indexation from 1982 to April 1998 – i.e. the book cost will be £20,000). Any such transfers may have income tax or inheritance tax planning implications and so may not be advisable, but they should be considered.

One other change which was announced some time ago, and after proper consultation with the industry, is the merger of PEPs and ISAs. On 6 April 2008 all PEPs become ISAs and if you have both a PEP and a Stocks & Shares ISA with the same plan manager then the two will be merged. The maximum Stocks & Shares ISA investment per tax year rises to £7,200 with effect from 6 April 2008 and ISAs are to be available indefinitely. Furthermore, from 6 April 2008 it will be possible to transfer any previous years' cash ISAs into a Stocks & Shares ISA without affecting the current tax year allowance. The names 'Mini' and 'Maxi' ISAs disappear to be replaced by Stocks & Shares ISAs and Cash ISAs. The maximum cash ISA saving per tax year rises to £3,600. Our industry has been calling for the amalgamation of PEPs and ISAs for many years and it is good to see it coming to fruition and we welcome the fact that the present government see ISAs as a permanent savings vehicle.

\*Tax 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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