KEYSTONE

PERSPECTIVE

SPRING 2022

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DEAR READERS,

Welcome to the fifth edition of Perspective – our half yearly newsletter. The eagle-eyed amongst you will have spotted it is the fifth and not the sixth edition as it should have been. Last autumn we decided to put the newsletter on hold and focus our energy on a live event instead, having not had such opportunities in almost two years. It was a great call and wonderful to see so many of you in person, so thank you for supporting it. Now that life seems to have returned to some sort of normality it seems good time to resume publication of our newsletter.

We say life has returned to some sort of normality quite loosely. The last six months have turned most forward-looking economic commentaries on their heads. We have gone from emerging from a global pandemic with prospects of a strong economic recovery to a full-scale war in Europe with fears of stagflation for the world economy; so much has changed in so short a time. In this edition of Perspective, we sit down with Henry Johnstone of Cazenove Capital to discuss recent events and their long-term impact on financial markets; we explore the importance of diversifying your investments and Mark Levitt of Blick Rothenburg sheds some light on why Family Investment Companies are fast gaining in popularity. Yet again, we are extremely grateful to all our guest contributors for their contributions. If an article piques your interest and you would like to learn more, please get in touch with us. As always, we welcome your feedback on this newsletter and indeed previous editions so please do not hesitate to drop us a note with your thoughts at help@keystone-capital.co.uk

At Keystone, it has always meant a lot to us to support a local charity in more ways than just financially. Many of you will know that we have been patrons of the Watts Gallery in Compton, Surrey for the last three years. We are delighted that from this summer, we plan to support the World Heart Beat Music Academy in South London and the amazing work that they do. We will let you know more on this in the months ahead but for now you can read all about the positive impact the Academy is having on the lives of young people through music in our interview with David's cousin, Sahana Gero MBE, Founder and Artistic Director of the Academy. We hope you will enjoy reading this latest edition of Perspective and wish you a Happy Easter.

All the best,

Samik & David

Adjusting to a new reality

INTERVIEW WITH HENRY JOHNSTONE

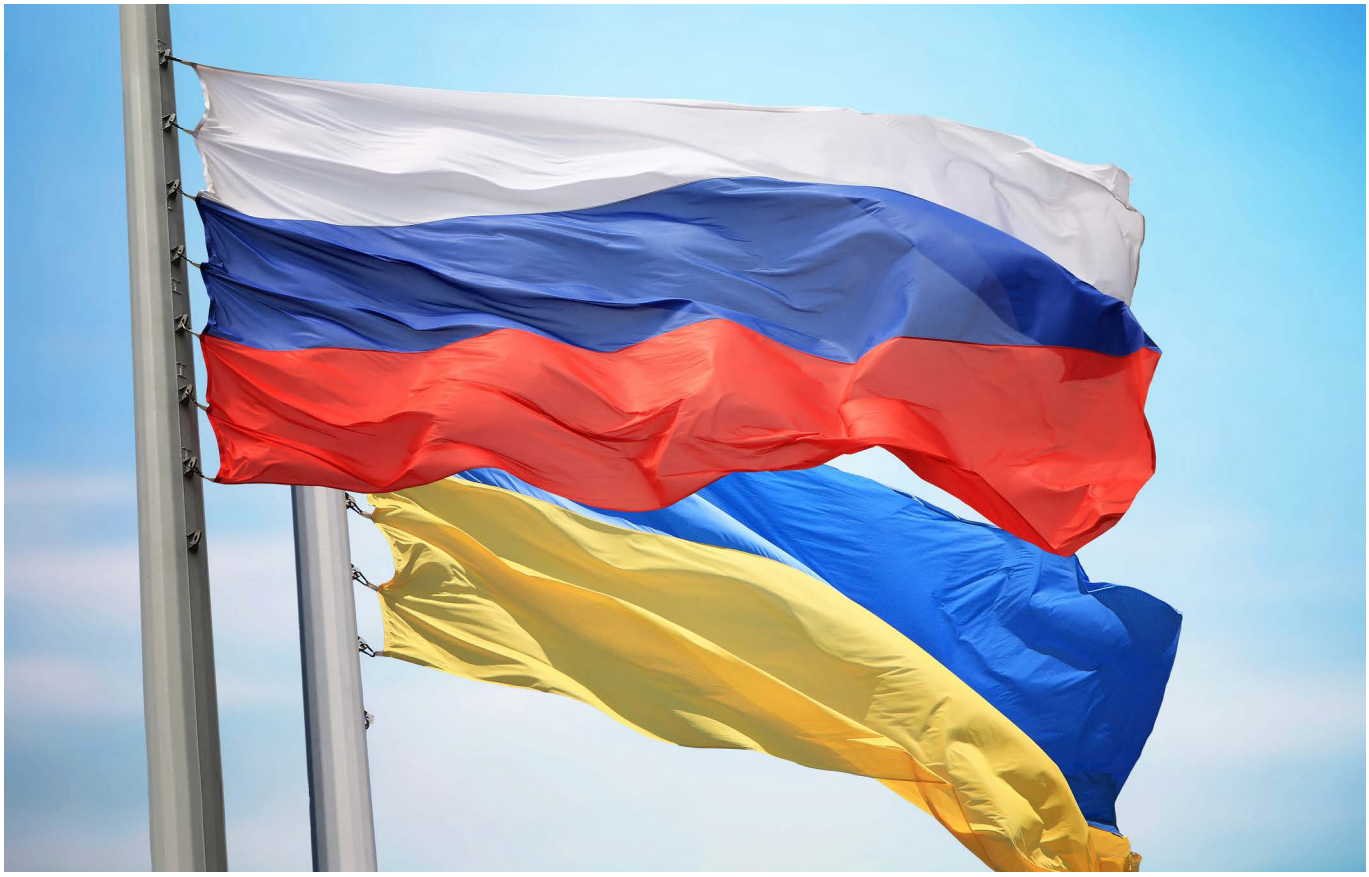
Portfolio Manager, Cazenove Capital
www.cazenovecapital.com

So much has changed over the last few months, particularly since we penned our thoughts at the start of this year, when inflation and how it is tackled by Central Banks was above all else the overriding cause for concern. It only seems appropriate then to discuss how the outlook has evolved for global financial markets following the events of the first quarter of 2022 and what it really means for our client portfolios. We sat down with one of our panel asset managers, Henry Johnstone of Cazenove Capital to find out their views.

Q. RUSSIA'S INVASION OF UKRAINE MAKES IT LESS LIKELY THAT INFLATIONARY PRESSURES WILL EASE IN THE NEAR TERM. WHAT ARE YOUR THOUGHTS?

HJ: Late last year, we identified conflict between Russia and Ukraine as a possible risk to markets in 2022. However, we did not envisage the scale of the invasion that has since taken place. It has understandably become investors' key focus. Even if Russia and Ukraine reach an agreement that brings fighting to a halt, sanctions on Russia are likely remain in place for the foreseeable future. As a result, much of the inflationary pressures arising from the conflict is set to persist.

Equity markets initially fell sharply in response to the invasion, but the selling was not indiscriminate: as a rule of thumb, the nearer a country is geographically to the conflict, the worse it has performed. Amongst non-Russian markets, Germany and Italy have been hardest hit, reflecting their dependence on Russian energy and greater financial exposure. The US, which is a net exporter of both energy and agricultural commodities, has fared better on a relative basis.

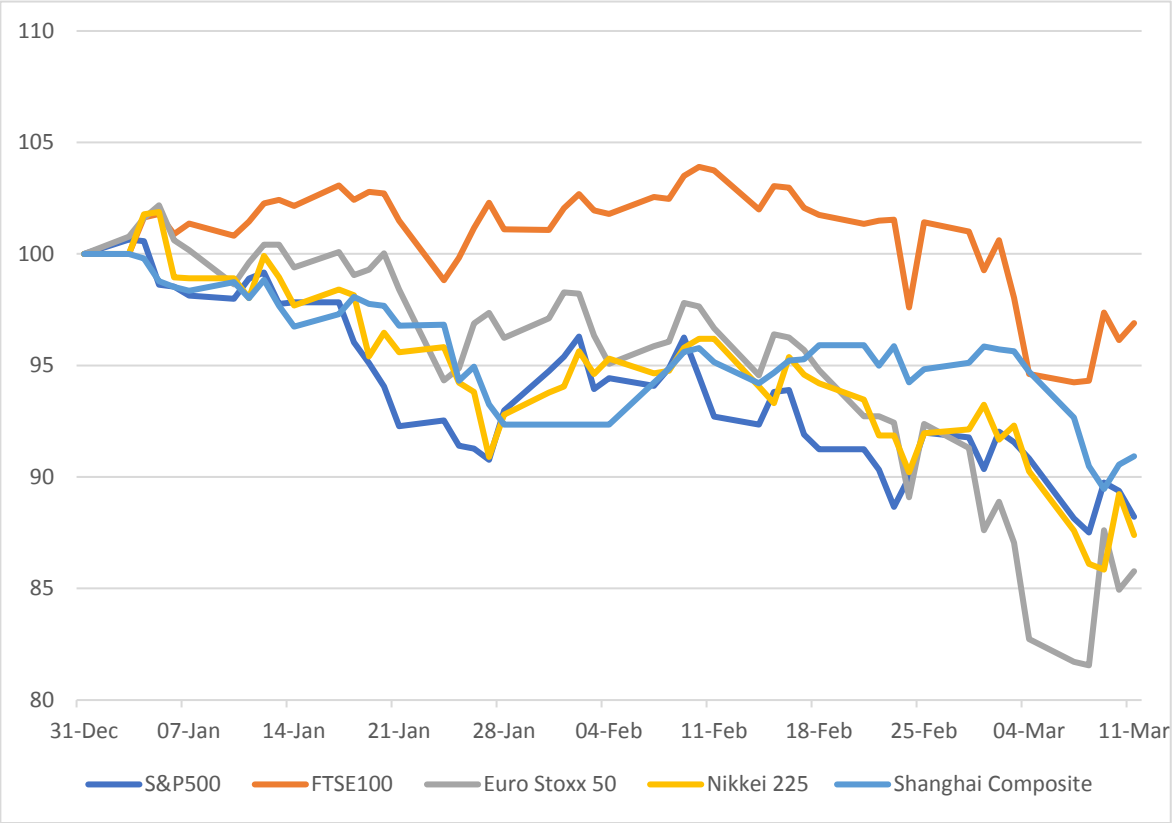


Q. SOME COMMENTATORS ARE NOW RAISING THE PROSPECTS OF STAGFLATION. WOULD YOU AGREE THIS IS NOW A RISK AND HOW DO YOU PREPARE FOR IT?

HJ: In the second half of 2022, it became apparent that inflation was more than a "transitory" phenomenon. This was already prompting many investors to take on more "inflation-proofing" within portfolios. This includes assets such as inflation-linked government bonds and commodities.

Recent geopolitical developments raise the risk of stagflation – a combination of high inflation and low or negative growth – and may mean further adjustments are required. Equities can struggle in this environment, with corporate profits coming under pressure as costs rise faster than revenues. A slightly lower weighting to the asset class may be appropriate.

European markets have come under the greatest pressure



Source: Refinitiv Datastream as of 25 March 2022.

Performance of major equity markets YTD, rebased to 100. Past Performance is not a guide to future performance

Q. ARE ALL PARTS OF GLOBAL FINANCIAL MARKETS AFFECTED SIMILARLY OR IS THERE A DIVERGENCE? HOW SHOULD INVESTORS ADAPT?

HJ: Investors may also need to consider changes within their equity allocations. European economies are very likely to face the greatest pressure from high energy prices and reducing exposure in favour of other markets (e.g. US or emerging markets) may make sense. Investors may also want to focus on "quality" companies that exhibit characteristics such as balance sheet strength and the ability to pass on higher costs to customers.

There are a number of interesting thematic opportunities that may be emerging. The invasion of Ukraine is adding momentum to the transition towards an energy system based on renewable power. However, this will not be without near-term challenges as renewable manufacturers face headwinds from rising input costs.

And despite the prospect of higher interest rates, we could yet see technology return to favour. The sector looks relatively well positioned in an era of higher inflation: tech firms are generally not big consumers of raw materials and employ relatively few people per dollar of revenue. In fact, in previous episodes of inflation there has been stronger demand for technology services which can help companies deal with higher costs.

Q. DOES THE RISK OF STAGFLATION MAKE DIVERSIFICATION HARDER?

HJ: A multi-asset portfolio which includes diversifying assets has helped investors navigate recent volatility. However, the outlook for the traditional portfolio diversifier of conventional government bonds looks challenging. This reflects low starting yields, continued concern about inflation and the prospect of further interest rate increases this year. With this backdrop, there is often a preference for gold and commodities alongside US inflation-linked bonds. All have performed well in recent weeks – and in previous periods of stagflation.

Q. WITHOUT WISHING TO BE AN ALARMIST, IS THERE A CHANCE WE COULD BE HEADING FOR A REPEAT OF THE 1970S?

Western economies experienced very high inflation in the 1970s and early 1980s, with prices in the US rising at annual rates of more than 12%. Oil was a key contributing factor. Prices spiked higher following the Arab-Israeli war of 1973 and subsequent conflicts in the region.

As alluded to above, prior to Russia's invasion of Ukraine, inflation was already high – and well above central bankers' targets. In the US, the annual rate of inflation reached 7.5% in January, the highest level since 1982. The worry is that another spike in oil prices will cause inflation to become even more entrenched and trigger a cycle of rising prices, as we saw in the 1970s.

Even if oil and gas prices do rise further in the short term (as they may well), we think a repeat of the 1970s inflation dynamics remains unlikely. For one thing, the world economy is much more globally integrated than it was. This means more international competition for many goods, limiting producers' ability to raise prices. At the same time, significantly lower levels of unionisation means that employees are not in as strong a position to demand wage increases as they once were.

Rapid advances in technology are having a similar effect, with many jobs that could only be done manually in the 1970s now fully automated. This is also helping to increase companies' productivity, reducing some of the pressure to raise prices.

Henry Johnstone is a Portfolio Manager at Cazenove Capital, managing portfolios for private individuals, trusts and charities. Henry holds the CISI Chartered Wealth Manager qualification and graduated from Durham with a BA (Hons) in Geography. Prior to Cazenove Capital Henry worked at RBC Wealth Management.

Diversification: History's lesson for investors

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The temptation among investors often is to stick with what you know. And that is no bad thing. It is a strategy championed by some very successful investment pioneers such as Warren Buffett, a famous devotee of the stock market.

It can and does work when you have a really long time horizon of 20 years or perhaps even longer, or when the market is rising, and you have picked the right assets to invest in. However, many of us also invest for the medium term which can be any duration between 3-10 years, let alone having a foresight on which asset classes are likely to perform best over that period and which are the ones to avoid. The value of diversification is really highlighted when – as with the pandemic in 2020 and even more recently the conflict in Ukraine this year – entirely unexpected events throw economic and market expectations into sudden disarray.

PAST PERFORMANCE IS CERTAINLY NO GUIDE TO FUTURE

A recent study from Schroders reveals how different asset classes have fared in each of the last 16 years. It is evident from the table below that no single asset class has continued to rank in the top quartile of the table with any degree of consistency. In fact, ones that appear at the top of the table in many years also feature just as prominently at the bottom.

Asset class performance 2006-2021

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Property 18%	Commods 16%	Govt bonds 10%	High yield bonds 60%	Commods 16%	Property 8%	High yield bonds 18%	Equities 26%	Property 19%	Property 7%	High yield bonds 15%	Equities 19%	Emerging Mkt debt 5%	Equities 28%	Equities 14%	Property 37%
Equities 17%	Insurance-linked 15%	Emerging Mkt debt 10%	Equities 30%	High yield bonds 15%	Investment grade bonds 7%	Equities 16%	Insurance-linked 11%	Investment grade bonds 12%	Insurance-linked 4%	Commods 11%	Emerging Mkt debt 10%	Insurance-linked 3%	Property 25%	Hedge Funds 10%	Commods 27%
Insurance-linked 12%	Govt bonds 10%	Cash 5%	Commods 18%	Property 14%	Emerging Mkt debt 6%	Emerging Mkt debt 14%	Property 10%	Equities 9%	Emerging Mkt debt 3%	Emerging Mkt debt 10%	High yield bonds 8%	Cash 1%	Emerging Mkt debt 13%	Investment grade bonds 8%	Equities 25%
High yield bonds 11%	Hedge Funds 10%	Insurance-linked 2%	Insurance-linked 13%	Insurance-linked 11%	Govt bonds 6%	Investment grade bonds 13%	Hedge Funds 9%	Emerging Mkt debt 8%	Investment grade bonds 1%	Investment grade bonds 10%	Govt bonds 7%	Property 0%	Investment grade bonds 9%	Emerging Mkt debt 8%	Hedge Funds 6%
Hedge Funds 10%	Equities 7%	Investment grade bonds -3%	Hedge Funds 11%	Equities 11%	Insurance-linked 3%	Insurance-linked 10%	High yield bonds 7%	Insurance-linked 6%	Cash 1%	Equities 9%	Hedge Funds 7%	Investment grade bonds -2%	Hedge Funds 8%	Insurance-linked 6%	Insurance-linked 5%
Emerging Mkt debt 7%	Cash 6%	Hedge Funds -21%	Investment grade bonds 11%	Emerging Mkt debt 9%	High yield bonds 3%	Hedge Funds 4%	Emerging Mkt debt 0%	Hedge Funds 3%	Equities 0%	Property 8%	Investment grade bonds 4%	Govt bonds -2%	Commods 8%	Govt bonds 2%	Cash 0%
Govt bonds 6%	Emerging Mkt debt 5%	Property -22%	Emerging Mkt debt 6%	Investment grade bonds 8%	Cash 1%	Property 2%	Investment grade bonds 0%	High yield bonds 2%	Govt bonds -2%	Insurance-linked 6%	Commods 2%	Hedge Funds -2%	High yield bonds 7%	High yield bonds 2%	Emerging Mkt debt -0%
Cash 4%	Investment grade bonds 1%	High yield bonds -27%	Govt bonds 2%	Govt bonds 5%	Hedge Funds -5%	Govt bonds 1%	Cash 1%	Cash 1%	High yield bonds -2%	Hedge Funds 1%	Cash 1%	Equities -7%	Insurance-linked 4%	Cash 1%	High yield bonds -3%
Commods 2%	High yield bonds 1%	Commods -35%	Property 2%	Hedge Funds 5%	Equities -6%	Cash 1%	Govt bonds -4%	Govt bonds -1%	Hedge Funds -2%	Cash 1%	Insurance-linked 0%	High yield bonds -9%	Govt bonds 4%	Commods -3%	Investment grade bonds -3%
Investment grade bonds 0%	Property -5%	Equities -39%	Cash 1%	Cash 1%	Commods -13%	Commods -1%	Commods -9%	Commods -17%	Commods -24%	Govt bonds 0%	Property -2%	Commods -11%	Cash 1%	Property -16%	Govt bonds -4%

Best performing asset class

Worst performing asset class

Source: Schroders, Datastream as of 31 December 2021

This table simply emphasises the importance of spreading your money across different asset classes in order to smooth out the volatility that could come from holding just one or two asset classes. Having a diverse and less volatile portfolio of investments will allow you to make and then stick to your life plans without being held hostage to the vagaries of the financial markets. Not only can diversification potentially help reduce risk, it may even improve the long-term performance of your overall portfolio, unless you are downright lucky in making the right call every single year as to which asset classes will likely emerge as the winners and which ones will find themselves relegated to the bottom of the table.

The table above reflects how the fortunes of different assets often diverge. Take the historic performance of equities, which typically make up a large portion of investors' portfolios. Their performance is often unrelated to (or not "correlated" with) the performance of government bonds. In other words, good years for equities, such as 2013 (+26%), 2019 (+28%) and 2020 (+14%), were also comparatively poor years for bonds (–4%; +4%; +2%).

The opposite is true in that good years for government bonds tended to be poor for equities. In the case of 2008, for example, which was the epicentre of the financial crisis, government bonds were the highest-performing asset class returning 10%, while equities were the worst, falling 39%.

The table also shows how some asset classes, for example cash, demonstrate relatively consistent nominal returns year after year. These may not be exciting, but they offer defensive characteristics where investors seek to protect themselves from the more volatile categories where performance leaps about the chart year on year.

WHAT ARE THE BENEFITS OF DIVERSIFICATION?

The key benefits of diversification could be summarised as below:

MANAGING RISK:

A crucial imperative for investors is not to lose money i.e. try to avoid a capital loss. Every investment carries a risk – the risk that you will receive back less than you have put in or the probability that it delivers less than you had expected. This risk varies depending on the type of investment. Holding a range of different assets mean this risk can be spread. This is something that an investor can actively manage themselves if they have the time and expertise or delegate to an investment professional.

ACCESSING YOUR MONEY:

The ease with which you can enter or exit an investment is also an important factor to bear in mind. Selling a property can take a long time compared with selling equities, for example. Holding different types of investments that vary in terms of "liquidity" (the ease of buying and selling) means you can still sell some of your investments should you suddenly find yourself in need of money.

SMOOTHING THE UPS AND DOWNS:

The frequency and the magnitude by which your investments rise and fall determines your portfolio's volatility. Diversifying your investments can give you a greater chance of smoothing those peaks and troughs. Whilst over the longer term one should expect a well-managed portfolio of investments to deliver strong returns, quite often the journey is just as important as the final destination and well diversified portfolio delivers on both counts.

Johanna Kyrklund, Global Head of Multi-Asset Investments at Schroders, sums it up well when she says -
"For me, the merits of diversification cannot be emphasised strongly enough. I've been a multi-asset investor for more than 20 years and have inevitably faced some pretty turbulent spells for markets. Each time, the ability to nimbly move between different types of assets has better equipped me to navigate those periods.

Diversification, if carefully and constantly managed, can potentially deliver smoother returns; it's a key tool to help in balancing the returns achieved versus the risks taken."

Source of data quoted in article: Schroders, Datastream.

The Rise of Family Investment Companies in Wealth Planning

BY MARK LEVITT

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Family Investment Companies (FICs) have increasingly been gaining in popularity whilst Family trusts are falling out of favour. The primary driver for this has been government policy over the past decade or so, which makes Family trusts less attractive than they used to be in the past. In this article we explore why FICs can be an effective wealth planning tool.

A FIC is a company which is set up with the specific purpose of meeting the needs of a family. It allows the family wealth to be protected as far as is possible. FICs enable ownership of assets to be separated from control over them and ultimately they can limit the exposure to inheritance tax. FICs can also be advantageous in reducing income and capital gains tax liabilities. Clearly, no single wealth structure will meet all the varying needs of a family so the overall solution may depend on their main priorities. It may also be worth considering a combination of structures for the most efficient outcome.

WHY ARE FICS ATTRACTIVE?

There is good reason for the rise in popularity of these wealth structures. Here are some of the key features of FICs:

- Wealth can be passed on to the next generation whilst retaining control of the underlying assets.
- They offer protection for assets if a shareholder goes through a divorce.
- Income or gains can be accumulated more tax efficiently in FICs than within a trust or even if held personally.
- The flow of income and capital can be controlled and any liability to personal tax can be managed.
- A FIC provides a governance structure to help manage a families' wealth.
- A FIC is permitted to deduct certain business expenses such as management costs, professional fees, salaries, and pension contributions. Interest on loans to purchase investments is also deductible against the profits of the FIC.
- In addition, certain income such as qualifying dividends from company shares should not be subject to tax in a FIC.
- Whilst a company structure can result in a double layer of taxation; where a FIC is funded by way of shareholder loans, then funds can be extracted tax free on repayment of these loans.

- Dividends can be a flexible way of shareholders extracting profits particularly where there are different share classes. This can help to optimise the tax liability amongst family members. The first £2,000 of dividend income usually falls within the tax-free dividend allowance.
- For dividends in excess of this, depending on the level of the shareholders overall income will be taxed at 7.5% for basic rate payers, 32.5% for higher rate taxpayers and 38.1% for additional rate payers (Note: for dividends paid after 5th April 2022, these rates increase by 1.25%).

It is worth noting that, the Government has announced that there will be an increase in the corporation tax rate from April 2023. This may impact FICs in the future, particularly if they fall within the definition of a close investment holding company as such companies will not benefit from the small profits rate or marginal relief. Even so, they continue to remain attractive from a tax perspective.

AND WHAT ABOUT TRUSTS?

Trusts also have a role to play in estate planning and often can form part of an overall solution. It is important that a balance is found between the way in which assets are held and the different tax consequences that one might be exposed to.

Since most trusts fall within the "relevant property regime" there has been less use of trusts. The difficulty is that assets can only be transferred into trust up to the value of the nil rate band (£325,000). Where amounts are settled above this amount there would be an immediate IHT lifetime charge at 20% with further charges every ten years through the life of the Trust.

A discretionary trust can be used where it is desired to benefit a number of beneficiaries and one wants to maintain flexibility in relation to the proportions. It gives the trustees wider powers over the investments and the distribution of funds. The beneficiaries of a discretionary trust have no fixed right to receive capital or income. This may have the advantage of protecting the trust funds if the beneficiaries have any creditors or go through a divorce.

WHAT IS HMRC'S VIEW OF FAMILY INVESTMENT COMPANIES?

Following the increased popularity of FICs in recent years, HMRC undertook a review which they have now completed. Some of the observations from that review are:

- The changes in trust legislation, and the related cost of using a trust has resulted in less taxpayers using trusts to hold family assets.
- FICs have become more popular than trusts since they are much easier to set up. Generally, the shareholders of FICs are made up of two generations, they often have multiple classes of shares, and the older generation tends to retain the voting control.
- FICs generally hold investments, which includes stocks, shares or property.
- HMRC found that the assets comprised in a FIC are on average worth £5m; they are used by wealthy taxpayers (HMRC's criteria for those taxpayers dealt with by its Wealthy Unit is annual income over £200,000, or those with wealth of over £2m).
- FICs are often used to enable wealth to be passed down to the next generation and to mitigate inheritance tax.
- Although one cannot rule out any specific legislation that might arise in the future, HMRC accepts that there are often commercial reasons for establishing FICs.

So, in summary, the company structure can be used to facilitate estate planning and wealth can be passed on without triggering an immediate tax charge. Control over the assets can be maintained more effectively and assets can be protected from the impact of events like a divorce. It also allows for the tax efficient accumulation of wealth. Little wonder then that their popularity among high net worth individuals are firmly on the rise. Please speak to a professional adviser if you would like to find out more.

Mark Levitt is a Partner at Blick Rothenberg and both a Chartered Accountant as well as a Chartered Tax Advisor. He specialises in advising corporate and private clients on all tax issues with an expertise in advising high net worth individuals. Mark also sits on the Private Client Committee of the Institute of Chartered Accountants of England & Wales and represent the ICAEW on the Wealthy External Stakeholders Forum, which deals with the personal taxation affairs of the UK's wealthy individuals.

Levelling-Up in Practise

INTERVIEW WITH SAHANA GERO MBE

Founder and Artistic Director, World Heart Beat Music Academy
www.worldheartbeat.org

It has always meant a lot to us at Keystone to be involved with a charity who could be supported in various ways beyond just financial help. From this summer for the next three years we are delighted to be supporting the World Heat Beat Music Academy which was founded by Sahana Gero in 2009 in as many ways as we are able, including focussing the spotlight on their extraordinary work where we can. To this end, we spoke to Sahana recently about the direction of the Academy and their exciting new venture.

KC. HOW DID THE ACADEMY COME INTO BEING?

SG: I established the Academy in recognition there was a real need for affordable music education for disadvantaged young people and the desire to open up pathways into music, the creative industries and wider employment. What started with myself in a sitting room with my grandfather's old piano has grown into organisation with 400 students and 41 teachers offering in addition to music lessons the opportunity to partake in composition, improvisation, performing formally and informally in, for example, Jazz groups, orchestras and bands.

KC. WHO ARE YOUR PUPILS?

SG: Students aged between 5 and 25 years, from south London and beyond. What was important from the beginning was to ensure that no-one is turned away, to remove any financial barriers. This means that 50% of our pupils do not pay for their lessons or instruments, they are funded via charitable donations. This has ensured the youth of the community from all walks of life are engaging with each other, just sharing their enjoyment of music in an inclusive and safe environment.

KC. SO, A REAL-LIFE EXAMPLE OF 'LEVELLING-UP'?

SG: Exactly, all those involved with the Academy envision a world where non-selective, richly diverse music programmes are accessible to everyone. We know that music education can be a powerful tool for positive change for young people, their families and their communities. We want all young people, including those who have struggled with formal education, to have equal access to these transformative benefits. In recognition of our efforts in this respect we recently were

successful in a bid to win a levelling up grant that will help towards creating our vibrant new Education Centre and Concert Venue at Embassy Gardens, Nine Elms, one of Europe's most significant regeneration projects.

KC. TELL US A BIT MORE ABOUT THIS THIS NEW VENTURE?

SG: The Academy has outgrown its original building which is bursting at the seams, and we recently won, out of 42 competitors, space in Embassy Gardens for an exciting new additional venue which will include the first newly built concert hall in London since 2008. There will also be teaching and rehearsal rooms and state of the art recording facilities and a fully flexible performance space where in addition to music lessons our students will be able learn about music production and performance in all aspects including audio engineering, recording publishing and even for example lighting.

This new site will extend our work at our existing Academy and be a centre for musical excellence, providing thousands more students with music education and doubling our teaching capacity per year. We will continue with our community-informed approach to engage more young people and local residents in the Nine Elms area including those living in the adjacent communities which are in the bottom 30% of the most deprived areas in the UK. World Heart Beat Music Academy will become a 'cultural anchor' in a rapidly changing neighbourhood, delivering a significant new programme of 150 plus events, reaching over 20,500 local residents by 2023.

Sahana Gero MBE is Founder and Artistic Director of World Heart Beat Music Academy. A highly accomplished musician and music teacher, she has performed in concerts in over 50 countries often visiting schools and teaching in many of these countries, striving to make music accessible and inspirational to the lives of children everywhere. She has twice been nominated for the highly prestigious Women of the Year Awards, which see women honoured for their outstanding contributions to society in the arts, science, politics, business and humanitarian arenas.

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