



BIRCHWOOD  
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NEWSLETTER  
J U L Y 2 0 1 1

## Junior ISAs

Six million children who missed out on child trust funds (CTF) because they were born before the scheme was launched, or after it was scrapped, will be able to invest in a tax-free Junior ISA from 1<sup>st</sup> November 2011.

Junior ISAs are an initiative by the Government to help parents save for their children's future. Junior ISAs will offer tax-free savings and investments. Each eligible child will be allowed to have one cash ISA and one stocks and shares ISA at any time, and contributions can be made up to the proposed limit of £3,000 per tax year.

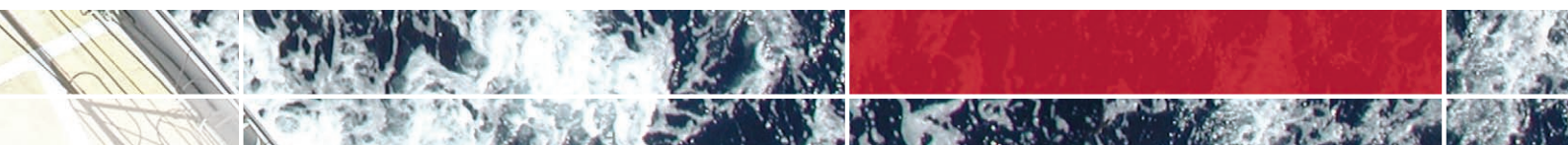
Junior ISAs will be sold by high street banks, building societies, investment companies and friendly societies already selling ISAs. The government expects 800,000 children a year to benefit from Junior ISAs, on top of those already eligible, including children in care.

Transfers will be permitted between cash and stocks and shares, or to another provider. The Government has said that it will leave it up to Junior ISA providers to set minimum contribution requirements and other terms and conditions.

One potential provider - Fidelity International - has calculated that if a parent invested the full allowance of £3,000 each year they could accumulate savings of £107,923 by the time their child reached 18, based on growth of 5% a year.

CTF holders will not be allowed to apply for a Junior ISA, but the CTF investment limits will be increased to £3,000 a year from the current £1,200 to make sure holders do not miss out. All children born between 1st September 2002 and 3rd January 2011 automatically received a CTF voucher for £250 or £500 (for those from low income families) at birth, and again on their seventh birthday.

Unlike CTFs, there will be no government contribution towards the savings pot, but any person or organisation will be allowed to contribute. Junior ISAs can be opened by anyone with parental responsibility for an eligible child, then management will pass to the child when they turn 16. They will not be able to access the funds until they turn 18, when the account will automatically default to an adult ISA.





## They're back ...but are National Savings Index Linked Certificates worth it?

National Savings have now launched the 48th Issue of Index Linked Certificates, which will pay the level of the Retail Price Index (RPI) plus an average rate of 0.5% over five years. These terms are different to past issues as they offered to pay RPI plus 1.0% and had the option of a three-year version, which is not available in the current issue. There is a maximum investment level of £15,000 per individual and all returns are tax-free.

The previous issue of the certificates was withdrawn due to exceptional demand and an inflationary

outlook. When considering Index Linked Certificates, it is important to appreciate that the return will be based on future, not current, inflation figures. The new issue has been introduced with a lower bonus rate at a time when Mervyn King, the Governor of the Bank of England, is assuring us that inflation is peaking in the next few months and will then start to fall back by the end of the year.

Whilst we can never be certain of this, the maths suggest he is right, as influences such as the unrest in the Middle East, the dramatic increase in oil and food

prices and the VAT increase are likely to gradually subside and consequently inflationary pressures should ease.

Early encashment of the Index Linked Bonds is possible, but no index-linking or interest is given if the bonds are surrendered within the first year. For those who commit to a five-year term, the total return could end up being disappointing, particularly if interest rates start to rise, as receiving 0.5% over the rate of inflation will begin to look less attractive.

## John Lewis, Tesco and now Sainsburys...

With many of us struggling to find cash accounts that will beat inflation, Sainsburys are considering launching a savings bond for customers.

We have seen a number of similar ideas recently, with a Tesco launch in February paying 5.2% and John Lewis raising £50m in 11 days with a bond paying 4.5% plus 2% in John Lewis partnership gift vouchers.

These companies are targeting their own loyal customer base and many investors feel warm and comfortable about the prospect of investing in an institution they know and trust.

However, the bonds are marketed with fixed rates of interest, which means many consumers will perceive the bonds to be secure. These bonds

are not to be compared with cash accounts with no risk to the capital. Yes, the interest rate is fixed, but the return of capital will depend on the fortunes of the issuing company and is not guaranteed. They are simply corporate bonds targeting a select audience and should only be considered on that basis, rather than as a secure investment alternative to a cash account.

# MARKET REPORT

## GLOBAL REVIEW



Global equity markets drifted lower in the second quarter as investors found little positive news to lift sentiment. Economic data continues to suggest a slowing of the global economy, partly due to events in Japan but primarily in response to higher oil prices. The civil unrest in North Africa and the Middle East has pushed up the price of a barrel of oil by 25% and with OPEC failing to reach an agreement on an increase in production there are few signs of relief.

Commodities did experience a brief sell-off in May ahead of the flotation of trading giant Glencore on the London Stock Exchange, as many investors took this as a signal that the market for natural resources had peaked. Investors also reacted negatively to the US Federal Reserve's recent announcement that further quantitative easing is now unlikely given that the recovery is continuing at 'a moderate pace'. Although concerns were raised over momentum in the job market, a further softening in commodity prices was highlighted as positive for growth in the second half of the year.

## UK



The £36bn flotation of Glencore is the largest in the history of the London Stock Exchange and immediately installs the company as a major constituent of the FTSE-100. As a consequence, mining, oil and gas companies now account for over one-third of the index, making it increasingly sensitive to commodity prices. The mining sector, down over 11% year-to-date, has been the major drag on

FTSE-100 returns as investors de-risk on concerns of a softening in demand and an easing in global growth.

The UK continues to lag its major trading partners, with the latest figures from the Office of National Statistics confirming that Britain's economy grew by just 0.5% in the first quarter. Coupled with the contraction in the fourth quarter of 2010, the economy has been effectively stagnant over the past 6 months. More robust government spending offset weaker household spending with the latter contracting 0.6% over the first 3 months of the year as wages failed to keep pace with inflation.

## US



Economic growth in the US was a relatively more buoyant 1.8% in the first quarter as business activity expanded at its fastest pace for two decades. Stronger domestic and overseas sales were also supportive, which in turn provided a boost for the labour market. However, the growth figure was lower than the Federal Reserve had forecast and helped support the central banks argument for the continuation of an expansionary fiscal policy in direct contrast to the European priority of deficit reduction.

Whilst the International Monetary Fund have given broad backing to the UK government's approach to tackling its deficit, the credit ratings agencies have been critical of the levels of US debt by downgrading the outlook for treasuries. The US government has reached its self-imposed debt ceiling of \$14 trillion and without an agreement within congress to increase this limit the US could potentially default on its debt. The Federal Reserves discounting of further quantitative easing may be more a matter of affordability than need.

## EUROPE



Sovereign debt issues also remain the concern of European investors with Belgium, which has the third highest level of borrowing behind only Greece and Italy, the latest nation to experience a downgrade to its debt rating. The sovereign debt of Greece continues to be downgraded on expectations that it will default with further anticipated cash injections from the European Central Bank and the International Monetary Fund only delaying the inevitable. The austerity measures required under the terms of Portugal's £70bn rescue deal has already seen their economy slip back into recession with a second consecutive quarter of contraction.

However, economic growth in aggregate increased by 0.8% across the eurozone underpinned by robust numbers from Germany. This again highlighted the divergence in performance across the region and contrasted dramatically with the likes of Portugal and Spain, with the latter growing by just 0.3% in economic terms as it struggles with an unemployment rate of 21%, the highest in the industrialised world.

## JAPAN



The Japanese economy stalled in the aftermath of the earthquake in March as GDP contracted by 3.7% year-on-year to the end of the month. Industrial production declined by a record 15% in March on the back of supply chain issues and energy shortages. As a consequence, exports have fallen and imports risen, with fuel a major contributor as Japan reviews its nuclear energy programme and oil prices climb on global demand.

This is expected to impact on growth for the year with estimates cut from 1.6% to 1.4%, the same as that now expected in the UK.

Encouraged by the government's £30bn emergency budget for disaster relief, industrial production bounced back in April and many companies are suggesting a return to full production in the coming months. The company reporting season has also raised optimism with full-year profits exceeding expectations in many cases. There are already signs that pent-up demand will be a major driver of growth in the second half of the year.

## ASIA



Asian equity markets ended March higher despite events in Japan and the ongoing civil unrest in North Africa and the Middle East. Strong gains in Korea and Taiwan, driven by robust economic growth and corporate earnings, offset lacklustre returns from India and China as investors held back in the face of further policy tightening. The People's Bank of China has again raised banks' required reserves as inflation climbed to 5.5% year-on-year in May, having already raised interest rates to 6.31% in the previous month.

Despite continued policy tightening the Chinese economy grew by 9.7% year-on-year in the first quarter and ahead of expectations. India's first quarter GDP fell short of expectations but the economy still grew at a healthy 7.8% year-on-year and, with inflation rising to 8.7%, led the Reserve Bank of India to raise lending rates to 7.25%. A similar pattern of strong growth and policy tightening is emerging across the region in stark contrast to western economies struggling under the weight of excessive debt.

15 June 2011

# Exchange Traded Funds (ETFs) – simply complicated



Exchange Traded Funds (ETFs) are pooled investment funds, similar in concept to that of a unit trust, which can be bought and sold on a stock exchange. They are index-tracking with the primary purpose of mirroring any specific index around the globe.

ETFs have been around for more than a decade in Europe, where in more recent years, their popularity has grown rapidly through investors and financial advisers alike. They are now available from many providers and at the end of 2010, there were 2,459 across the globe, with assets of \$1.3 trillion, according to the investment house Blackrock.

The problem now, of course, is the sheer number of ETFs available in the marketplace to choose from. Knowing how each of them operates and how they affect your portfolio is a real challenge for many professionals, let alone those less experienced investors.

Investors seeking products with lower charges have fundamentally fuelled their growth in popularity. ETFs are also one of the few ways in which you can seek comprehensive exposure to a range of commodity products using Exchange

Traded Commodities (ETCs), tracking oil prices, gas, agricultural and soft commodities, as well as physical gold. ETCs are quoted in USD, therefore currency risk is also a feature within the returns over time.

Their cheap charging structure, however, requires a significant investment of time with some Exchange Traded Funds providing prospectuses with over 1,000 pages of information. Whilst many investors see ETFs as a passive investment similar to that of an index tracker, which are not without risk, in the main they are more complex and whilst many use them as a diversifying tool, they can import additional risk to most portfolios.

Exchange Traded Funds deliver their performance in different ways;

## Physical ETFs

These funds replicate index performance using the 'cash' markets to buy all of, or a sample of, the securities within the underlying benchmark - this is known as a physical replication. There are two forms of physical replication, the full and sample methods.

Full index replication is accomplished by purchasing all the underlying securities that make up the index. Sampling, or optimisation replication, allows the fund managers to purchase a subset of index components, reducing administration and transaction costs, however, this can distort performance when compared to the full index being followed.

## Swap-based ETFs

In addition to physical methods of ETF construction, a further approach has evolved in recent years. This method is usually referred to as 'synthetic replication' and relies on swap agreements between the bank and fund provider.

The ETF in this example holds a basket of equities prescribed by the swap counterparty and they exchange the performance of this basket for the performance of the relevant index. The equity basket itself will not however contain all of the securities in the index. Rather, it will hold a selection of liquid stocks while the swap provides the performance of the index.

A swap is an agreement between two parties, one usually being an investment bank, to swap one stream of payments for another. Swaps are individually tailored contracts and can be based on any terms between the two parties.

The mechanism within this type of EFT relies on the financial security of both parties and therefore imposes more risk than other types of collective investments.

There is no doubt that ETFs will grow in popularity over the coming years and many commentators and journalists will continue to praise them for being cheap and simple, but simple they are not. They can be very complicated investment funds, which require a significant amount of research and understanding. They are providing a cost-effective route for passive investors, however proceed with caution: when you scratch the surface of these products, there is more to them than meets the eye.

**Birchwood Investment Management Ltd**, 8 Prospect Place • Welwyn • Hertfordshire AL6 9EN • UK  
**Telephone:** 01438 840 888 (Welwyn) • 0161 932 1038 (Manchester) • **Fax:** 01438 840 097  
**Email:** [info@birchwoodinvestment.com](mailto:info@birchwoodinvestment.com) • **Website:** [www.birchwoodinvestment.com](http://www.birchwoodinvestment.com)

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