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# FINANCIAL SERVICES

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## INTEREST RATES ARE SET TO RISE

The Bank of England has signaled its intention to raise interest rates, and other central banks, including the US Federal Reserve, are likely to be making a similar response to rising inflationary pressures.

After years of easy money following the financial crisis ten years ago, they are concerned to prevent their economies from over-heating.

What does this mean for investors? The most direct impact will be on fixed-interest securities, or 'bonds'. These are issued by both companies and governments which wish to raise money from investors. The capital is repaid at a fixed date in the future and meanwhile interest is paid at a rate which is fixed at the time when the bonds are issued.

Some government bonds are known as gilt-edged securities, or 'gilts', because repayment of the capital invested is guaranteed by the government.

Some government bonds are index-linked which means that the value of the capital repaid is linked to the Retail Prices Index, thus providing protection against inflation. However, most bonds lack this protection and the value of the capital repaid will be subject to erosion by inflation.

This threat to capital, combined with the low interest rates currently available from bonds, make them a poor investment at times like the present when inflation and interest rates are set to rise.

The best time to invest in bonds is when interest rates are high and set to fall. At such times bonds offer the attraction of higher interest rates than are available from deposits and greater security of capital than is available from shares.

However, apart from index-linked gilts (which can be expensive when inflation is on the rise), there are two types of bond investment which might be considered.

First, strategic bond funds, whose managers have the flexibility to invest in all types of bond, both in the UK and internationally.

Secondly, short-dated bond funds, which invest only in government bonds which are due to be repaid within the next 12 months and are the nearest alternative to cash deposits, but usually with a slightly more attractive interest rate.

### MARKET TIMING

*"Exchange traded funds ("ETFs") make no sense unless they are vehicles for market timing"*. So wrote investment commentator John Authers in the Financial Times on 24 February 2018. So how does one square the fact that ETFs have become *"the hottest investment product"* with the FT's comment that timing the market is generally regarded as *"a mug's game"*?

What are ETFs? According to Wikipedia, ETFs are investment funds which are traded on stock exchanges and hold assets such as stocks, commodities or bonds which are the constituents of an index – for example the FTSE 100 index of shares in the 100 largest companies quoted on the London Stock Exchange. In short, therefore, ETFs are index-tracking funds.

Why are ETFs so popular? The answer is that most actively managed funds fail to out-perform the index to which their mandate relates. Also, ETFs economise on manager charges and are consequently cheaper.

However, index funds provide no protection against market declines. If the index which is being tracked falls, so also does the value of an ETF which tracks that index. By contrast, fund managers would hope to justify their fees by avoiding shares which might be most vulnerable to a sell-off.

Bearing in mind that stock markets do not usually move in unison, there might be advantage in switching from one index fund to another, though this might incur a charge.

A further disadvantage of index funds is that they have no option but to invest in shares when their prices are high and therefore qualify for inclusion in an index, and to sell them when they fall in value, thus exposing the investor to the perennial danger of buying high and selling low.

There is a widespread view that the best of both worlds can be achieved by holding both actively managed funds and passive index funds within an investment portfolio - perhaps on a core and satellite basis with differing time frames.

Which brings us back to the *"mug's game"* and another oft-quoted observation, namely that successful investment depends not on timing the market, but on time in the market. Nick Train, a successful fund manager, counselled against over-active portfolio management with the words *"don't just do something: sit there"*. Market-timers spend more on dealing costs and usually end up worse off than if they had stayed put.

There is a further, potentially more insidious, dimension to this debate, which was suggested as a possible factor behind the sharp correction suffered by markets last month. Namely, that the increasing volumes of indexed investment, combined with computer-generated activity, might exacerbate volatility and distort markets when they are no longer driven by the intrinsic value of the shares and bonds of which the indices are composed.

The active v passive debate continues, but there is no dissent from the view that investment portfolios, however composed, provide one of the best ways of accumulating wealth over the long term. Though allocations should be tempered by John Galsworthy's cautionary words – *"moderation in all things"*

## DORMANT PENSIONS GRAB

The government is considering including pension and insurance products in the scheme which it established in 2011 for diverting to charitable causes holdings in bank and building society accounts which have been dormant for at least 15 years.

It is estimated that between £400 and £500 million of funds could be involved, with a further £40 to £50 million added each year.

Assets would only be transferred after efforts had been made to identify savers and assist them to claim their assets; and if a claim were made after the money had been transferred, the owner would be in the same position as if the transfer had never taken place.

## THE BUSINESS OWNER'S DILEMMA

*"I have spent my working life getting people to see me, and will spend the rest of it getting people not to see me but still use my business"*

Dentist approaching retirement, quoted in the Daily Telegraph 26/02/18