Goodbody

Wealth Management Quarterly Report
Q3 2022

WEALTH MATTERS

Is the tide turning?

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No safe havens in the first half of the year

Joe Prendergast, Global Strategic Advisor

Financial markets have endured a punishing H1 amid persistent inflation and growing concerns over global growth. Against this backdrop, safe havens have struggled to deliver. Nevertheless, we believe the volatility experienced in H1 should not deter investors from their strategic course.

The first half of 2022 has closed with heavy losses for almost all investor portfolios. Even the most conservative risk profiles, which would normally be well insulated from the type of declines in risk assets we have seen this year, have suffered notable declines. According to estimates from Asset Risk Consultants (ARC) the average 'cautious' risk profile investor (defined as a portfolio with 0-40% equity exposure) has suffered losses of -10.5% in the first half of the year. Moderate balanced portfolios (centred on 50% equity exposure) are estimated to have lost -12.4%. There have been few safe havens for any investor among the major asset classes, with government bonds, corporate bonds and gold all recently in decline alongside world equities. Even commodities turned lower in June.

The distressing investor experience in the first half raises many questions about the viability of diversified portfolio strategy. Some investors may now question whether sticking with a conservative or moderate strategy makes sense – or should it be reviewed since it has demonstrated such vulnerability in early 2022?

> *The volatility experienced this year should not in our view deter investors from their strategic course.*

Assuming no change in an investor's circumstances or objectives, the volatility experienced this year should not in our view deter investors from their strategic course.

Firstly, it is important to realise that the capital preservation objective of the safe assets in the portfolio is not necessarily impaired by the drop in valuations seen in the first half. Bonds can be volatile, as we have seen, but it is their fixed par value which earns them their ultimate reputation as safe assets.

Yields are also now higher, which makes fixed income instruments notably more attractive than before. Core government bond yields are no longer in negative territory and so there is opportunity to embed positive yield into portfolios while enhancing capital preservation.

Figure 1 emphasises these points together: equities alone have been volatile, but not unusually so – even over five years, a negative outcome is quite possible for equities according to history. Bonds have had a terrible past 12 months, but with higher yields they should have a high probability of generating positive returns now over five years. Bonds

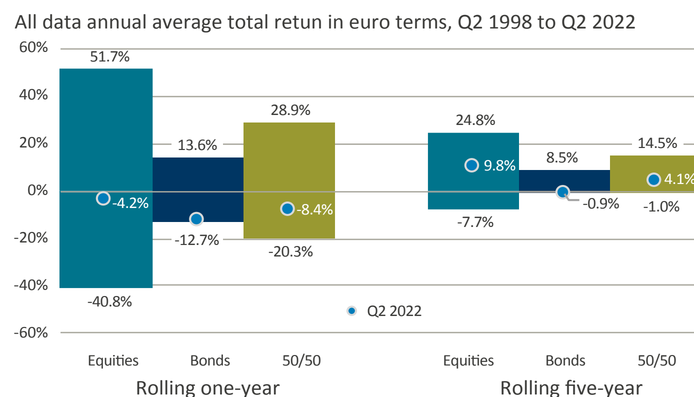
> *Yields are also now higher, which makes fixed income instruments notably more attractive than before.*

rarely generate negative returns over the medium term. The bond/equity portfolio mix should continue to have a low probability of a negative outcome over five years.

So, far from exiting core bonds after the extreme volatility of the first half of this year, we favour adding these safe assets to portfolios at these higher yields. See our Chief Investment Officer Bernard Swords' deep dive on financial markets on page six for more on our outlook and our portfolio strategy.

The role of safe assets as capital preservers in a portfolio and the value of sticking with a long-term plan are principles that form part of a larger body of disciplines that can help to drive investment success. Perhaps the single most important factor of all of these principles is to start investing early, to accumulate and compound investments over time. As Wealth Management Executive Conor Crowley reminds us in a short Q&A on page seven, it's never too early to start a portfolio or trust for the next generation – for example, with a bare trust. On a related topic, Grace Webster, Senior Wealth Management Executive, also takes a focused look on page four at different approaches to funding children's education.

Figure 1. Stick with the plan: ranges of equity, bond and 50/50 portfolio returns



Source: Bloomberg Finance L.P., Goodbody calculations.

IN FOCUS

How to fund your child's education

Thousands of students will return to school or head off to university this autumn. But for parents, school and university costs can be daunting. Here we consider ways to plan ahead for these costs.

Grace Webster, Senior Wealth Management Executive, Team Lead

From cradle to childcare to college, life changes when you have children – and so do your financial priorities.

That is why it is important to take the time to do some financial planning around how to best structure your savings and investments to cope with the increased demands on your income for today and tomorrow. With a little planning and discipline, the costs of raising a child can be managed.

One such expense is education. It's not easy to pay school or university costs, but unlike most other major expenses in life, it never comes as a surprise.

Sure, no one knows when they might need to replace a car, but from day one you can time your child's entrance to school and third-level education almost to the day. In this way, education is more like an investment than an expense.

A costly lesson

When it comes to second-level education, many parents are opting to send their children to private or fee-paying schools. Last year, enrolments in fee-charging schools climbed to more than 26,226[1] – marking the highest level of enrolments on record.

The most expensive private schools charge over €9,000 a year for day pupils and up to €24,500 a year for boarding. That is before you add the costs of grinds, extracurricular activities, and Irish college.

When it comes to university, in addition to standard fees, consideration now must be given to surging inflation, higher rents and rising food prices.

According to the TU Dublin Cost of Living Guide for 2022/23, the cost of living away from home for third-level students is €1,478 a month, or €13,305 for the full academic year – that includes the €3,000 a-year contribution charged by publicly funded colleges.

Overall, that works out at over €53,000 for four years of third-level costs – a major expense in the future.

How to manage the costs

An understanding of the potential costs of education and a clear deadline to work towards should clarify your investment objectives and define a concrete outcome for your saving plans.

Instead of having to figure out how you are going to pay school or university fees out of current spending when the time comes, you can know in advance that it's taken care of. In other words, saving enough comes down to a question of 'how much?' rather than 'if' or 'when.'

The best place to start is with child benefit – it's a simple and convenient way to build up an education lump sum without even making an extra effort.

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Child benefit payments align perfectly with long-term education saving – they are untaxed, monthly, and run for 18 years; so, they can be particularly beneficial to fund third-level costs.

The current child benefit payment for one child is €140 a month for 18 years (€30,240) – and if it is feasible, parents could put this aside every month to help towards their child's future education costs. While it's a small hit to your cash flow, it alleviates a significant future expense.

If these funds were saved on a monthly basis into a well-diversified investment fund for 18 years, with an average return of 5% per annum, it has the potential to grow to €48,533.

Parents may need to consider additional funding for private school fees, extracurricular activities and so on. There are a number of investment options out there for parents – the right option for your family depends on whether you have a lump sum upfront or whether you prefer to make contributions over time.

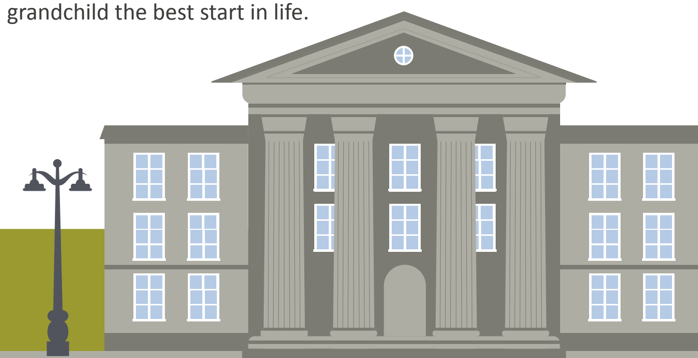
Another consideration is the Small Gift Exemption, which parents and grandparents may wish to take advantage of. Each parent or grandparent can individually give a maximum of €3,000 (the tax-free annual gift allowance) per annum to a child/grandchild.

That way, both parents and / or both grandparents could transfer a maximum of €6,000 per child per annum which is currently outside the inheritance tax net. Again, investing this rather than saving it can have a significant impact on the amount available when it is needed for education costs.

Planning ahead is key

Remember, when it comes to putting money aside for your children's education, two things are key – starting early and saving consistently.

That way, you'll be better prepared to wave your child off to college when the time comes. After all, a good education will give your child or grandchild the best start in life.



[1] Source: Department of Education (Latest enrolment figures available for 2020 to 2021).

MARKETS DEEP DIVE

Q2 2022

Bernard Swords, Chief Investment Officer

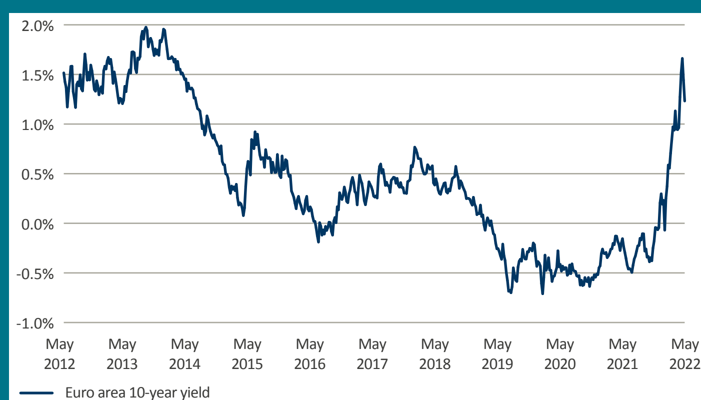
The second quarter was another difficult one for investors as both bonds and equities delivered negative returns. Tightening monetary policy and the resultant growth fears were the primary drivers. The reason behind this remains the same: inflation is more persistent than expected. There has been some subsidence in core inflation, but the rate of decline has been too slow. Central banks have become focussed on taming inflation and there was a rising fear that a recession will be the outcome.

Economic growth forecasts were reduced during the quarter, but the consensus is not projecting a global recession. Indicators, such as business sentiment surveys and labour market statistics, are well off levels normally associated with the arrival of recessions. So, while the probability has risen, it is still well below 50%.

A significant shift in interest rate expectations

Fixed income markets remained under pressure in the second quarter, and the euro area was particularly weak as there was a significant change in interest rate expectations. At the start of the quarter, interest rates were expected to reach 0.5% in 12 months' time, but by the middle of June this had moved up to 2.0%. Our strategy of being short duration was a big positive during the quarter, and the widening in peripheral sovereign spreads (Italy, Spain etc.) where we have low exposure offset the impact of wider credit spreads.

Figure 2. Yields have spiked higher



Source: Bloomberg

The move in yields in the euro area was large and we increased our fixed income exposure during the quarter. We added sovereign exposure as the five-year Bund yield near 1.25% anchors expected returns in positive territory now. We maintain a preference for shorter duration as the interest rate turbulence may not be quite finished yet.

> *Fixed income markets remained under pressure in the second quarter, and the euro area was particularly weak as there was a significant change in interest rate expectations.*

What history tells us about recessions

For equity markets the fear of recession grew during the quarter, however the moves seemed overdone. If we look at the six recessions in the US since 1970 (excluding the Covid-induced recession), there was a consistent drop in the S&P three months before the onset of each recession – and the median decline was 9%. We moved considerably more than that in Q2.

The sectoral performance during the quarter was defensive. Three of the top four performing sectors were Healthcare, Consumer Staples and Utilities. Energy was the top performing sector as the oil price rose marginally during Q2. Consumer Discretionary was the worst performing sector due to the impact of inflation on consumer spending. Defensive and dependable growth was in vogue and should remain that way as it always does in the latter part of the cycle; we remain overweight these sectors. The energy sector continues to defy us but with a softer economy, the upside in the oil price seems limited and risks appear to the downside. Hence, we still have very low exposure here.

Will the second half of the year be better?

It has been a very difficult first half for financial markets, but we would expect a better second half. Inflation indicators should be improving as we lap strong figures from 2021, the current softening in activity reduces inflationary pressure and China's re-opening improves supply chains. This would mean central banks need not do any more than is expected at the moment.

As a result, bond markets should be better behaved as they have moved to price in a lot of interest rate hikes from central banks – and we have increased bond exposure in anticipation of this. This should bring some stability to equity markets, while easing inflation should help consumers and limit the extent of the economic slowdown. Given recent falls in equity markets, there is scope for recovery but a neutral position in equities still seems best for this stage of the cycle.

> *It has been a very difficult first half for financial markets, but we would expect a better second half.*

Let's talk bare trusts

In conversation with Conor Crowley, Wealth Management Executive

What is a bare trust – and how is it managed?

Put simply, a bare trust is a type of trust that allows money to be paid by a settlor to a trust fund managed by a trustee (often parents and grandparents) on behalf of the beneficiary (often children) of the trust. A bare trust can be used to gift money to children under the age of 18.

Unlike some other trusts, a bare trust cannot be revoked. Once monies are paid into the trust, the beneficiary becomes absolutely entitled to the assets. So, a transfer of money into the trust cannot therefore be reversed.

Take for example, our clients John and Sarah[2]. They wanted to set up a bare trust for their three-year-old daughter Ava with the objective of providing for future life events, such as a deposit for her first house or college fees. They will be making contributions of €250 each per month (role of settlors), and they are responsible for managing and controlling the funds until they are released to Ava at a date in the future (role of trustees).

Ava's grandparents also expressed an interest in making sporadic contributions to the trust at times such as birthdays – and so, ensuring flexibility with contributions is an important feature of Ava's bare trust.

With a longer time horizon and relatively small amounts of money, parents are often happy to use more risk to try and grow the trust over time. This may mean a higher allocation to equities in multi asset funds or even 100% equity funds.

At Goodbody, we worked with John and Sarah to ensure their objectives were met for Ava's trust with both regular and irregular contributions getting invested in line with their objectives and risk tolerance over time.

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How much money do you need to invest in the trust and for how long?

Capital Acquisitions Tax (CAT) legislation currently allows for the first €3,000 of the value of gifts received by one person from another person in any year to be free from gift tax; this is referred to as the Small Gift Exemption. In the case of minors, this allows each parent to contribute up to €3,000 per annum and they will not owe gift tax on the money, neither will it be eating into your child's lifetime inheritance allowance of €335,000.

What does this mean for John and Sarah?

John and Sarah will make regular contributions of €250 each a month – that means a total of €6,000 per annum will be gifted to Ava's trust (the maximum allowable which applies to everyone, not just parents, under Small Gift Exemption) for 15 years plus irregular contributions from Ava's grandparents, which will provide for a significant sum of money for Ava at the point when John and Sarah release the funds.

When does the beneficiary get access to the trust? And can the trustee retain some control over what the money in the bare trust is used for?

The beneficiary becomes entitled to access the proceeds of the investment when they are 18 years, unless otherwise specified. The purpose of the trust is to hold the investment in the name of the beneficiary. However, once the funds are released to them, trustees have no control over what the money is used for.

What tips would you give to a beneficiary in receipt of a bare trust?

For the beneficiary, learning that they have a meaningful sum of money now at their disposal can be quite life-changing given they are often still in some form of education.

Financial education for young adults is an important life lesson, and we regularly engage with the children of our clients before, during and after these life events to ensure the money which has been accrued over a number of years is put to work for the beneficiary's needs, for example, payment of college fees, or a deposit for a house.

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[3] Names have been changed to protect client anonymity.

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