Goodbody

Wealth Management Quarterly Report
Q2 2023

WEALTH MATTERS

TECHNOLOGY ON TOP FOR NOW

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Contents

Technology on Top for Now

Joe Prendergast, Global Strategic Advisor

Welcome to the Q2 2023 edition of Wealth Matters. This quarter we are focusing on options for excess cash, succession planning and ask has tech become the new defensive sector?

World equities have been consolidating in a broad range below their late 2021 highs. Having bottomed out alongside the peak in bond yields last October, the world market has been edging unsteadily higher. Despite the volatility centred on the banking sector in March and the drag of the stronger euro, the FTSE All-World Equity Index is up over 6% in euro terms in the new year to mid-May. The Information Technology Sector is up a more dramatic 20% year-to-date, which is worth looking at in more detail.

> *It's a challenging time for equities and risk assets in general. We expect modest returns from equities and have correspondingly been shifting capital to the more certain expected return from bonds.*

We've long argued that we are in the late phase of the world economic cycle, when economic growth peaks and starts to slow, when interest rates may still be rising, and when financial accidents tend to happen. It's typically a challenging time for equities and risk assets in general. We expect modest returns from equities and have correspondingly been shifting capital to the more certain expected return from bonds over time. In this phase of the cycle, we also tend to keep our equity preferences on the defensive side, overweight in Healthcare, and Consumer Staples in particular. But not Information Technology, where we are slightly underweight. Although IT has become less cyclical over time, it is in our view still not a clearly defensive play and indeed there are several concentrated risks facing the small number of mega-capitalisation stocks which have been leading the sector. Senior Research Analyst Sebastian Orsi looks at this topic in detail on page 8.

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In our view, IT's recovery of nearly half of its 2022 losses largely reflects the cyclical narrative of peaking world interest rates, which in turn has been fuelled by the gyrations in US smaller and regional banks. While the mega-caps have flourished as financial strains have helped push market rates lower, small-cap and micro-cap stocks have fallen far behind – partially dragged by the prospect of tightening lending standards at banks.

Strategically, we still prefer to keep our overall equity exposure relatively low and our sector exposure biased toward more traditionally defensive sectors, where we see lower cyclical sensitivity and positive structural growth trends contributing to high earnings visibility. With euro area short-term bond and bill yields back to levels not seen since 2008, we continue to favour accumulation of high-quality fixed income assets. And for investors sitting on significant amounts of cash, we see several attractive options to improve yields without unduly extending risk – see page 4.

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Relatively high yields on safe assets like short-maturity government bonds might also be a factor influencing business owners decision making in terms of seeking an exit. According to our independent survey of Irish business owners, some 57% intend to exit within five years. Most of those surveyed also indicate they don't have a formal succession plan in place and more than third have never done a financial plan. See page 6 for the first steps in getting started with Goodbody's series of events for business owners.

Your Options When Putting Excess Cash to Work

Elizabeth Geoghegan – Head of Fixed Income

Excess cash in a time of high inflation is both a blessing and a curse. While it's essential to have money in the bank for ongoing spending and emergencies, cash that is sitting in your account maybe quickly losing value. Below, we discuss how much cash to keep on reserve and how to get the rest of it working for you.

Excess cash in your account maybe losing value

The exact amount of money you need in the bank, depends on your financial situation and preferences. After the pandemic, many people have more cash in their accounts then they currently need for security purposes. Given the market backdrop today, it is worth exploring what options may be available to you to get a positive return. Investing your money can help to fight against inflation and the subsequent erosion of your overall net wealth.

Identify true excess cash

Before you identify any amount for investing, it is important to ask some significant questions:

What are your current and future cash requirements?
Look at your current household bills and any future maintenance costs you may have.

Are your liquidity needs matched to your investment?
Make sure there is ample liquidity planned for large purchases, liabilities, or life events in the near future.

What is your ultimate financial goal?
Once you identify cash that is truly excess, think about what you want to use it for and discuss with your financial adviser a suitable investment plan to make the most of its future value.

The Options Available

Let's say you have excess cash and need the amount to stay liquid with a low level of risk, what are the options available to you? The following are just some examples of strategies but always seek advice to understand what might be best for your specific circumstances.

Bonds are Back

As an asset class, fixed income is a lot more attractive today relative to recent history. A year ago, investors looking to invest in short term government bonds were faced with negative yields, meaning a guaranteed negative return if the bond was held to maturity. Today there are significantly positive yields on offer, presenting an attractive opportunity for investors.

Government Bonds – A Safe Haven

Core European government bonds (issued by highest-rated euro area sovereigns) are considered among the lowest risk investments. They are non-complex instruments, typically highly liquid and available to all investors. In addition to this, government bonds can demonstrate safe-haven characteristics. In March 2023, banking sector concerns had a negative impact for some markets. During the same period, government bonds posted positive price performance and outperformed corporate bonds due to safe-haven investor demand. Gross yields of nearly 3% are currently available on AAA-rated shortdated euro government bonds.

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Safety in Short Duration

Investing in short duration assets limits the risk sensitivity to unexpected interest rate moves relative to longer duration (longer maturity) assets. In addition to this, given the unique backdrop of interest rate markets today, shorter duration bonds, offer higher yields relative to longer duration bonds of the same issuer. Today the German Government two-year bond yield is roughly 0.45% higher than the 10-year yield. This combination of lower interest rate sensitivity and higher yield of shorter maturity bonds relative to longer maturity bonds introduces a unique opportunity for investors today.

Income Portfolios

For investors with a larger amount of excess cash and willing to accept a little more risk on capital value, another option is positive-yielding, high grade, short-maturity fixed income portfolios. These portfolios can be constructed using core government bonds, high quality corporate securities or a blend of both. This low-risk conservative blend can generate a gross yield around 4% today.

Blended Investment Portfolios

The longer you spend invested in the market, the higher the potential rewards. A blended investment portfolio of equities and bonds is the higher-risk alternative for excess cash. Remember that equities (stocks) are higher risk, with exposure to market vulnerability, a company's loss/profit margin and many unforeseen events. However, based on the historical data available to us, a well-balanced investment portfolio has a high probability of keeping its value and adding significant growth over a period of more than five years.

Take control of your excess cash

The most important thing is to not underestimate the options available for excess cash. Talk to a financial advisor and consider your objectives. Take time to establish how much money you need, along with your ideal risk tolerance. Small steps today to diversify your wealth will help to avoid capital erosion, grow your money, and preserve your purchasing power.

To avail of a no commitment, complimentary consultation on options that might work for you and your circumstances, please contact Owen Redmond at owen.p.redmond@goodbody.ie

> *Take time to establish how much money you need, along with your ideal risk tolerance. Small steps today to diversify your wealth will help to avoid capital erosion, grow your money, and preserve your purchasing power.*

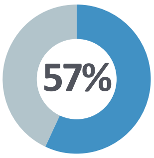
Business Exit and Succession Planning

Catriona Coady, Head of Tax

Stepping away from a business is a matter of when versus if, start planning now. Whether you choose to sell your business or intend to pass it on to the next generation, exiting your business is one of the most important personal and professional decisions any entrepreneur can make. Preparation and planning are key to achieving the best outcome.

Earlier this year, together with AIB Capital Markets, we conducted an independent survey with Irish business owners to learn about what exit planning, if any, they have put in place.

What we learnt:



of owners intend to **exit within 5 years**

1 in 3
are planning to start another business after exit

Yet just **15%** have a **formal succession plan** in place

37%
have never done a personal financial plan

Tax was the most important driver of exit decision making

52%
surveyed intend to sell, while **23%** wish to pass on to family

Less than half
surveyed have a leadership succession management plan

To arm owners with information and practical tips to be aware of and to action where appropriate, the Succession Advisory Team recently produced a 40-page report detailing some of the most important things owners should be aware of to maximise their financial position before and after a business exit. This team is made up of M&A, tax specialists and wealth planners who offer business owners a coordinated one-stop advisory service across all aspects of a potential business exit, including both personal and corporate financial readiness.

Prepare with the end in mind

Succession planning is a process rather than an event, the sooner you start the better. Entrepreneurs should have a good idea of how they intend to exit the business from the early days of its life, but most owners don't think about their exit strategy until much later. When your business starts being profitable, always keep an eye on the entitlement to any tax reliefs that might apply as the business scales. Take the time to become familiar with the tax requirements and have a plan in place for funding a tax liability. Very often a business owner won't know what the ultimate objective for their business is. For example, if the end goal is a sale, then it's important to start getting ready for that sale. This means working on your own personal balance sheet and the funds you might wish to extract from the company to live off.

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Four reliefs to remember

1. Pension Funding

Currently, there are four key tax reliefs to be aware of, the first being pension funding. In the last *Wealth Matters newsletter*, we detailed the positive impact changes to Finance Act 2022 had on pension funding for business owners which you can access *here*. If the next generation are considering taking over the business, decide how soon you need to bring them into the business. When it comes to renumerating family members, make sure that you are paying them in the right way and setting up pensions for them too.

2. Entrepreneur Relief

Selling the business and making a capital gain can be very efficient if the owner benefits from entrepreneur relief, the second relief to be aware of. The standard rate of Capital Gains Tax (CGT) is 33% on the gain, but entrepreneur relief allows a business owner to pay only 10% CGT on gains of up to €1,000,000, subject to certain conditions being met. This is a lifetime cap, with the balance chargeable at 33%. To qualify for the relief, there must be a disposal of a qualifying business asset by a qualifying individual.

3. Retirement relief

Retirement relief is a relief from CGT, which can be applied in particular circumstances where an individual is disposing of all or some of the 'qualifying assets' of their business. While its name would suggest otherwise, it is not a condition that the owner must retire to qualify for the relief. If you are between age 55 and 65 and decide to hand the business down to the next generation, full CGT relief with no cap on the value may be available. The beneficiary must retain the business for six years or the CGT relief will be clawed back. If you are 66 or over, the relief is restricted to proceeds of €3,000,000. If you choose to sell the business to someone outside the family, the limits are €750,000 for those aged 55-65 and €500,000 if you are older. If the business is worth over these thresholds, marginal relief may apply to limit the CGT liability to 50% of the difference between the actual value and the threshold. Retirement relief generally encourages owners to keep the company in the family so it's an excellent way of safeguarding jobs for at least six years.

4. Business relief

Business relief can apply before or after the business owner dies, so it's a useful tool for financial planning before inheritance. A person retiring from their business, for example, can transfer ownership to their children while benefiting from business relief, which allows the children to save on tax immediately and simplifies the inheritance process later. Business relief reduces the taxable value of a gift or inheritance of a relevant business property by 90%. The property could include unquoted shares or securities, which would qualify for the relief provided that the beneficiary satisfies one of the following criteria after taking the benefit: they either own more than 25% of the voting rights; or for example they control the company by owning more than 50% with other people; or they own at least 10% of the aggregate nominal value of all the company's shares and securities, and they have also worked full-time in the business for the previous five years.

To have a complimentary consultation with our Succession Advisory Team and obtain guidance about how you can position yourself for these tax reliefs, go to *www.goodbody.ie/business-owners*. You can also register for our event series, running for the rest of the year, to help you get exit ready, whether your exit is around the corner or much further away.

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Tech: The New Defensive Sector?

Sebastian Orsi CFA, Senior Research Analyst

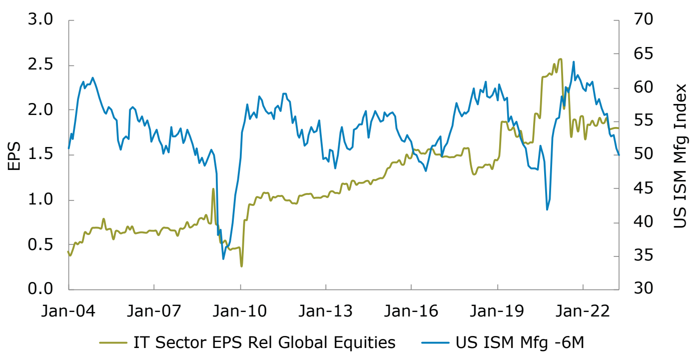
Some market commentators have suggested that the Information Technology sector may be a new 'defensive' sector like Healthcare, Consumer Staples, and Utilities. The earnings of defensive sectors are less sensitive to the economic cycle than cyclicals, and this typically makes them relatively attractive late cycle equity holdings. Below, we outline why we think it's too early to tell, and how there may be other risks inherent in the mega-cap stocks.

Structural changes to some IT business models are supportive of the suggestion that technology sector earnings may be less cyclical in the future than they were in the past. Two examples are: software-as-a-service (SAAS), where customers pay annual subscriptions rather than one-time perpetual license fees; and cloud services where customers outsource IT infrastructure and software over the internet. These changes typically convert customers' capital investments into smaller annual operating expenses, which may be less cyclical. But, as penetration increases and markets mature, they tend to become more cyclical.

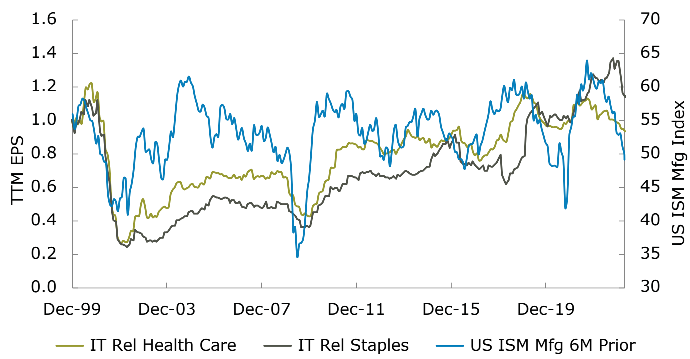
During the Covid-19 pandemic, some tech companies saw strong revenue growth and behaved defensively. However, this was an unusual economic cycle when digital delivery and remote working were favoured. There was also an accelerated demand for hardware and software to enable it. So, is there much support for the defensiveness theory in a traditional cyclical downturn? History would suggest that even with tech's secular growth component, the sector's earnings are more 'cyclical' than 'defensive'.

The chart below left illustrates global IT sector earnings per share (EPS) relative to global equities. On the right, the chart illustrates the S&P 500 IT sector EPS trend relative to the defensive Healthcare and Consumer Staples sectors. Both charts show the US ISM (Institute for Supply Management) Manufacturing Index, a typically reliable cyclical indicator; we've lagged it by 6 months to let the economic cycle feed through to reported earnings. Despite Tech's longer-term earnings outperformance, the charts clearly show that there is a strong cyclical impact on Tech earnings compared to global equities and more so to defensive sector earnings. When we look at historic annual EPS forecasts (not shown), tech sector forecasts are cut faster than defensives and coincident with the falling ISM Manufacturing Index. This is consistent with cyclical trends rather than defensiveness.

S&P 500 Sector EPS



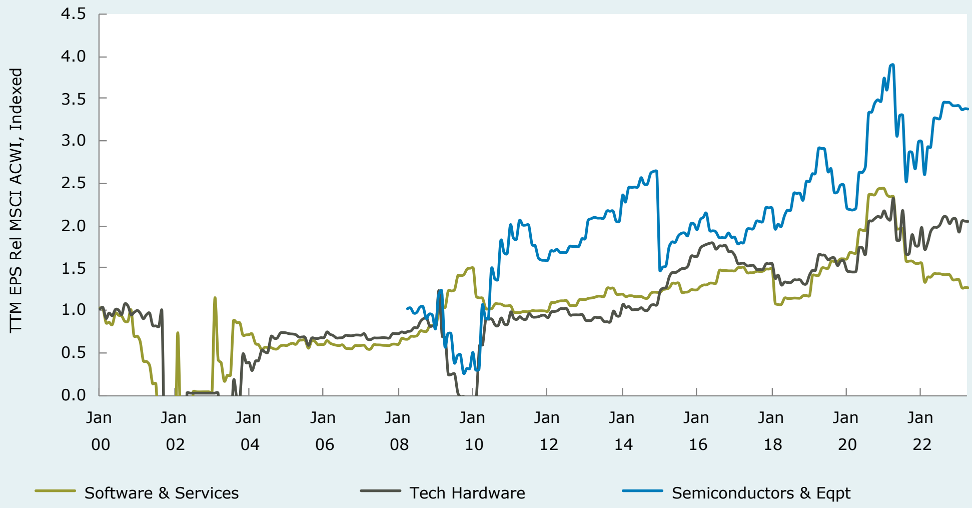
IT Sector Relative EPS



> *During Covid-19 some tech companies saw strong revenue growth and behaved defensively. However, this was an unusual economic cycle when digital delivery and remote working were favoured.*

The three IT sector industry groups are broken out in the chart below: Software & Services, Hardware, and Semiconductors. The latter two are unsurprisingly more volatile than Software. Outside of the global financial crisis period and until recently, Software's earnings have performed consistently with Hardware's.

Industry Group EPS vs Global Equities



Obviously, the charts in this article are historic rather than forward looking. We can't say with any certainty that technology sector earnings will or won't perform better than average through future recessions, but there are a few other points worth highlighting.

Generally, it's the US mega-cap stocks, Microsoft, Apple, Alphabet (formerly Google) and Amazon, that are referred to as having defensive characteristics (although the latter two fall into Communications Services and Consumer Discretionary, respectively, rather than the IT sector despite their large cloud services segments). These names have come to dominate the market value of their sectors. Microsoft has increased from ~20% of global Software and 7% of the global IT sector in 2010, to ~45% and 18% respectively, now in 2023. Apple has increased from 23% of global Hardware and 10% of global IT to, in today's market, over 60% and 20% respectively. Alphabet has increased from 20% of the global Communications sector to over 35%, and Amazon has grown from 3% of global Consumer Discretionary to over 14%. While we are not positing a view on their investment merits here, as companies become a larger part of the market, it becomes more difficult to outgrow and outperform it.

The companies referred to above are high-quality businesses and have been dramatically successful. It's worth keeping in mind that an investment into the IT sector, 40% comprised of two companies, is an increasingly concentrated risk that requires a confident view of the giants. And the pace of change in technology does not seem to be slowing. It seems any company's moat could be breached by some recent developments.

Going back to the relative cyclical defensiveness, the four mega-caps have experienced years or multi-year periods of negligible or negative operating profit growth individually and collectively. We're not projecting this, just highlighting it could recur. Furthermore, the individual and collective growth trends have been slowing on an annual basis and on multi-year compound bases.

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To summarise, while IT has a long track record of above average growth, it appears more cyclical than defensive. This is also the case within the Software industry group, which is perceived to be less cyclical. In addition to the cyclicality, the high concentration of the sector in a small number of mega-cap names that have exhibited slowing growth trends, and periods of relatively low/no growth, could undermine the thesis. Hence, we'd be hesitant to view IT as the new defensive sector.

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