**Cover story**

**Why wait until March to invest in an Isa? The final quarter of the year historically provides the best returns, reports Mark King**

**Fund tips: James Britton, T Bailey**

I would encourage anyone to take a close interest in funds for their Isa – and I nearly always recommend equity or equity-linked. For long-term investments, say five to 10 years.

But for most people it makes more sense to invest in their Isa with a fund of funds manager, because of the greater diversification it offers, the superior fund picking on offer, the constant supervision and the subtle ways in which funds of funds can shift asset allocation to respond to market changes or opportunities.

Provided you know where to look there are also good Isa funds to buy. However, finding the very best ones is hard and requires dedicated research and time. The go-to Palmer Arnold once said: “The more I practise the luckier I am.” And, in fact, many investors during the final quarter of 2006, depending on their particular take on inflation, the US economy and UK stock market valuations. If many UK industry experts are to be believed, the UK stock market is currently seriously undervalued. If this proves to be true, now is the ideal time to open a stocks and shares Isa to take advantage.

James Ridgwell, manager of New Star UK Special Situations Fund, explains: “When in doubt, always look at the fundamentals. The UK market is on a price/earnings (p/e) ratio of around 12.5 times earnings, so we are now as cheap as we have been for many years. We are almost as cheap as we have ever been.”

Andrew Teufel, director of research at Fisher Wealth Management, agrees. He says equities are undervalued to a greater degree today than at any other time since the bottom of the bear market in March 2009. Chris Lygo, senior UK strategist at AXA Framlington Investment Managers, adds that the UK stock market’s forward p/e ratio is at its lowest since the mid-1990s.

The correction comes

Private investors returned to equities in droves during the first half of the year, driving trading volumes up to levels not seen since 2001. But in May the market weakened, which suggested a correction had come after three bullish years of continued stock market outperformance.

A correction is typically defined as a decline of between 10 and 20 per cent from peak to trough, and what happened in the UK happened across the world. The MSCI World index fell 12.7 per cent before bottoming out on 13 June. But by the end of the second quarter, the index had retraced about half of that decline, rising 5.4 per cent.

Teufel explains: “Bull markets die with a whimper, not a bang. Recent market activity was a bang, which implies it is not a new bear market but, rather, a correction. The last bear market was a perfect example. It started to sputter in April 2000 and declined over the next 10 months, falling about 0.5 per cent a month on average. Only after this period did declines start to accelerate.”

In contrast, bull market corrections characteristically begin with sharp, sudden drops followed by quick rebounds. For example, in 1979 investors were concerned with the US Federal Reserve chairman, Paul Volcker raised interest rates against a backdrop of rising gold and oil prices as well as tensions with Iran. Sounds familiar? The result was a decline in the MSCI World index of over 10 per cent in just over a month, followed by an immediate revaluation of the bull market trend.

Of course, some corrections evaporate as suddenly as they begin and have only one down leg before rebounding, whereas others have a second plummet. Either way, global corrections tend to be short-lived (see our table on page 24).

Ultimately, corrections create volatility that scares some people away from equities at precisely the wrong times, while more patient investors achieve decent returns. Trying to alter your short-term asset allocation to react to a correction is difficult and dangerous. For example, changing defensive in anticipation of one can backfire as the market runs in advance.

Similarly, prematurely looking resolve near the bottom of a correction is one of the worst mistakes an investor can make.

What is the best way to invest?

According to the experts we contacted, the outlook for UK equities is at worst neutral and at best highly positive.

The share tips on these pages will help more aggressive Isa investors find suitable shares among the huge number of options offered on the market. Opposite, a financial adviser draws up Isa fund portfolios for UK investors.

**Portfolio tips: Dan Kemp, Chisworth**

I have kept each of my Isa funds and tried to limit the maximum investment to £1,000. For this level of investment, a balanced fund is the most suitable for most investors. On the downside, there is a risk that funds do not suit the specific needs of individual investors.

On the upside, there are many investment trusts that offer funds with the most favourable opportunities in equities at present, hence our inclusion of a diversified US equity fund.

**Fund name**

<table>
<thead>
<tr>
<th>Aggressive choice</th>
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<tr>
<td><strong>Saracen UK Growth</strong></td>
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| Ranby John Fisher and Julian Fosh based on their ‘seven pillars of wisdom’ investment approach, this fund has emphasised many larger-profile competitors since I first bought it in September 2004. Only 1 per cent of funds in the UK All Companies sector have done better. Over this time they have led the FTSE 100 Tracker Sharpe by a shading 3.5 per cent.

**Medium-risk choice**

**Merrill Lynch UK Dynamic**

This fund takes a different approach to Saracen but has similarly impressive results. Mark Lyttleton has access to vast amounts of research as well as Merrill Lynch’s global team of analysts. He uses this ability to deliver strong performance, possibly with a lower risk profile than Saracen.

**Cautious choice**

**Merrill Lynch UK Absolute Alpha**

This new fund, also run by Lyttleton, may not be everyone’s cup of tea, but is losing less than 2 per cent at the worst in recent market setbacks, compared with the FTSE All-Share’s near 10 per cent decline. Its investment objective is clearly demonstrated.
## Allocation

<table>
<thead>
<tr>
<th>Fund</th>
<th>Proportion</th>
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<tbody>
<tr>
<td>Artemis Income</td>
<td>700</td>
</tr>
<tr>
<td>L&amp;G All Stocks Gilt Index</td>
<td>1000</td>
</tr>
<tr>
<td>M&amp;G High Interest</td>
<td>1000</td>
</tr>
<tr>
<td>Investec UK Value</td>
<td>700</td>
</tr>
<tr>
<td>SWIP Property Trust</td>
<td>1100</td>
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<tr>
<td>ACDS Lindsell Train UK Eq.</td>
<td>14%</td>
</tr>
<tr>
<td>L&amp;G All Stocks Gilt Index</td>
<td>7000</td>
</tr>
<tr>
<td>M&amp;G High Interest</td>
<td>1100</td>
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<tr>
<td>Investec UK Value</td>
<td>14%</td>
</tr>
<tr>
<td>SWIP Property Trust</td>
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<tr>
<td>ACDS Lindsell Train UK Eq.</td>
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<tr>
<td>L&amp;G All Stocks Gilt Index</td>
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<tr>
<td>M&amp;G High Interest</td>
<td>9%</td>
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<td>Investec UK Value</td>
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<td>SWIP Property Trust</td>
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<td>ACDS Lindsell Train UK Eq.</td>
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<td>1000</td>
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The strongest quarter of the tax year. Markets have already absorbed the recent rate rise and, with shares looking cheap and the corporate and economic environment remaining robust, the conditions exist for the remainder of the year to be a more profitable period for investors.

Clem Chambers, chief executive of Advfn, adds that with the bonhomie and window dressing of Christmas around the corner, the UK’s main index tends to rally. Even crash-prone October shouldn’t be a deterrent, he says, because the UK’s main index increases on average 0.89 per cent in this month alone if the effects of Black Monday in 1987 are excluded.

But there are a number of understandable, and realistic, reasons why UK investors are nervous. The US is at the forefront of the jitters because of rising inflation and because it looks to be entering a period of economic decline. How you view the state of the US will inform how you see the UK market.

Iggo of AXA Framlington holds the consensus view that the US is entering a period of economic decline but will achieve a soft landing rather than a recession. Things have been undoubtedly tough, with 17 interest rate hikes taking the Federal Reserve rate to 5.25 per cent. This has led to slower economic growth and a difficult environment for corporate earnings due to lower demand.

This is not necessarily negative. If growth slows further, interest rate cuts will follow the rises. This scenario makes the stock market rally quite possible since the positive effect of lower interest rates tend to outweigh lower earnings growth.

Much of the gloom about the US centres on its housing market – a victim of other sectors that look sound,’ he says. While it may be slowing, there are plenty of other sectors that look sound,’ he says. ‘Also, in the UK we had a soft landing in the housing market, and I believe the US market issued a profits warning and the shares began to fall, but Ridgewell says it is cheap on a p/e of 11 with earnings growing at 20 per cent. ‘Brokers haven’t upgraded the stock for some time and I believe this is a strong operator in a specialist retail area.’

Finally, Ridgewell rates BAE Systems (BA, 380p). ‘It’s had a lot of problems in the past and the share price has been marked down, but the defence group continues to be a “best in class” company. Its cashflow is much greater than its profit, which indicates the group is being careful with its money and holding cash back. People haven’t owned this for some months and I think that is wrong.’

**AVG Quarterly Performance of UK indices**

**Quarterly Returns from All-Share Index**

**Average Quarterly Performance of UK Indices**

**Bull Market Corrections: MSCI World Index**

<table>
<thead>
<tr>
<th>Peak</th>
<th>Trough</th>
<th>Return</th>
<th>Duration (mths)</th>
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<tr>
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<td>29/12/76</td>
<td>-1.19</td>
<td>2</td>
</tr>
<tr>
<td>21/10/77</td>
<td>28/2/78</td>
<td>-12.8</td>
<td>4.3</td>
</tr>
<tr>
<td>28/5/79</td>
<td>26/7/79</td>
<td>-11.5</td>
<td>1.9</td>
</tr>
<tr>
<td>17/8/81</td>
<td>17/8/81</td>
<td>-13.7</td>
<td>1.7</td>
</tr>
<tr>
<td>5/3/85</td>
<td>18/4/85</td>
<td>-15.8</td>
<td>1.4</td>
</tr>
<tr>
<td>5/6/85</td>
<td>25/9/85</td>
<td>-11.1</td>
<td>3.7</td>
</tr>
<tr>
<td>17/10/91</td>
<td>24/1/91</td>
<td>-10.7</td>
<td>2.2</td>
</tr>
<tr>
<td>1/6/92</td>
<td>25/8/92</td>
<td>-12.2</td>
<td>2.8</td>
</tr>
<tr>
<td>6/10/97</td>
<td>12/11/97</td>
<td>-14.2</td>
<td>1.2</td>
</tr>
<tr>
<td>17/7/98</td>
<td>8/10/98</td>
<td>-23.4</td>
<td>2.7</td>
</tr>
<tr>
<td>16/7/99</td>
<td>18/10/99</td>
<td>-12.3</td>
<td>3.1</td>
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<tr>
<td>4/6/06</td>
<td>13/6/06</td>
<td>-26.7</td>
<td>2.2</td>
</tr>
</tbody>
</table>

Source: advfn.com
**Isas: the basics**

- Isas are tax-efficient wrappers into which you can put a range of savings and investments.
- Isas come in two forms: maxi and mini.
  
  Under each form you may invest up to £7,000 each tax year. However, only the maxi Isa allows you to invest the whole amount in stocks and shares. A maxi Isa can include up to £7,000 in stocks and shares less anything invested in cash (maximum of £3,000).
  
  With a maxi Isa, the same provider manages both investment types. Most providers of maxi Isas limit investments to stocks and shares.
  
  Mini Isas allow you to choose different providers for the different investment types. Under the mini Isa route, you may invest up to £3,000 in a cash mini Isa plus up to £4,000 in a stocks and shares mini Isa.
  
  Anyone over 16 may invest in a cash Isa but you have to be 18 to invest in a stocks and shares vehicle.
  
  The government has guaranteed that the existing annual Isa allowances will be maintained until 2009.

**Isa: the basics**

*It is simply a year behind us. UK housebuilders say things are ticking over quite nicely at the moment. The same should happen in the US.*

Ian Kershaw, senior economist at Royal London Asset Management, puts it in a nutshell: ‘With US interest rates set to fall next year and bond yields remaining low, this will underpin US equity valuations, which look very attractive now.’

‘The risks to this view are twofold: either interest rates move much higher or the US slowdown turns into a recession. Neither scenario would be good for equity markets.’ Neither scenario looks especially plausible at present.

**Excitement builds**

Why else are some fund managers excited about UK equities? At the time of writing the City was eagerly awaiting the latest round of company reports, with all the companies with June or July year-ends due to announce their final results.

Ridgewell expects great things: ‘The litmus test always comes in September, when the reporting season kicks off. Last year was very good, and this year should be similar. Most companies reporting in September have their year-end in June and if there were any profits warnings, they would already have come out.’

Moreover, Ridgewell and most other fund managers we spoke to believe UK interest rates have either peaked or will endure only one more rise before holding steady. Most fund managers report that retail sales will continue to grow when the reporting season kicks off. Last year was very good, and this year should be similar. Most companies reporting in September have their year-end in June and if there were any profits warnings, they would already have come out.

Second, when retail sales were buoyed by the World Cup. By raising rates in August, the Bank of England’s monetary policy committee (MPC) was stating that consumer spending was healthy once again. Although this monetary tightening came as a shock, it seems to have been well received by the market. Now, bullish fund managers believe retail sales will continue to grow at or near the MPC’s two-year target of 2.75 per cent, while the bears point to July’s dip of 0.3 per cent as evidence that consumer spending is on shaky ground, made worse by rising utility bills, which many commentators blame solely for higher inflation.

But Fisher’s Teufel dismisses the high cost of energy as an important factor. He is not a believer in the ‘perma-bull market’ for energy prices because alternative energy sources as well as demand from China being sated by its own massive coal deposits will help alleviate the pressures on demand for oil.

A great positive for UK-focused investors is that UK companies continue to generate decent levels of cash, buoyed by healthy balance sheets. As a result, they are still highly acquisitive.

Hugh Duff, senior investment manager of Scottish Investment Trust, says mergers and acquisitions as well as pri-
Investment trust tips

John Newlands, Newlands Fund Research

Many Isa and PEP investors will be looking to tuck their money away for a number of years. This is where top-quality investment trusts can serve you well. Globally diversified trusts with a sound long-term track record are a good starting point. Two trusts stand out at the moment.

The first, Alliance Trust (ATST), should strike a chord with those who like the words prudent, cautious, canny and competent. Alliance has been worthy and introvert for decades but a new management team has generated a number of ideas to revitalise the self-managed trust and develop extra sources of inward cashflow without any increase in investment risk.

Another great generalist trust is Scottish Mortgage (SMT), run by Baillie Gifford in Edinburgh. Although the trust has a global remit, it is far from being a quasi index tracker. Its lead manager, James Anderson, has proved adept at developing and refining a relatively concentrated portfolio of heavily researched key shares that he believes will produce value over the medium to longer term. Both trusts are trading at useful discounts to net asset value (NAV) – Alliance 13 per cent and Scottish Mortgage 14 per cent.

Looking further afield, JP Morgan European Fledgeling (JFF), managed by Jim Campbell since 1995, offers an ideal way to gain exposure to a diversified portfolio of dynamic smaller companies across Europe. The trust has risk controls that limit active positions to within a few percentage points by industry, country and stock. However, that has not stopped its thorough management team from producing strong performance. Moreover, the trust is attractively priced, standing at a discount of 13 per cent.

For the slightly more adventurous I recommend the ordinary shares of J2 Equity Partners (J2E) a split-capital trust run by Wall Street financiers Jay Jordan and David Zalaznick. J2EP has weathered the entire technology boom/bust cycle and split-capital trust crisis in style, producing strong investment returns during some incredibly difficult equity market conditions.

Because of fads and fashions, the trust, which invests mainly in US private equity ventures, stands at an extraordinary discount of more than 20 per cent to NAV while yielding over 6 per cent. Note that J2EP has never held, nor ever will hold, cross-investments in other trusts.

John Newlands produces a bimonthly private newsletter about the investment trust sector. See www.newlandsfr.co.uk for details.

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Fisher Wealth Management
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Newlands Fund Research
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New Star Asset Management
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Royal London Asset Management
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SVM Asset Management
www.svmonline.co.uk, 0131 226 6699

T Bailey Asset Management
www.tbailey.co.uk, 0115 988 8200

Troy Asset Management
www.tampl.co.uk, 020 7499 4030

Share tips

Francis Brooke, Troy Asset Management

We have been buying Vodafone (VOD, 113.5p), Shell (RDSA, 1796p) and BP (BP, 591p) because we believe the very largest companies are cheap and the easiest to buy. We like stocks trading on 10.11 or 12 times earnings per share and yielding 4-5 per cent. I also like British American Tobacco (BATS, 1460p) because the expectations are very low, but its earnings per share are consistent.

active equity remain strong drivers of the UK stock market. ‘Healthy company balance sheets will mean more cash being returned to shareholders through the preferred routes of share buybacks and special dividends,’ he claims.

Francis Brooks at Troy Asset Management agrees, adding that there is currently a ‘great deal of liquidity out there, with private equity money committed but waiting to be spent’.

A Money Observer sweep of fund managers’ views shows they are either neutral or positive in their outlook for UK equities, despite what they think might happen in the US.

Luke Newman, manager of F&C Special Situations Fund, is typical of the neutrals. But even he admits the UK market ‘doesn’t look particularly stretched’ and says the May sell-off has opened up a plethora of buying opportunities among companies that he believes have been ‘indiscriminately marked down’. He currently rates the very largest companies in the land, rather than the FTSE 100 as a whole or the All-Share en masse (see the boxes on share tips to put in your self-select Isa).

Active fund managers almost always argue that the market is ripe only for experienced share pickers. Now that could be different. Even if it isn’t, we have provided you with a host of fund, trust and equity suggestions to ensure you don’t miss the boat. So why delay investing in an Isa until next year when you could easily profit from investing today? Think of the fun you will have on the golf course if you get it right. And if you don’t play golf, you can just feel smug by yourself.

Fund tips

Robert Goldschmidt, Cumberland Place Financial Management

Only with the benefit of economic hindsight will one be able to decide if the current level of markets both here and abroad makes them ‘cheap’.

For any investor a diverse allocation of investments is very important. Contributions to Isas can be used as a chance to rebalance overweight positions, augment existing allocations or to gradually become either more defensive or aggressive.

A defensive investor should consider the Baring Directional Global Bond fund run by Colin Harte. It seeks to deliver a return of three-month Libor plus 4 per cent a year (currently an equivalent rate of 8.99 per cent). It is a bond fund that seeks to achieve its return by a mixture of interest rate and exchange rate anticipation, whichever way bond markets move. While this is not a fund from which to expect fireworks, it should form a part of an investor’s exposure to bonds.

M&G Managed Funds is a fund-of-funds managed by David Janes. It utilises many of the other M&G funds, including the successful M&G Global Basics. Moving away from the UK investors looking for a more aggressive approach will find Newton Asian Income of interest. The more mature Asian markets now boast a number of companies with a solid and growing stream of dividend income. These tend to be utilities, infrastructure and banking groups. This is the age-old argument in favour of UK dividend income transposed to Asia.

A combination of the reinvestment of dividend income, currently estimated as over 4 per cent, and capital growth could make this an interesting long-term holding, not least because the income has the potential to rise steeply – relative to the UK – in future years.

The fund was launched in November 2005 and, as such, may not yet be on many radars.

Newlands: seeking out value