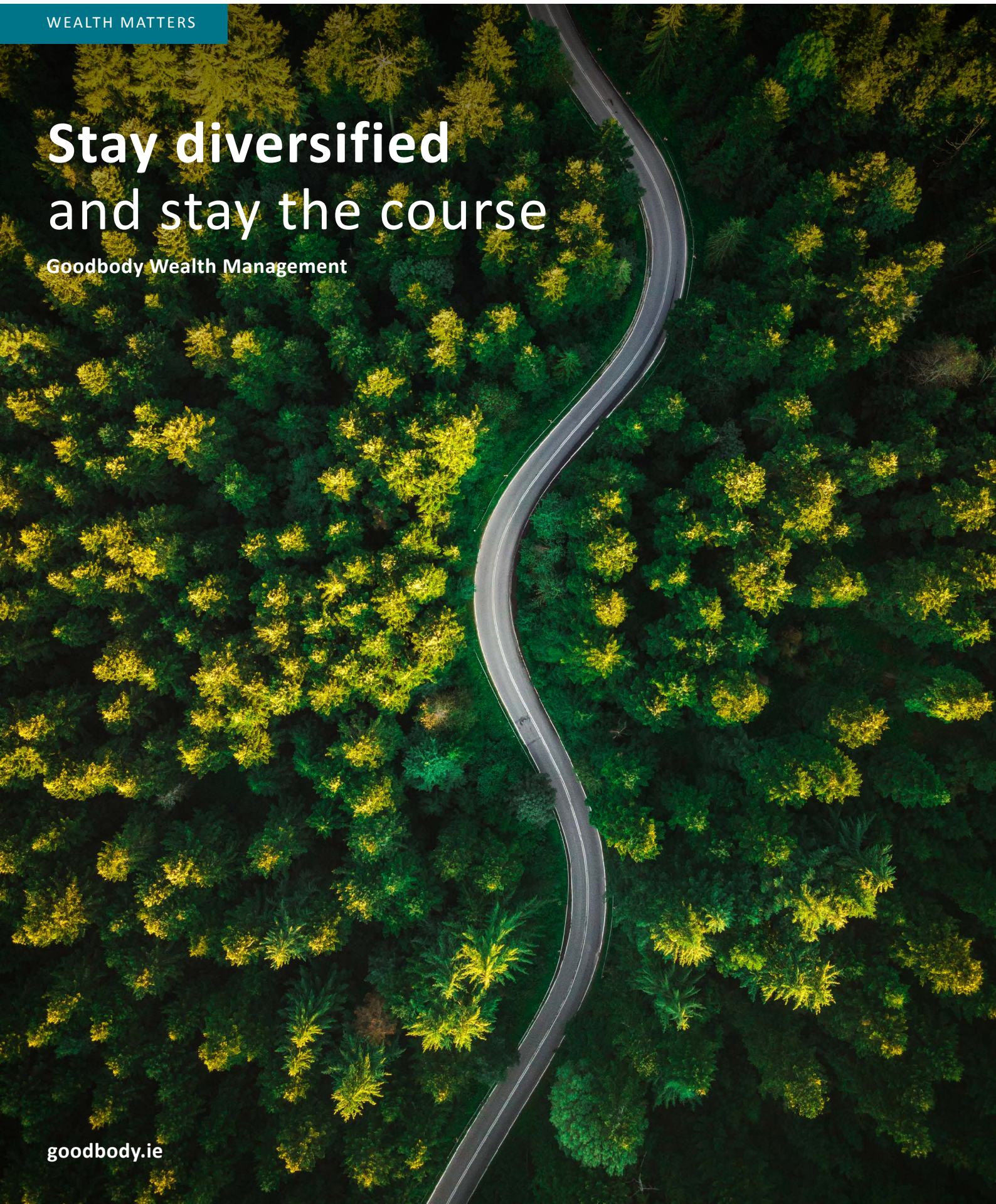
Goodbody

Wealth Management Quarterly Report
Q1 2022

WEALTH MATTERS

Stay diversified and stay the course

Goodbody Wealth Management



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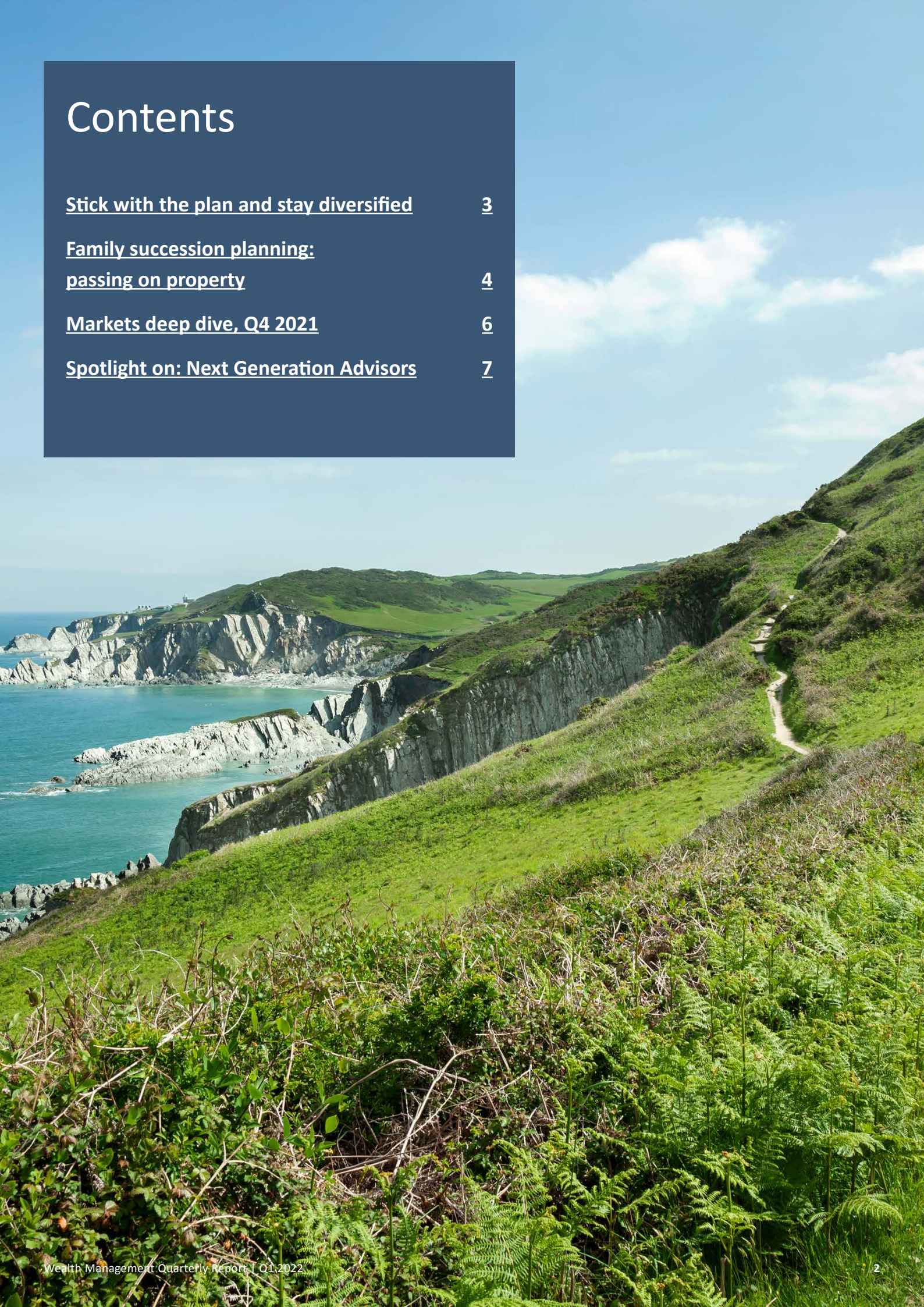


Stick with the plan and stay diversified

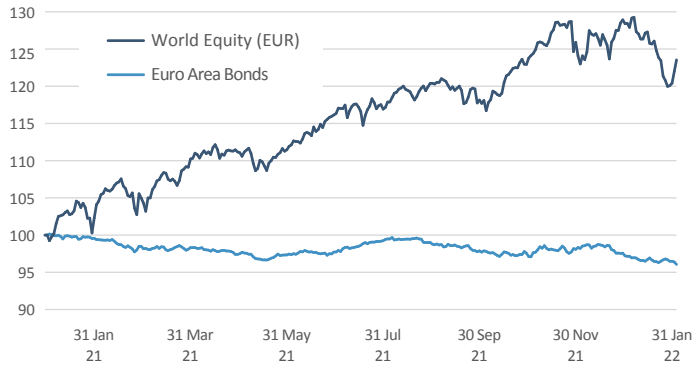
Joe Prendergast, Global Strategic Advisor

Welcome to Wealth Matters – a quarterly publication that presents our views on the investment landscape and explores key wealth planning themes to help build and protect wealth on behalf of individuals, families and entrepreneurs across generations.

The opening weeks of 2022 have certainly lived up to the 'lower returns and higher volatility' theme that we anticipated for this year. As interest rates rise, risky asset markets like equities and credit have been vulnerable – especially those companies whose rich valuations rely most heavily upon future growth expectations.

Should we extend this trend of January to the rest of the year? We think not. January is most often a positive month, but a weak January says little about what is to follow. Indeed, January 2021 was a down-month that started a stellar year. And 2018, the only meaning full down-year for stocks since 2008, started with the strongest January we had seen for two decades. We stick with the fundamentals as our guide for the year ahead.

Figure 1. Bond and equities diverged in 2021



Source: Bloomberg Finance L.P.

January's stock and bond market weakness follows a notable year for both stock and bond returns, for rather different reasons. While world equities soared nearly 28% in euro terms in 2021, bonds suffered. By the end of the year, the euro investment grade bond market index was down nearly 3%, recording its first material loss since 1998.

To some degree, this divergence of stock and bond performance in 2021 was not a bad thing for the diversified investor. We have consistently highlighted the merits of a diversified portfolio between equities and bonds – to the degree that what is good for equities can be bad for bonds, and vice versa, so the losses made on bonds in this case were well compensated by the robust equity performance. This is clearly not always the case, however, and with inflation on the rise, both bonds and stocks are vulnerable.

> We stick with the fundamentals as our guide for the year ahead.

As noted in our annual outlook, we are anticipating lower returns and higher volatility ahead – but there are still good reasons, in our opinion, to stick with the plan and stay diversified.

First, while interest rates are still very low by historic standards, we start 2022 with far fewer bond yields in negative territory. For example, at the start of 2022 the 10-year German government bond is nudging above zero yield, in contrast to the -0.57% it offered at the start of 2021. Hardly exciting but given that this is probably the most secure asset available to a euro-based long-term investor, core diversification for portfolio protection is now less costly. There is also now more potential for a bond recovery if the equity market is volatile.

Second, as our CIO Bernard Swords notes on page six, equities are still supported by strong earnings growth alongside economic recovery. That should underpin equity valuations as well as support ongoing low levels of corporate default. That means stocks and corporate credits still have potential to deliver significantly positive returns over time, though one must be selective to avoid sectors and companies where valuations are challenging or where rising interest rates will hit hardest. Bonds still play a balancing role, but with a continued tilt towards shorter-dated corporate credit as a source of positive expected return at the core of the portfolio. Property also features as a desirable portfolio diversification (see page four where our Head of Tax Catriona Coady offers an overview of property from an inheritance perspective).

Sustainability will remain a key theme for all investors in the year ahead, not least as the industry adjusts to the more onerous requirements of the European Union's green taxonomy, Sustainable Finance Disclosure Regulation and Corporate Sustainability Directive, effective on 22 July 2022. On page seven, next generation wealth advisor Marco Lupo highlights the importance of this theme for portfolios, society, and the planet – for current generations and those to come.

IN FOCUS

Family succession planning: passing on property

Property ownership is a big component of personal wealth in Ireland – and so, for many, protecting property wealth and passing it on to the next generation is a central part of their succession planning. It is therefore no surprise that clients are increasingly seeking advice on how they might avoid forced property sales to meet tax liabilities, which in turn can reduce family wealth materially. While options are limited, here we outline the most popular ways that clients can protect property wealth.

Catriona Coady, Head of Tax

Transferring your property to a child

If you wish to transfer a family home or a single residential property to a child, normal Capital Acquisitions Tax (CAT) rates apply over and above the tax-free threshold. However, a child may be able to avail of Dwelling House Exemption. It provides that the gift or inheritance of a property can be exempt from CAT where certain conditions are met. The main conditions are set out below.

Gifting

- In the case of a gift, the exemption can apply to a beneficiary who is a dependent relative – meaning someone who is permanently and totally incapacitated due to a physical or mental incapacity; or a relative aged 65 or over.
- In addition, the beneficiary must have continuously occupied the dwelling house as their main residence for three years immediately preceding the gift.

Inheritance

- In the case of an inheritance, the exemption can apply to a beneficiary where the disponer has occupied the dwelling as their main residence at the date of their death (this is not required where the beneficiary is a dependent relative); and
- the beneficiary has occupied it as their main residence throughout the three years immediately preceding the date of the inheritance.

In addition, to qualify for this exemption, the beneficiary must not at the date of the gift or inheritance own any other dwelling house or hold an interest in any other dwelling house in Ireland or abroad. In the case of an inheritance, further residential property to be inherited by the beneficiary from the deceased can be included in this test to deny the relief. After the property has been transferred to the beneficiary either by way of gift or inheritance, they must continue to own and occupy it as their main residence for six years. Otherwise, the exemption is clawed back (this rule does not apply to those aged 65 or over and to other limited circumstances). This is a complex relief and many of the terms mentioned have specific definitions. Advice should be sought to determine if the relief is due.

Another consideration is the Capital Gains Tax (CGT)/CAT offset rule: if parents are considering gifting a property during their lifetime to a child, any CGT due on this same event can be credited against the CAT liability arising, provided the asset is not disposed of within two years commencing on the date of the gift. That said, the parents will need to consider how the CGT liability from the property transfer will be funded.

Early transfer: funding the tax liability

For a parent wishing to help a child during their own lifetime, Section 73 policies can be very useful. Such policies can offer the option of paying a beneficiary's CAT bill on a gift without the payment itself being considered a further taxable gift.

Indeed, gifting property assets early has both practical and tax-efficient outcomes: a property gift made alongside a Section 73 policy provides the child with a property and a means to fund the gift tax liability. Importantly, future capital appreciation on the property will accrue to the child, for whom no charge to CAT will arise. This can work especially well when the asset being gifted does not attract a CGT liability and where the Stamp Duty liability may also be minimal.

Via inheritance: using a life assurance policy

A Section 72 life insurance plan is a policy to cover the inheritance tax bills of the beneficiaries of an estate. Put simply, it allows the beneficiaries to inherit assets without then having to find the money to pay a significant tax liability. If the beneficiary does not want to sell assets to pay their tax bill or can't do so quickly, it may be a useful option.

Succession planning: communication is key

Passing on property can fundamentally influence financial outcomes for the beneficiaries, so it is important to talk openly about your plans. After all, a little preparation can preserve property wealth for your children – and generations to come.

So, while succession planning may be a sensitive issue, it is essential that your children understand your plans because once they do, they can educate themselves about what they are going to receive, prepare themselves for the tax bill they may have and manage the process as effectively as possible.

What about farms?

The gifting or inheritance of farms and the interaction of dwelling house relief on a farmhouse is a topic we'll come back to again.

MARKETS DEEP DIVE

Q4 2021

Bernard Swords, Chief Investment Officer

Equity markets were strong in the final quarter of the year, but it was a cautious rally owing to the emergence of the Omicron variant. There was a shift towards defensive and dependable earnings growth. Meanwhile, fixed income markets remained under mild pressure in Q4, with the euro area delivering a negative return. But how has this impacted our strategy?

Equity markets: a strong preference for healthcare

Our equity positioning was little changed during Q4. Healthcare remained our largest overweight. As the economic cycle matures, the relative earnings growth rate of the sector should be attractive.

We believe there is a lot of potential from the full re-opening of economies and so, we are overweight Consumer Discretionary and Industrials. Our main underweights are in deep cyclical sectors – Materials and Energy – which generally perform best in the early stages of an economic recovery but fade as the recovery matures. We remain underweight IT as the high valuations remain vulnerable to rising bond yields.

Fixed income: a bias towards shorter-dated corporate credit

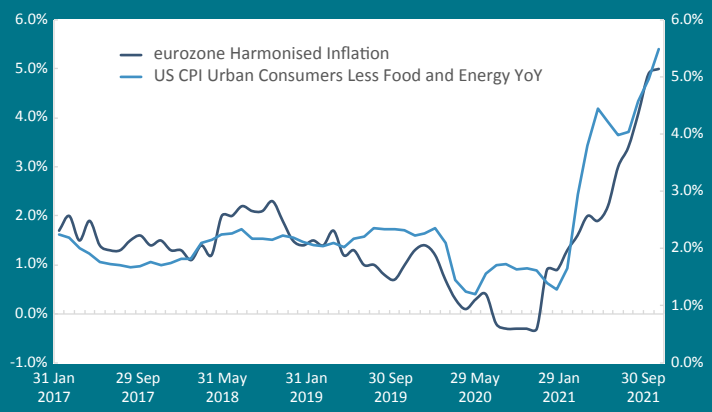
Our fixed income strategy remained unchanged in Q4, with no major portfolio changes. In 2022, higher starting bond yields should provide some better protection for longer-dated bonds. Yields are now near zero in the benchmark 10-year German government bond, compared to below -0.5% at the end of 2020. As interest rates rise in 2022, we will likely see another year of poor returns in fixed income, but the role of quality bonds as a stabilising and diversifying asset in portfolios remains an important one. Within fixed income allocations, a clear bias towards shorter-dated corporate credit remains our preferred strategy for the year ahead.

Bracing for 2022

We had a strong end to a strong year, but we expect returns in 2022 to be more subdued and to be more volatile. This year central banks will be moving to normalise monetary policy and there will be heightened uncertainty as investors try to judge how far will interest rates rise and at what pace. This is what we are witnessing in the US now as the Fed has been altering its timetable for interest rate increases and the timing of those increases. In the euro area, early key rate rises are unlikely but the level of bond buying will decline this year. However, an important point for us is that the change in monetary policy is being driven primarily by a robust performance of the global economy despite the ongoing pandemic. Unemployment has declined sharply and economic growth rates remain well above trend.

Meanwhile, in all major regions, inflation readings are at multi-year highs (see figure 2). We still believe that the present level of inflation is unsustainable. Supply chain stress will ease as work practices get back to some normality, and the widening of the digital economy remains a deflationary force. However, we do not expect inflation to fall back to the very low levels experienced in the 2010s or 1990s.

Figure 2. Inflation spike



Source: Factset.

Inflation is being driven by strong aggregate demand. This is the main reason why equities remain our favoured asset class. In 2021, equity markets showed their inflation-hedging characteristics, and we expect this to continue this year. Although the level of return will likely be significantly lower, over time we still expect high single digits on a total return basis for global equities in euro.

We expect a negative return from fixed income markets as central banks move to normalise policy, but in the context of negative interest rates that is hardly a surprising outcome. Fixed income assets can still provide protection should we see another flare-up in the pandemic or any other type of growth scare.

SPOTLIGHT ON

Next Generation Advisors

Marco Lupo, Associate Wealth Manager

What investment theme are you most excited about?

Sustainability – from tackling the climate crisis and biodiversity loss, to gender equality and human rights, investors are increasingly seeking to align their money with their values to benefit their portfolios, society, and the planet – for current generations and those to come.

In recent years, the concept of environmental, social and governance (ESG) investing has gone from niche to mainstream. That said, while many clients understand the concept of ESG, some are less sure about how it applies to them as an individual investor. So, while more and more people care more about how their behaviours impact the planet – there's an opportunity to help them understand and recognise the financial effect of their values too.

In simple terms, what is sustainable investing?

Sustainable investing incorporates ESG factors into investment decisions to better manage risk and generate sustainable long-term returns. It complements traditional analysis and portfolio construction techniques.

At Goodbody, we have developed an approach to sustainable investing which is based on three pillars: integration, screening, and a principles-based investing approach.

Has Covid-19 changed the conversation around sustainable investing?

The coronavirus pandemic didn't start the sustainability revolution, but it did bring the theme into sharp focus. Historically, much of investors' focus had been on governance practices and the environmental factor (after all, the climate emergency is the greatest challenge of our time). But Covid-19 turned the spotlight on social factors – in particular, companies' treatment of their employees, customers, and suppliers. Indeed, this focus will help investors understand how companies approach social considerations particularly in relation to business ethics and the treatment of the labour force.

Will this focus on sustainability last?

Yes, I believe so. The pandemic has served to concentrate investors' minds and enhanced their focus on sustainability – and I think that will continue to increase for millennials and Gen Z investors who are particularly passionate about the sustainability agenda and the future of the planet, as we continue to tackle the climate crisis. What's more, new disclosure rules around sustainable investing should support the continued growth of investing in this area.

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