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H&P Review

GOING FOR GOLD

Investing in metal or mining

PLUS: Europe

Is now the time to invest?

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ISSUE 6

> *The number out of work for more than a year is now 904,000, the highest since 1996.*

Welcome to the latest edition of H&P Review, the Holden and Partners newsletter. As we are all very much aware, the domestic and global economic situation remains fragile, whilst the European debt crisis rumbles on with seemingly no end in sight.

The UK has now been in recession since the last quarter, with the most recent data showing that the economy contracted by 0.5% in April to June of this year. Worryingly, the number out of work for more than a year, according to official figures is now 904,000, the highest since 1996.

And yet, despite this gloomy backdrop, the UK stockmarket has proved to be fairly resilient, having moved between 5,500 and 5,900 points since the start of the year. So where should investors look for value and opportunities? This question is probably harder to answer than ever, however in this edition of H&P Review we look at two areas in particular- gold and Europe. Is it time to start looking at European stocks as value investments? And is it too late to invest in gold or should investors consider gold based shares instead?

We also look at the possible impact of the Retail Distribution Review on financial advice generally, and for those clients who are self-employed, we consider the merits of a Limited company versus self-employed status. We also include articles on the emerging field of geothermal energy and the rising costs of long-term care.

As always, please feel free to contact us if you have any questions regarding any of the articles we have included. Your views are important and we always welcome any feedback.

If you would like or prefer to receive a PDF version of our magazine in the future please email us at ewinn@holden-partners.co.uk

Getting Older and More Expensive

The Rise and Rise of Long-term Care Costs

Research shows that as life expectancy in the UK rises, the number of people who will need to make use of formal long-term care services will grow from 840,000 today to 1.1 million by 2025 - an anticipated 37% increase. Furthermore, 11.5 million Brits are expected to need to use their property to cover the cost of care in their later years.

On top of this, it is predicted that the average annual cost of long-term care will rise by £7,000 to £33,000 per person in real terms per year by 2025 – that's a 27% increase, taking the cost to a staggering £38 billion a year.

Currently, 52% of those in formal care receive it in their home (domiciliary care), whilst 48% are cared for in a residential home.

For residential services in nursing and care homes, currently those with assets worth over £23,250 are not eligible for government support. With the average wealth, including assets such as investments, savings and property after mortgage of those over age 55 in the UK currently just over £32,000, many would have to fund the entire cost of care themselves with no help from the state, decimating their savings and what some consider to be their lifetime's work.

Whilst some will receive support from their loved ones, avoiding the need to pay for care themselves, worryingly almost half of those expecting to fund care for others have not thought about how they will pay for it.

Nearly one in five believe they will have to fund the cost of their own long-term care in the future, with a quarter expecting to fund this from their property, either through equity release, re-mortgaging or selling their home.

The main reasons for the rising cost in the future include women working later in life when they traditionally would have provided care; families increasingly living further apart, lessening the option of care within the family; and most significantly, the rapidly increasing elderly population who are living longer, putting additional pressure on the care infrastructure.

This all leaves the UK facing an uncertain future on the funding of long-term care. Low interest rates and rising living costs continue to be a problem, creating additional financial worries.

If you are concerned about care in your later years, our advice is to consider the options now and plan ahead.

Article by Mark Dodd.

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Going for gold

Metal or mining?

For many investors, gold is an accepted part of the investment universe, but perceptions of its value as an investment are heavily divided. **Article by Robert Allinson.**

"Gold is real money and a store of value". In principle, this is a credible statement because, unlike currency, gold is not simply the liability of a central bank and therefore cannot be 'printed' and debased. But like equities, bonds and property, the gold price has over time been subject to powerful upward and downward market trends. Frequently, the time when the investment case looks the most compelling is when it's too late. All of the good news is already reflected in the price.

'Bull-ion up'

During the 1970's bull rally, Vietnam related spending, price controls, a US dollar devaluation and an oil shock, created rampant inflation. The gold price rose from $35 to $850 /oz. The catalyst for this period is often referred to as the 'Nixon Shock' when President Nixon ended the convertibility between US$ and gold without consulting members of the international monetary system.

Gold 'bears' down

Gold then entered its bear decline in the 1980's and 90's, which saw the price plummet back to $252/oz. The US dollar rose sharply as the central bank hiked interest rates to 20%. Additional downward pressure was also exerted by non-US central banks (including the BoE), who sold down gold reserves in exchange for paper currencies.

Whilst the precise drivers of gold during these periods can be linked to real interest rates and movement in the US dollar, the common denominator is inflation. Interestingly, what differentiates the latest bull rally from that in the 1970s, is that the reduction in value of the US dollar has not resulted in consumer price inflation. This process has been prevented both by the dollar's reserve currency status and by the mercantilist policies of Asia, where countries including China have 'pegged' their exchange rates to the dollar. The result, rather than a price increase in consumer products, has been a transmission of inflation into real asset prices, such as commodities and real estate.

For many years, commentators talked of a perfect 'goldilocks' scenario where western economies exhibited moderate growth and low inflation, however, this came to an abrupt end with the banking crisis, the Arab Spring and latterly, the Eurozone meltdown. Undoubtedly, the price of gold already reflects many of these problems, having risen more than fivefold since 1999. Yet, in order to at least match its prior high on an inflation-adjusted basis it would have to exceed $2000 /oz.

A price of $10,000 would be needed in order for America's entire stock of outstanding dollars to be fully backed by gold, as it traditionally was. So with these factors one can see that there is still potential for gold to reach greater heights.

Debts and deficits have exploded in developed economies as governments, believing that 'goldilocks' was a new paradigm, have spent beyond their means. In response, central banks have drowned the system with liquidity and started printing i.e. monetising private and public debt. This has resulted in paper money being de-valued relative to real assets. This results in wealth being confiscated from savers and debt burdens being inflated away. History shows that this process of debt reduction normally takes 10-15 years from the peak in the debt cycle (2008).

Physical demand for investment purposes has increased significantly in recent years, yet gold held for investment purposes still represents only around 1% of global financial assets. More importantly, there has been a significant shift in demand in China – even though China is the world's largest gold producer, very little gold leaves the country and its imports have jumped sharply, rivaling that of the biggest consumer, India.

Illustration by Chris Radley.

Central banks became net buyers of gold in 2010 for the first time in 20 years, removing a large supply from the market. Importantly, China announced in 2009 that it had quietly doubled its gold reserves to 1054 tonnes, whilst also that year India raised its reserves by 56%. Other official buyers of note include Mexico, Russia, South Korea, Thailand, Turkey and the Philippines.

So how attractive is gold based on current prices compared with gold mining shares?
The obvious advantage of a mining company is that it offers additional potential for return i.e. profits AND dividends. But as a sector, the shares have failed to keep pace with the metal over the last 10 years. This can be attributed to mines hedging their forward sales, rising production costs and poor capital management. Country-specific risks have also impacted.

Undoubtedly, today, mining businesses are in better shape and margins have improved considerably, so much so that share prices today appear undervalued if gold can remain at these levels. Consequently, mining shares offer a potentially lucrative way of benefitting from an extended period of rising gold prices, however, the higher volatility of this asset class, together with its close correlation to other equities, offers little protection against short term risks and requires a much longer time horizon. In contrast, physical gold potentially offers returns which are less correlated to other assets and on this basis, its diversification value should be superior.

The economic conditions that have driven the latest gold bull run remain firmly intact. Indeed, as policy makers continue to intervene more and more in 'free' markets in order to support the financial system, the merits of physical gold become more compelling. In the short term, the greatest threat to the gold price is an uncontrolled unraveling of the euro-area, or an attempt by euro members to introduce capital controls. Both scenarios would produce a huge flight towards the US dollar which could undermine gold. Logically, however, this would be a temporary phenomenon because the 'shock' to the US of a soaring currency would provoke further debasement. In these uncertain times, it seems gold remains an important and distinctive part of a diversified portfolio, whilst gold mining shares offer an interesting "value play".

The impact of RDR

Back in the February 2011 issue of H&P Review we featured an article on the Retail Distribution Review (RDR) and its potential impact on both advisers and clients. We can already see some of the effects of RDR taking place; for example in banks withdrawing from the provision of investment advice although the deadline is only a few months away. The new rules take effect on January 1st 2013. Signifcantly, there seems to be some uncertainty as to what type of advice consumers will actually receive – independent or restricted.

What is the difference between being an' independent' adviser and a 'restricted' adviser?

An independent adviser will be able and expected to advise on all investment and pension products and will recommend products from across the whole market whilst those advisers offering "restricted advice" will – as the name suggests – offer a more limited service. In theory this sounds straightforward, but in practice there are likely to be different types of advice, possibly blurring definitions. For example, many stockbrokers will decide to be "restricted" on the basis that they provide advice primarily around the buying and selling of shares. Some IFAs currently call themselves "independent" but for example specialise in Inheritance Tax or Long Term Care and will therefore opt for "restricted" advice.

Some "restricted" advisers will effectively be salesmen just selling one company's products. However, those that recommend from a broad spread of product providers, in the ISA market, for example, but don't offer structured products, will still have to call themselves "restricted advisers" although they will be offering a far more comprehensive service. Likewise, there may be a similar gulf between the experience and technical knowledge of a firm of Chartered Financial Planners and a firm of independent financial advisers who hold the minimum level of RDR compliant qualifications.

We remain 'independent' to ensure a continuing high standard of service

At Holden and Partners we have always taken the view that we want to provide a comprehensive level of service and our clients tell us that's what they want. So the issue of being restricted or independent was never going to require a great deal of consideration. It has to be the independent route for us. This is what we have always provided and will continue to provide.

Interestingly, in a poll of 2,000 individuals by YouGov on behalf of Deloitte, 84% are not even aware of the Retail Distribution Review, and that from the beginning of 2013 they will have to pay for financial advice. One of the impacts of RDR is that the advice gap (the shortfall in the amount of advice required and that provided) will actually increase. This is perhaps an unintended consequence of the changes brought about by advisers leaving the industry and those left focusing on wealthier clients. Indeed, there are concerns that the attempt to improve standards could see a swathe of people excluded from financial advice altogether.

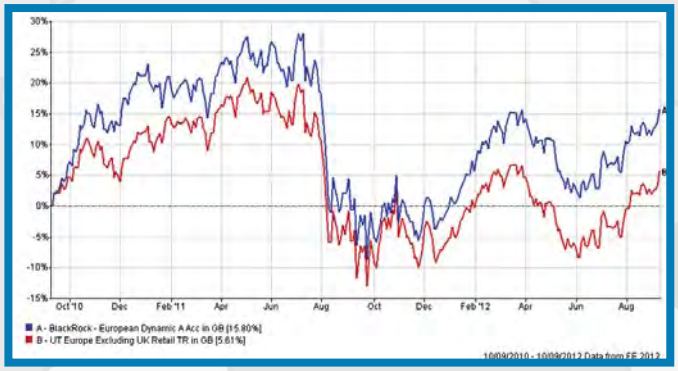
The main issue is that those on lower incomes won't be able to afford the fees that better qualified financial advisers will charge. This problem has been exacerbated by the fact that many high street banks appear to have pulled out of the advice market. Barclays, Royal Bank of Scotland (RBS) and NatWest will still sell investment and pensions, but won't offer any advice on them at all – it will be left to consumers to decide what, if any, product they need.

Europe

Is now the time for the brave to invest?

Less than 2 years ago, markets where rising, investors were happy, then with the aftershocks arising from Lehman Brothers and Goldman Sachs, confidence fell away rapidly and the rest is history. Economies around the world went into decline, most notably Ireland, Greece and Portugal, followed by Spain and Italy.

From a low point in October 2011, as demonstrated in the chart below, we have seen a modest recovery, punctuated by periods of retrenchment. Even our most favoured European managers, who have consistently outperformed the market are still demonstrating fund values significantly lower than the heights of August 2010.



Many European equity investment managers are now looking to increase their sector exposure. They consider that Europe has become a more fertile hunting ground for investors who are looking for good value, through high quality companies with the potential to generate attractive levels of income. So, is it time to follow suit and increase portfolio holdings in this diverse sector?

Whilst there may still be more questions than answers, with many quality stocks having been oversold as investors ran for cover following the well publicised economic events across Europe, for the brave of heart, there are currently opportunities to buy at significant discount.

At the same time, Europe offers the highest dividend yield of all developed markets. For those seeking to boost income in this record breaking low interest rate environment, the enhanced yield and cash return to shareholders surely cannot be ignored.

There are both positive and negative factors to consider:
Macro Outlook – macro economic momentum has been weakening in both the US and Europe over the last 6 months, which is likely to lead to further economic weakness in the coming months.

Political Outlook - investment markets have two clear political requirements to restore confidence in Europe, a clear commitment to sovereign debt reduction and the recapitalisation of the European banking system. Unless Europe moves towards greater fiscal and political integration, the crisis has the potential to widen further, and the possibility of any of the following:

- Eurozone break-up
- Widening of the sovereign debt spreads increasing refinancing pressure
- Spain needing a bail out, with the risk of contagion to Italy and France
- A banking collapse, with increased bank failure as liquidity dries up

Until one or more of these scenarios pans out, the political indecision and widening sovereign spreads will continue to feed a high state of uncertainty, which in turn impacts both consumer and business confidence, leading to a deteriorating economic outlook.

With the ECB voting recently to maintain the benchmark interest rate at 0.75% and still no clear direction on how Europe's problems will be resolved, there may well be more bad news to come, which could damage market confidence further, though this may well have already been factored into the market.

So with these significant concerns, can you justify a decision to increase your European investments? Well, there are some positives, to counter the negatives.

Corporate Earnings - the weakening euro is improving prospects for exporting companies, while weakening commodity prices have eased pressures on inflation and costs, helping companies build earnings. One example of this is the strengthening Chinese renminbi as a result, Chinese customers are increasingly buying their luxury goods in Europe and with tourism rising, certain sectors are reporting strong sales growth.

Investor positioning - European equities remain extremely attractive on a historical valuation basis, attracting the attention of value, contrarian and income investors, looking to take advantage of the price distortion.

For those prepared to ride out the storm and with a long term view, in our opinion, there are obvious opportunities. However, with economic conditions still fragile, unless you are prepared to take a gamble, it could be some time before investing in European is considered as a justifiable component of your investment portfolio.

Article by Mark Dodd.

Geothermal

Deeply interesting

Geothermal energy refers to the heat that is naturally present below the earth's surface. This energy can be converted into electrical power (GeoPower) or used directly as heat. Geothermal energy isn't new, but in an age of global warming and high fossil fuel prices there is renewed interest in its potential.

Geothermal energy is essentially renewable and has minimal CO2 emissions. There is a lot of thermal energy under the surface, although only a small proportion of this is accessible today. GeoPower has an advantage over most other renewable energy sources, particularly solar and wind, in that it can produce power nearly all of the time. A geothermal power plant will deliver power about 95% of the time; compared to only about 40% for wind and 15% for solar.

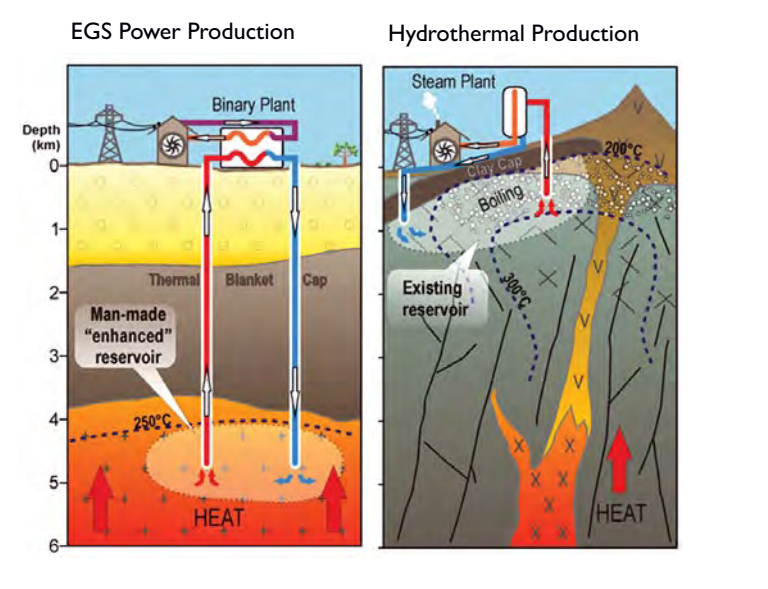
Geothermal energy can be extracted from naturally occurring sub-surface aquifers after drilling to a depth of a few thousand metres. These 'hydrothermal' sources occur near geological fault lines, such as the San Andreas fault in Southern California. These provide the best geothermal resources because naturally occurring high temperature fluids exist at modest depths which can be 'produced' economically. Where these resources exist there is already a substantial geothermal industry: in California geothermal energy supplies about 5% of the States' total electricity demand. However, these resources are geographically limited and this restricts the global growth of the 'geo-power' industry.

A second source of geothermal energy is called 'engineered', or 'enhanced geothermal systems' (EGS). EGS do not need to be close to fault lines but are created artificially by engineering a sub-surface flow system at depths over 4km, (much deeper than hydrothermal systems)and introducing a fluid to transfer the heat to the surface. EGS is relatively new and there are few commercial examples today, but it offers enormous future potential growth for the industry.

The challenge to the commercialisation of EGS is part economic and part technical. The commercial challenge arises because drilling deep is expensive. There is now a considerable effort underway to develop technologies which will reduce the cost of deep drilling in hard rock types where the best EGS resources are found.

The technical challenges arise from the need to create flow channels in the rock so that the working fluid can extract the heat to the surface. This may require hydraulic fracturing, the use of which causes debate among scientists and the public. However, in spite of this, the current government has recently approved its use. Significantly, there is a lot of work to do to refine this technology and win public acceptance of its use.

Two EGS projects are under development in the UK. EGS Energy Limited and Geothermal Engineering Limited are both trying to use geothermal heat from granite rocks in Cornwall. If these projects can succeed, it would be a tremendous endorsement for the technology and possibly lead to further projects, or expansion of these initial ones, to give UK a reliable new source of renewable, low carbon power.



The geothermal energy industry is one to watch. It does however require more government support until the economics of EGS are improved through technical innovation. The industry would also benefit from the involvement of major oil and gas companies. Several are now looking, and these crucially will have the subsurface skills and financial strength to catalyse the industry development. Things may be heating up sooner than many think.

Article by Andy Tomkins, Director of Atomki Limited.
Andy specialises in developing business strategy and managing change. He has been evaluating the business and technical potential of geothermal energy for the last two years.

Save tax by incorporating

If you earn £40,000 or more as a self employed person or as a partner in a partnership you may want to consider forming a limited company. The potential tax and National Insurance savings can be very attractive.

HOW THE TAX SAVING WORKS

As a director and shareholder of a limited company, we would suggest that your company pays you a salary of £7,200 per annum. If you have no other source of income you would not pay any tax on your salary as it is below your personal allowance. At this level of salary no national insurance contributions are payable, either by you or by your company. However, £7,200 is enough for you to qualify for the basic state retirement pension. Your company obtains tax relief on your salary of £7,200 by claiming it as an expense in its own accounts. No doubt however, you need more than £7,200 pa to live on! Any further monies that you need to draw from your company can be paid to you as a dividend. No tax at all is paid by you on the first £30,900 of dividends if you have no other source of income. If you need more income you pay tax at only 25% (not 40%) on dividends in excess of £30,900 (above £135,000 the tax is 36%).

TAX SAVED

The overall tax savings are as follows:

TAXABLE INCOME	SAVING
£40,000	£2,999
£50,000	£4,257
£75,000	£4,757
£150,000	£7,566

If you have a low earning spouse, gift her some shares in the company and she can receive dividends of up to £30,900 and pay no tax at all on them. That's £30,900 that you don't need to draw, so if you would have paid tax at 25% on those dividends you have saved yourself £7,725 on top of the savings figures above.

The above figures assume that you draw out every penny of the company's profit. If you are a higher rate taxpayer, leave £25,000 in the company and your personal tax bill goes down by a further £6,250.

So if you are a self employed higher rate taxpayer at present, form a company with you and your spouse as shareholders, leave £25,000 in the company, and save tax of close to £20,000 – every year.

GOODWILL

If there is genuine "free goodwill" in your current business it can be sold to your new company at market value. In most cases the tax payable by you on the sale would be only 10%. And you can deduct your annual capital gains tax allowance (CGT) of £10,600. Your company can write off the goodwill over, say, 10 years and actually claim tax relief on it. If your free goodwill is £100,000, you would pay CGT of £9,000, your company would save tax of £20,000 (£2,000 each year for 10 years) and you would be entitled to draw £100,000 out of your company whenever you wanted completely tax free, enabling you to reduce your dividends and save additional tax.

ANOTHER WAY TO SAVE TAX

Do you have a room in your house that you use for your work? If so your company could pay you rent for the use of that room. Suppose the market rent for an office the size of your study is £200 per month - £2,400 pa. Add up your total house costs for a year – mortgage interest, electricity, gas, council tax, water rates, insurance, cleaning, repairs and maintenance. If your study is one room out of five main rooms, divide your home costs by five. Suppose this comes to £2,500 pa. Using the above figures you make a loss of £100 – by receiving rent of £2,400 and incurring costs of £2,500 – so you have no income tax to pay. But your company is entitled to charge the rent paid to you of £2,400 against profits in its accounts and save corporation tax of £480 every year. Make an agreement between yourself and your company to include a restriction that the office can only be available to the company for designated hours each week. With this in place there is no possibility of you having a CGT problem on a future sale of your home.

This article has been prepared by Philip Friede of Philip Friede & Co Ltd. Philip specialises in the accountancy and taxation affairs of self employed persons and owner managed companies. He can be contacted on 020 7269 6575 or at philip@philipfriede.co.uk

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