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Investment Prospects

For most of 2012, stock markets were preoccupied by the debt crisis in the Eurozone, the looming "fiscal cliff" combination of tax rises and spending cuts in the United States, and questions over the strength of the Chinese economy.

Consequently, investors sought refuge in Fixed Interest securities, despite record low interest rates. But is the tide turning? Virtually everyone now agrees that government bonds are expensive, and the fact is that many good quality equity shares are generating higher yields. In addition, brighter economic news is reducing investors' risk aversity.

So, what is the best investment strategy for 2013? The first point is that we are not yet out of the woods; there is still potential for politicians to throw spanners in the works, whether over fiscal cliff negotiations in the US, elections in Italy and Germany or further dissension over how to fix the Eurozone. In addition, an escalation of tensions over nuclear ambitions in Iran or North Korea could throw predictions off-course.

However, the consensus is that it is time to start reducing exposure to both bonds and cash. In the UK, interest rates are expected to start rising in the second half of 2013, and to buy now would be to combine the certainty of a low level of income with the strong likelihood of a capital loss.

However, it seems unlikely that there will be a stampede out of bonds. Research conducted by the Financial Times suggests that one of the main determinants of stock market performance is demographics – that is to say, the age profile of the population.

The demand for equities, and therefore their price, has been highest when the proportion of the population planning for retirement has been greatest. The most notable example in the UK has been the way equity prices surged when the 'baby boomers' started to prepare for retirement.

The research found that up to the age of 40, most people invest in home purchase rather than retirement provision; and in retirement the appetite for risk reduces and the preservation of capital becomes the top priority, with the result that cash and bonds become the favoured types of investment. This trend is reinforced by the fact that insurance companies have to buy bonds to provide the income to pay retirement annuities.

These trends are subject to shorter-term influences, such as the increase in money supply created by the Government's 'quantitative easing'. Another factor is the increased level of investment by foreign nationals.

However, many developed countries are experiencing a combination of lower birth rates, a reduction in the working population and an increase in the retired population, boosted by improvements in health care.

Over-65s accounted for 12% of the population of the developed world in 1982, and this figure has now risen to 16% and is predicted to rise to 25% by 2042. It is estimated that almost a quarter of the UK population is likely to have retired by 2035.

It may be thought that the historically very low returns on cash and fixed interest assets would deter people from investing in such assets, but the experience in Japan suggests otherwise. Despite interest rates being close to zero, deposits account for roughly half of total assets.

These trends are long-term, and in the shorter term equities are regarded as holding greater appeal. Jim O'Neill, the respected Chairman of Goldman Sachs Asset Management, favours growth stocks and emerging markets over developed markets, with the possible exception of Europe. However, the boom years for equities of the 1980s and 1990s may never return, as demographics dictate a preference for security over risk.

Taxman turns Snooper

Her Majesty's Revenue & Customs is getting tough with people it thinks may be resorting to unacceptable methods of avoiding tax. Its secret weapon is a "break-through" computer system, known as 'Connect', which has been created for HMRC by BAE Systems, the defence contractor.

HMRC has connections with the electoral roll and with a wide range of databases, including those of the Land Registry and Companies House; and 3,000 Connect analysts in offices around the country use the system to identify significant relationships between the various sets of data in a way which would be impossible without the use of technology.

An example of the application of Connect is Inheritance Tax. HMRC receives 300,000 paper returns every year, most claiming to relate to estates which fall below the tax threshold. Connect enables HMRC to sift through information on property transactions, company ownerships, loans, bank accounts, employment history and self-assessment records to indentify under-declarations.

More conventional methods are also used. Spot checks are carried out by tax inspectors posing as customers of businesses where cash changes hands, such as hairdressers and restaurants. Tip-offs are another source of useful information.

Ownership of overseas property may also trigger the interest of HMRC if it appears that the cost could not be afforded by legitimate means. Foreign bank accounts will be checked, utilising information gained from overseas tax authorities with which the UK has reciprocal agreements.

If you want to sleep easy at night, honesty is clearly the best policy.

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