PARAGRAPH

THE NEWSLETTER FROM PARADIGM NORTON

WINTER 2010

From Cottage Industry to the Emergence of a Profession?

Financial planners and advisers are typically a disparate group, operating a myriad of different business models and ways of delivering advice to clients. The sector as a whole is characterised by poor levels of service, and a recent PWC report highlighted that the advice given by the UK private banks was typically geared more in their favour than in the interests of their clients.

The FSA has recognised that this situation cannot continue and that radical change is required. The recent banking crisis has further reinforced the need for change and the need for all UK FSA regulated businesses to be more financially robust.

In 1986, financial services went through a revolution when the Financial Services Act was introduced. Finally the regulator had recognised that selling double glazing on Friday and pensions the following Monday was not exactly a recipe for good and technically accurate advice. Other than the introduction of the concept of 'independence' and numerous changes of regulators; we have seen minimal change since that time.

This is all about to change. In January 2013 the landscape for businesses offering regulated investment advice will change for ever. The most radical and sweeping changes proposed by the FSA include:

- the abolition of the current commission structure for investment related product sales where a 'product provider' effectively pays the adviser for selling his products
- the requirement, as a result of the banking crisis, for regulated businesses to hold much higher levels of capital and reserves
- the requirement to hold much higher levels of professional qualifications in order to be allowed to give regulated investment advice to clients

The impact of these significant changes will be enormous. Most commentators are of the view that UK adviser numbers will fall by at least 25% (12,000 advisers) over the next two years, primarily as a result of many either not being prepared to take further examinations or not being able to pass the more rigorous examination regime.

So, what does this mean for Paradigm Norton? Well, not much change in reality. We have worked on a fee basis since day one, whereby, we have always agreed our remuneration tariff directly with our clients, rather than a product provider.

With two Chartered Accountants overseeing the Paradigm Norton finances, we have always sought to be well capitalised, avoid the need for a bank overdraft and run our own financial affairs in a low-risk and prudent manner. The strategy for the company finances reflects the counsel that we give to our clients. So no change here either.

When it comes to professional qualifications we set the bar at its highest level. The new standard has been set at QCA (Qualification Curriculum Authority) level 4. The standard set by Paradigm Norton internally has always been level 6, with the adviser team either being Certified or Chartered Financial Planners or both. There will be what the FSA are referring to as the need to 'gap fill'. This simply requires that additional CPD (continuous professional development) is undertaken over the next two years to ensure that knowledge of some of the more obscure areas of financial planning that may not be routinely examined through the traditional route to level 4 and beyond is achieved. Once again this will have minimal impact on the Paradigm Norton team.

We welcome and support the changes proposed by the FSA and we hope that the current requirements are not watered down through lobbying from the banks. UK consumers are typically poorly served when it comes to financial advice, and our hope is that these new FSA proposals will move us a step closer to the day when advisers will be recognised by the public as a profession.

Barry Horner – CEO

The End of the Holiday?

I am sure that most of you will be aware of the favourable tax rules that apply to 'furnished holiday lettings' (FHL) – where a rental property satisfies certain conditions, it is notionally treated as a trade for tax purposes and, as a result, various income tax and capital gains tax reliefs are available to FHL properties, which are not available to rental properties generally. In particular, losses on FHL properties, are available to set against other income, and capital gains are taxed at a lower rate. This has made it very worthwhile to ensure that, where possible, second properties or holiday homes satisfy the FHL conditions.

These beneficial FHL rules were due to be entirely withdrawn from 6 April 2010, but in the June 2010 Emergency Budget it was announced that they would continue after 5 April 2011, but subject to new rules. These are expected to be confirmed before the end of 2010.

Under the new proposals the qualifying conditions for furnished holiday lettings will be tightened up by increasing the minimum period that a qualifying property must be actually let, to 105 days instead of the current 70 days, and increasing the minimum period that the property is 'available' for letting in a year, from 140 days each year, to 210 days.

HM Revenue and Customs argues that these new conditions more accurately reflect the modern tourist industry, where there is a widened letting season with variations of school holiday periods and an increase in Christmas, Easter and half term lettings.

The current proposals also restrict the use of FHL losses so that losses made in a UK or European Economic Area FHL business can only be set against profits from the same FHL business.

The new proposals also formalise treatment of capital allowances when a property qualifies in some tax years, but not in others.

Under the existing rules it has been relatively easy for individuals to have a holiday home, use it for three weeks themselves in the school holidays and still manage to let it out for the ten weeks required to satisfy the FHL conditions. They can then take advantage of the favourable tax regime, including setting losses against their other income. However, under the proposed new rules this is going to be far more difficult for locations where the holiday season is restricted; for example at UK seaside locations (who wants to go to Skegness in February?) and in foreign resorts such as in Greece where there is a 'closed' season.

Even if properties do manage to satisfy the new stricter conditions to qualify as an FHL, the restriction of the use of the losses is going to come as a big blow. At least we can console ourselves that it looks as if the capital gains tax reliefs may be here to stay – but we need to wait until the proposals are confirmed before this is a 'dead cert'!

Tracy Clamp – Tax Consultant

"The staff and directors of Paradigm Norton would like to take this opportunity to wish you all a very Merry Christmas and a prosperous New Year. As usual we continue to support, in David Norton's memory, Bristol-based charity Hammer Out by way of a Christmas donation."

Christmas Shoe Box Appeal

Once again this year, we supported the Samaritan's Purse Christmas Shoe Box Appeal. The Paradigm Norton team and their families have wrapped and packed 56 shoe boxes with small Christmas gifts which will find their way to the little hands of orphans and vulnerable children in Belarus.

This is a big improvement on our first year when we sent 14 boxes! It is too late to get involved for this Christmas but there is always next year....

www.operationchristmaschild.org.uk/about

Tracy Clamp – Tax Consultant

Overseas Financial Planning

According to figures provided by the Institute of Public Policy Research (IPPR) there were 594,000 British pensioners living abroad in 1991 and this had grown to over a million by the beginning of 2006. The Foreign & Commonwealth Office estimate that 38% of over-55s are planning to relocate in the next few years.

There are many reasons why people retire abroad, and the weather tends to head the list. Other reasons include the lifestyle abroad, the high cost of living in the UK as well as the high tax rates. In addition, many people come to the UK to work, and retirement is often the time they look to move home.

Whatever the reason, we believe that retirement abroad does not necessarily mean the end of high-quality UK-based financial planning. Indeed, the decision to retire abroad will often require a high degree of advanced planning, and having a suitable retirement plan in place is essential.

Once the move abroad has been made it is still necessary to regularly review the retirement plan in conjunction with the management of pension and non-pension assets so that expenditure needs can be met.

Our research suggests that financial planning advice is often extremely limited, especially in Europe and the Far East.

One development that has increased in popularity over recent years is the Qualifying Recognised Overseas Pension Scheme (QROPS). This is a pension policy that enables an individual who has left the UK (or is about to) to transfer their pension benefits away from the UK. Once that individual has been non-resident in the UK for five years or more there is no requirement to notify HM Revenue & Customs (HMRC) of any payments from the plan. There are a number of advantages associated with a QROPS:

- Pension benefits are not subject to UK income tax and there is no need to complete a double taxation claim form.
- It is generally possible to leave any remaining pension fund to one's heirs.
- As with a UK pension, there is no need to purchase an annuity.
- Any pension income can be paid in local currency, e.g. Euros, and a suitable investment strategy can be implemented to facilitate this.
- QROPS members are no longer subject to the Lifetime Allowance Charge.

It is extremely important to consider which QROPS provider to use and in which jurisdiction it is based. We have seen some alarming articles recently regarding Hong Kong-based QROPS losing their tax status and potentially incurring their members punitive tax charges. We would generally favour a jurisdiction such as Guernsey which has strong ties with the UK as well as a demonstrable record of dealing positively with HMRC.

It is also important to remember that clients who live outside of the UK should seek local tax advice. Where we are asked to provide financial planning advice for clients outside of the UK, we will always work closely with their tax adviser.

As we prepare for the daily commute, scraping the ice off our car windscreens, wrapped up in scarves and gloves, it is often tempting to imagine living in a warmer climate with a much more laid-back lifestyle. If one of your goals is to retire abroad, then you will need a robust retirement plan and this is an area where we can certainly help.

Matt Kneller – Senior Financial Planner

Mount Kenya Trek

www.justgiving.com/leeandmatt-mountkenyatrek

Two of our Senior Financial Planners, Lee Dunn and Matt Kneller, will be climbing Mount Kenya in February to raise funds for the Paradigm Norton Trust.

One of the charities that the Paradigm Norton Trust supports is The Nest. The Nest is based in Limuru in Kenya and helps to prevent the children of imprisoned mothers from fighting for survival on the streets. It is often the case that single mothers in Kenya can be imprisoned for 'petty offences' such as selling vegetables to support their families. Once they are imprisoned, the children are often left to fend for themselves and this is where The Nest steps in. The Nest rescues affected children and improves their living conditions during the imprisonment of their mothers.

Lee and Matt are hoping to raise as much as possible in sponsorship and are funding the costs of their expedition themselves to ensure that 100% of any funds raised go directly to The Nest.

We know that there are so many deserving causes to give to, but if you would like to sponsor Lee and Matt please visit their "Just Giving" site at: www.justgiving.com/leeandmatt-mountkenyatrek

Lee and Matt are aiming to visit The Nest whilst in Kenya and we will report back to you in a future edition of Paragraph.

Further information on The Nest can be found at www.thenesthome.com

Will Driver – Financial Planner

The Responsible investment trade-off

Some of our clients choose an ethical investment approach, opting to exclude 'sin stocks' such as tobacco, alcohol, armaments etc from their portfolio. This is a noble approach and is to be commended, but is not costless. The purpose of this article is to demonstrate the trade-off that is made in terms of lower expected portfolio returns and also higher portfolio risk. Let's try to quantify this trade-off. While you might not change your mind about how you invest, we hope you'll be more informed about your decision.

In an ideal world we would apply our standard low-cost investment strategy to responsible investment by investing in ethical index funds. In theory there are perfectly acceptable benchmarks that could be tracked. For instance the FTSE4Good index excludes sectors such as tobacco and armaments. FTSE also has a responsible investment unit which undertakes a global engagement programme of continuous dialogue with global companies to promote corporate responsibility standards. Unfortunately while a promising benchmark exists there are currently no funds available which track this benchmark (Cooperative Bank used to offer a FTSE4Good tracker, but it has since been closed to new investment).

Consequently, the only option when putting together an ethical portfolio is to use expensive actively managed funds. Let's compare costs. Our standard portfolios use the Vanguard UK Index fund with an annual management charge of 0.15%. If we compare this to a typical ethical fund, with a total expense ratio of 1.15% (net of the 0.5% trail commission that active funds pay to financial advisors), then a 1% cost differential might be a realistic figure.

Management fees are the visible costs. Trading costs are the hidden costs of investing and are much higher for active funds compared to index funds. This is because they trade much more heavily in their effort to outperform the market. In practice it would be fairly typical for an active fund to add a minimum of 0.5% p.a. in additional costs through much heavier trading. Combining the higher management fees of 1% and the additional trading expenses of 0.5% gives an estimated total extra cost of 1.5% p.a.

What is the impact of a 1.5% p.a. reduction in return over 30 years? If £1 million is invested in a low-cost efficient portfolio and produces 7.0% returns p.a., it will grow to £7,612,255. By contrast, if an equivalent ethical portfolio forgoes 1.5%, it grows by 5.5% p.a. to £4,983,951. Clearly the potential opportunity cost of the ethical approach is not trivial. The compounded difference is 35% or an extra £2,628,304 over 30 years.

A further problem faced by an ethical investment strategy is that it is limited to a much reduced option set of asset classes. We have not, for example, found ethically screened funds for small cap, value, or emerging market funds. By excluding these crucial asset classes from the portfolio we would expect it to suffer potentially reduced returns.

When you exclude areas of the market for investment the other trade-off is additional risk. You now lower the diversification potential of the portfolio and thus increase portfolio risk. From a portfolio efficiency perspective 'sin stocks' are likely to play a valuable role. For instance, tobacco companies have useful non-correlation properties in that they might be expected to hold up better than average in a recession: generally smokers will still smoke.

So what should you do? Let's summarise the responsible investment trade-off:

1. Invest ethically with a clear conscience, but compromise your returns through higher costs and less diversified portfolios.
2. Invest efficiently and enjoy the best returns possible, but compromise your principles.
3. Some of our clients have a third way: invest in the more efficient market portfolio to produce higher returns, which ultimately generates more to give to charitable causes.
4. Elect to take a positive approach. Perhaps 10-20% of the portfolio might be earmarked for causes that can create positive change, such as microfinance, forestry and renewable/clean energy.

There are no right or wrong answers to this conundrum and we cannot tell clients which route to take. It is a question of conscience and a question of personal choice; like ice cream flavours - you can't say chocolate is better than vanilla.

At the moment, we do not believe there is an ideal ethical solution but we are hopeful that better options will become available in the future. For instance, Dimensional run a sustainable portfolio in the USA, which gives investors the opportunity to take the ethical route without such high active management costs. There are plans to launch an equivalent fund in the UK at some stage. We're also talking to Vanguard and iShares about options. We'll keep you posted on developments.

Lee Dunn – Senior Financial Planner

Paradigm Norton Paradigm House, Macrae Road, Ham Green, Bristol BS20 0DD
Tel: 01275 370 670 • Fax: 01275 370 671 • Email: info@paradigmnorton.co.uk • Web: www.paradigmnorton.co.uk
Paradigm Norton Financial Planning Ltd is authorised and regulated by the Financial Services Authority
Registered office: Paradigm House, Macrae Road, Ham Green, Bristol BS20 0DD Reg. No: 4220937 England

All articles in this newsletter are of a generic nature and are not designed to be read as specific recommendations or advice.
If you would like advice on any of the areas covered, however, please do contact us to discuss a strategy that is appropriate to you, your goals, and your circumstances.