

MDM ASSOCIATES LTD

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Welcome to our latest newsletter, which hopefully provides useful information on topical financial subjects.

As many of you know, MDM bought the business of Grosvenor Wood last December. We would like to welcome the Grosvenor Wood clients as our clients.

Enclosed with this newsletter is a response sheet. If you are interested in any of the subjects covered, or have a more specific question regarding your own finances, could you either telephone or send in the response sheet and we will be pleased to help you.

Lisanne Mealing – Managing Director

**SPECIAL POINTS
OF INTEREST:**

- **MDM Buys Grosvenor Wood Financial Services**
- **Chancellor hits back with stealth tax**
- **MDM financial Podcast online at I Tunes**
- **MDM House: Wired for the future**
- **REIT's**

BUDGET—MARCH 2007

This was Gordon Brown's 11th Budget, delivered on 21 March 2007. It was, in our opinion, a very neutral, steady as you go Budget. There were big headlines – "basic rate of tax cut from 22p to 20p....." but mostly clawed back by abolishing the 10% income tax band, which was introduced in his first Budget!

As announced in the 2005 and 2006 Budgets, the inheritance tax nil rate band allowance is being increased by more than inflation. For the current tax year, the nil rate band is £300,000, increasing in stages to £350,000 in the 2010/11 tax year.

One of the most complicated aspect of taxation is fast becoming tax on travel, be it vehicle excise duty, owning a company car or tax on flying. There are now seven different bands for vehicle excise duty, with the cost ranging from £0 if you are somehow able to pedal your car and

BUDGET—MARCH 2007...CONTINUED

emit very low levels of carbon dioxide, to over £300 for the year. The maximum cost is due to rise to £400 for 2008/09.

Did I say that the tax duties on travel were the most complicated area? Well actually, they could be viewed as quite simple compared to the child and working tax credits and child benefit!

One of the least used tax breaks is the annual capital gains tax exemption. This is currently £9,200 per annum – double for a married couple. If capital gains are taken as income, a married couple can take gains of £18,400, together with their normal taxable allowances before paying tax.

With such strong equity gains over the last four years, you should consider taking advantage of this allowance.



MARKET MUSINGS FROM MDM

Market Update

We normally take a look at what has happened in the investment markets, generally and then add a few comments on where the major investment houses see the good, the bad and the ugly looking forward.

This time, having seen a change in the broad pattern which had run for over three years, we thought it appropriate to look further forward, so you may broadly position your portfolios for some time ahead – at least, that is the plan!

There are four main assets you might invest your money in: cash, property, fixed interest and equities. Of these, only property and equities offer meaningful prospects for longer-term inflation-beating returns, so we shall start with these first.

Equities may come in a broad variety of shapes and sizes but all could rely on two main drivers – decent business returns and a willingness for investors to pay for them. The former we shall call fundamentals and the latter, sentiment.

Ultimately, the fundamentals behind companies making a good profit, which might then be passed on to its shareholders, could either translate into share price rises or take-over bids – which could only work at a higher price than share-holders may get by selling their shares in the stock-market, thus also driving up the share prices. In the short term, however, sentiment could drive share prices up, or down, quite savagely.

The longer your time horizon, the more you may need to look to the fundamentals, while the shorter it is, the more you might need to take note of sentiment.

All told, at present the fundamentals appear pretty reasonable, so there may be little reason for longer-term investors to bale out of equities – although there might be scope for re-alignment to try to get more out of them. Sentiment, however, could have been quite severely damaged lately, as many investors appear to have become complacent about the risks inherent in many investments and could now be frightened by the recent volatility, which they may have thought had largely disappeared. This could be the main reason why we have seen such large upsets lately.

So, the main problem with shares at the moment could be seen as sentiment, which is all about human emotions – always a hard one to call.

What about the fundamentals?

Looking firstly at the UK, a glance at some of the fundamentals could suggest that everything may be OK, as the Price Earnings (PE) ratio appears close to its long term average. The PE ratio could be a useful measure of how expensive shares are, as it measures their total income producing capacity (earnings) against their price – hence price/earnings ratio. Not all of each year's earnings are paid out each year, as some is retained, but the total value usually accrues to the benefit of the share-holder, in effect.

“So, the main problem with shares at the moment could be seen as sentiment, which is all about human emotions – always a hard one to call”

MARKET MUSINGS...CONTINUED

The minor glitch at present could be that not all shares have the same PE ratio and, right now, we have noted a marked difference between those of some smaller companies and those of the largest of companies. Better longer-term value might be gained from switching out of these smaller company shares into the larger company shares – some of which have already started to turn.

Some respected economists are of the opinion that, although the short term may well be bumpier than we have been used to for a while, the current market cycle probably has two or three more years to run, so the stock-market might be a good place to be.

Further afield, the fundamentals could appear benign in Europe and, in particular, China, with mixed issues in America. Japan looks to have a few difficulties to contend with in the short term.

Apart from that, it could be sentiment which is increasingly driving share prices in the short term, and investors are generally waking up to the risks they may face. This may be what has resulted in many investors pulling their money closer to home, so emerging markets could be finding few supporters – with the exception of some more adventurous souls, who might be content to ride out the short term fluctuations for the possible longer term returns in prospect in China.

For equities, it may be best to stick closer to home – i.e. UK and Europe



So, for investors with a medium to longer term horizon, now might be the time to stick with equity investments in the UK and Europe – particularly in larger company shares; more adventurous investors might benefit from exposure to China as well – but don't forget this could be bumpy for a little while yet. Most fund managers we have spoken to have been raising their cash levels in anticipation of "better buying opportunities" that might be just around the corner.

Property has appeared popular with retail investors, and possibly never more so than over the past few years.

In a number of ways this is good, but there are a few words of caution which we recommend you take on board.

No, it may not be a question of running away from property investment but more one of understanding what is on offer – and then re-assessing if this may be what you really want.

Traditionally, property funds, invested in commercial property by the big insurance companies, provided good, steady returns over time for relatively cautious investors who were looking for higher potential returns than building societies could offer but who still wanted to be able to sleep soundly at night.

This sort of property investment (UK bricks and mortar) could still be available but you may now have available a wider choice of property-related investment, which some may be confusing with the former.

First, however, it should be noted that the traditional "UK bricks and mortar" type of property investment has enjoyed a relatively good run for several years now, which could raise issues over whether or not prices are over-inflated. In reality, they probably are. For investors, however, the likelihood may be that returns going forward could be less than those which have been enjoyed over the past few years, while new investors could probably take a while to cover their initial costs.



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MARKET MUSINGS...CONTINUED

Probably the most important point to note might be that property should be viewed as a long term investment and also could offer very useful diversification within a portfolio.

It may not be inappropriate for balanced investors to be deserting traditional property investment in the hope of better returns elsewhere. Remember the tech boom? Many investors could have fared rather better if they had retained a level of property exposure through this period. Be warned!

The wider property investment choice might principally be accessed via property company shares. An important point to note here could be that they usually share the investment characteristics of both property and equities, so many of the earlier comments on fundamentals and sentiment may also apply to this type of investment.

In the UK several of the popular property investment funds are invested in property shares, not directly into bricks and mortar, and although their returns over the past three or four years may have appeared quite similar (strong upward growth with limited volatility in both cases), they are different animals – and should be treated as such. The FTSE 350 Real Estate Index is down nearly 3% over the past 5 months and down 7.5% since its recent peak on January 3rd this year – that'll be the equity part of the animal showing through!

Overseas the big news has been REITs (Real Estate Investment Trusts) – many of which may have risen by as much as the fall in the above index so far this year.

Some managers, however, are saying that REITs have surged in response to the bottleneck built up as investors waited keenly to invest in this new opportunity, so in some markets the only return in prospect is that of the income yield. There may be some truth in this but there may still be opportunities in this sector, although we have just seen a sharp downturn in Spanish property company shares – which could be one of the most overheated property markets worldwide.

Probably some of the best opportunities in property investment lie in the new overseas “bricks and mortar” funds, which are just starting to come on stream. Of these, the European property funds probably may present the lesser risk, as most will be invested in jurisdictions which should be well policed.

Fixed Interest investment may have been in the doldrums for several years now and recent upward inflationary pressures may also add to their gloomy outlook. There do, however, appear to have been a few interesting positives. One major investment house has an analytical model which has shown fixed interest investment to be its strongest “buy” recently. Also, it is usually “darkest before the dawn”, so don't be surprised if fixed interest suddenly perks up, just as most may finally give up on it. For most, however, it could probably be a little early to invest, although higher income seekers might possibly start looking soon.

Still one of the more important issues to remember could be that you are not being paid for taking extra risk. The normal interest differential between loan stocks issued by top quality, lower risk companies and loans issued by riskier companies appears to have virtually disappeared, so “high yield” funds may offer very little more return at present for possibly quite a lot more risk. Gilts could be seen as the best in terms of value for risk right now. BUT, it appears likely that the benign low inflation environment we could have enjoyed for a number of years now may well be behind us for a while. In which case this could pose a threat to nearly all fixed interest investments.

Cash has become more attractive with the rise in interest rates, although they may now have peaked.



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PENSIONS VERSUS ISA'S

Over the last ten years, there has been a lot of negative comments regarding pensions. There has been the Chancellor's tax grab on dividend income, pensions misselling, concern regarding having to purchase an annuity at retirement and of course the significant markets falls from 2000 through to 2003.

Some of these concerns have been alleviated – we have now seen a significant bounce back in markets although equity investments will always have a degree of volatility. It is now no longer compulsory to purchase an annuity, even after age 75. However, pensions will always be attractive due to the tax reliefs on offer – funds grow free from tax (apart from the effective 10% tax on dividends) and 25% of the fund is available as tax-free cash.

ISAs also have certain tax advantages and some advisers and market commentators feel they are a suitable alternative to providing income in retirement. Like pensions, ISAs grow free from tax, but they also suffer from the inability to reclaim the tax credit on dividends in a similar way to a pension fund. Importantly though, the money is always available although this could be a disadvantage if the money is spent before retirement! However, the great attraction of ISAs is that the funds can be taken as tax-free income in retirement.

There are however limits on how much can be paid into an ISA - £7,000 for the current tax year, increasing to £7,200 per annum thereafter. This compares to up to 100% of salary personally to pension (which can be topped up to £225,000 by a generous employer) – but be careful not to exceed the lifetime allowance!

So, which one is best? Receiving tax relief plus restrictions or no tax-free cash and the ability to take tax-free income in retirement?

In many respects, if you can afford to, you should look to do both. Both types of investment complement each other. For many, a pension will attract higher rate tax relief at 40% and a quarter of the fund is available free from tax – for most, the pension will only be taxed at 25%.

For many, ISAs are attractive due to the accessibility of the capital. The ability to be able to access the monies in emergencies, for example redundancy or sickness. Certainly, if debts have accrued, it is better to pay off the debts, which would not be possible from a pension fund – and just when you think children become cheaper, they hit 18 and the cost of university is not cheap, nor is the support they need in buying their first house, or getting married!

So, how much do you need in retirement? A lot depends on how long it is before you retire and your income expectations. After forty years in a good final salary pension scheme, you would expect to receive a pension of two thirds your final earnings, but assuming the mortgage has been repaid by retirement, many feel they can afford to live on 50% or less.

So, how much could I receive in retirement? An example may be helpful. Assuming a pension fund of £400,000 had been accumulated, £100,000 in ISAs and a State pension of, say, £7,500, including SERPS, the income and taxation position could be as follows:

State Pension	Pension	Tax-Free Cash	ISA/PEP
	£300,000	£100,000	£100,000
	Pension	Tax-Free Income	Tax-Free Income
£7,500	£18,000	£6,000	£6,000
		Total	£37,500
		Less Tax	£4,000
		Net Income	£33,500

PENSIONS VERSUS ISA'S...CONTINUED

- (1) Income assumed to be 6% per annum from pensions and savings.
- (2) It is assumed tax-free income is invested in a portfolio of OEICS, taking advantage of annual capital gains tax allowances, as and when required.
- (3) There is no guarantee that this level of income is sustainable.

Could you afford to live on this level of income? If not, you need to save more! Will you have this level of capital available by retirement? If you need this level of income, you will have to save more – or retire later!

It should be noted that the further you are from retirement, the more you need to make an allowance for inflation.

What if you have many years to go before retirement (or how much should your children pay!)? The following table, courtesy of Best Invest gives a useful guide as to how much should be contributed to a pension – ISA, or both!

% of Salary Contributed	Years to Retirement							
	40	35	30	25	20	15	10	5
5%	21%	17%	14%	11%	8%	6%	4%	2%
10%	41%	34%	28%	22%	17%	12%	7%	3%
15%	62%	51%	42%	33%	25%	18%	11%	5%
20%	82%	68%	55%	44%	33%	24%	15%	7%
25%	103%	85%	69%	55%	42%	30%	19%	8%
30%	123%	102%	83%	66%	50%	36%	22%	10%

Figures show pension income at retirement as a percentage of salary. Assumes salary increase by 2% above inflation each year and annual pension fund returns are 4% (net of charges and inflation). Assumes pension fund is used to buy a joint life five year guaranteed level annuity.

Source: www.bestinvest.co.uk

Interpolating the chart, you will see that if you are looking to receive a pension of 50% of your earnings in retirement, and in your 20s you will need to contribute around 12½% of your pay; if you are in your 30s around 17½% of your pay. It helps if some of this cost is met by way of an Employer's Pension Contribution.

If you would like us to provide an indication of the level of income you could expect in retirement, taking into account your existing fund and your current level of contribution, please return the response sheet.

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You can read the latest newsletters, listen to our financial Podcast and catch up on financial news on your home or business computer.

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