Think Investments

Spring 2023

Welcome

Think Investments helps you keep in touch with and navigate your way around the world of investments.

It's been a rollercoaster of downs, ups and downs again over the past few years as we've seen the pandemic and then the war in Ukraine have a big impact on markets. Inflation has made an unwelcome return and interest rates have increased. By now we're all feeling the pinch on our finances to some degree, as the cost of living keeps rising.

No matter how gloomy things seem in the short-term though, putting your money in stocks and shares could give you the long-term growth potential to offset some of the impacts of inflation. In our first article in this issue, we consider why now may be a good time to use your ISA allowance for investing.

Last year was a painful one for bond investors. But many experts expect inflation and interest rates to reach a turning point for the better this year, creating a more favourable environment for bonds. In our second article we look at what that means for portfolios.

Finally, while many of us continue to deal with the high cost of living and hefty winter heating bills, we examine how to balance investing alongside those pressures. With clean, renewable and secure energy sources an increasing priority for countries, we also highlight one potential upside of today's challenging times.

As always, we hope you find Think Investments an interesting and helpful read.

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Are you making the most of your ISA allowance?

In unpredictable economic conditions it's even more important to make sure your money is working as hard for you as possible.

One option is to make full use of your annual ISA (Individual Savings Account) allowance, currently £20,000 for the 2022/23 tax year. How you use your ISA will depend on your goals, timescales and how you feel about taking a risk with your money. However, targeting long-term growth (five years or more) that may help to offset the impact of today's high inflation or possibly even beat it when inflation starts to fall, means looking at stock market investments.

The main upside of ISAs, of course, is their tax advantages. You don't pay any income tax or capital gains tax (CGT) on investments held within an ISA. That means you can buy and sell those investments and receive any income or gains from them in a tax efficient way. The favourable tax treatment of ISAs may change in the future and is subject to individual circumstances.

A new reason to take shelter

From the start of the 2023/24 tax year on 6 April 2023, the CGT annual exempt amount for individuals and personal representatives is reducing from £12,300 to £6,000. Then it's reducing again to £3,000 for the 2024/25 tax year. It makes more sense than ever to make as much use of your ISA allowance as you can.

Keeping on top of inflation

Higher interest rates mean cash savings rates are more attractive than they've been for a long time. During 2022, we saw the rate of inflation increase to a forty year high and it continues to remain high. Inflation sat at more than 10% as 2022 drew to a close.[1] The Bank of England predicts that it will start to fall back later this year before a gradual return to more normal levels around the 2% target.[2]

1 BBC – Inflation eases to 10.7% but still near 40-year high, 14/12/22
2 Bank of England – When will inflation in the UK come down? 15/12/22

A clear shift from cash to stocks and shares

There are four types of ISAs: cash ISAs, stocks and shares ISAs, innovative finance ISAs and lifetime ISAs.

According to the HMRC's latest statistics[3], there was a marked shift in the 2020/21 tax year. The number of cash ISAs paid into fell by 17% while stocks and shares ISAs paid into increased by 31%. Total cash subscriptions were down by 24%, but that was largely offset by a 39% increase in subscriptions to stocks and shares ISAs.

You can subscribe your ISA allowance into a cash ISA, a stocks and shares ISA, an innovative finance ISA and a lifetime ISA or a combination of the four. Santander doesn't offer innovative finance ISAs or lifetime ISAs. You can also transfer between ISAs of the same or different types and this will not affect your ISA allowance in any way. To do this, you need to contact your new ISA provider who will request the ISA transfer on your behalf. However, any money withdrawn from your ISA will lose its tax efficient status and will count as current tax year subscriptions if paid back into an ISA.

When markets are lower it can be a great time to add to your investments if you can afford to. That way you can benefit from any recovery that comes.

Past performance isn't a guide to future performance, but in the year to February 2022 as inflation first began to take hold, research by Moneyfacts found the average stocks and shares ISA fund returned growth of just under 7%. That's more than 13 times the typical cash ISA rate over the same period.[4]

This was a period when inflation rose to 6.2%.[5] Average stocks and shares ISA fund returns may not have outstripped inflation by much, but they at least kept pace with it. By contrast, cash ISA savers saw the spending power of their money reduce.

Do you have the balance right?

While the specifics will always depend on your personal circumstances, at the very broad level cash can offer security and accessibility while investing can provide long-term growth. The trick is to get the balance right for you. The turn of a tax year is a natural time to review whether to move some of your cash into investments or the other way round.

It's always a good idea to keep enough money in cash to cover your essential and any emergency costs for three to six months. You may also prefer to save in cash for goals in the next five years, a wedding or holiday for example. If you're saving money outside of an ISA and are a basic or higher rate taxpayer, your personal savings allowance will allow you to receive an amount of interest each tax year without having to pay tax on it. Savings in tax-free accounts like ISAs don't count towards your personal savings allowance. Find out about the Personal Savings allowance on the gov.uk website.

Investing gives you the prospect of long-term growth that may potentially offset the impact of inflation. Keeping your money invested for a minimum of five years, and ideally longer, also means there's time to balance out the inevitable ups and downs that come with investing.

Investments can go down as well as up and we've seen some extreme instances of market volatility in recent years. But it's also worth reminding yourself that, extreme circumstances like wars and pandemics aside, financial markets are cyclical. While past performance is never a guide to the future, history does tend to show that investments generally increase in value over time and outperform inflation.

Reason to be optimistic?

In their market outlook for 2023, our experts at Santander Asset Management said "The world markets and economies face great challenges but as history proves, economic agents' capacity for readjustment and innovation has allowed them to overcome great obstacles, generating opportunities for growth".[6]

Downturns always provide opportunities to invest, so we can at least afford to be cautiously optimistic for the year ahead. Read the full outlook on our website **santanderprivate.co.uk/news-insights**

3 Official statistics – Annual savings statistics 2022, 08/06/22
4 Independent – Stocks and shares ISA funds 'have grown at 13 times cash ISA rates on average', 21/02/22
5 Official statistics – Consumer price inflation, UK: February 2022, 23/03/22
6 Santander Asset Management – Market Outlook 2023, 23/11/22

Time to look again at bonds?

When is a bond not a bond?

The word 'bond' is used for more than just the investment type. Savings bonds and Premium Bonds will be familiar to many. However, while there are some exceptions for savings bonds, these are cash-based savings products. Savings bonds will usually pay you a fixed level of interest if you keep your money locked in for a fixed term. Premium Bonds don't pay interest, but you can win cash prizes ranging from £25 to £1 million, drawn monthly by a computer called ERNIE.

Bonds have traditionally played three key roles in a portfolio: providing an income, diversification and capital preservation. High inflation and interest rates in 2022, capped by market turmoil following Liz Truss and Kwasi Kwarteng's ill-fated mini budget in September, challenged these roles. But balance is now returning to the fixed income market and bonds could be on the recovery path.

Conditions for a perfect storm

Bond market woes in 2022 came about because bonds tend to do badly in an environment of high inflation and high interest rates.

- **Inflation** – tends to be bad news because it eats into the future buying power of the fixed income that bonds typically provide.
- **Interest rates** – as Central Banks continue to raise interest rates to try to contain inflation, bonds that better reflect future rate rise expectations in the interest they offer also tend to become more popular. The overall effect is to push down the market value of bonds.

The US Federal Reserve raised interest rates seven times in 2022,[7] while the Bank of England raised rates at eight consecutive meetings.[8]

The swell begins to settle

This was an impossible backdrop for bonds after a long period of low interest rates following the global financial crisis of 2007/2008. It took time for markets to adjust to the new reality. The benchmark 10-year treasury (US government bond) yield moved from 1.65% at the start of 2022 to a peak of 4.25% in October before settling at around 3.50% in December.[9]

7 Trading Economics – United States Fed Funds Rate, 14/12/22
8 Money to the Masses – When will interest rates rise (or in fact be cut) – Latest predictions, 15/12/22
9 MarketWatch – U.S. 10 Year Treasury Note

What's a bond yield?

Bonds traded on the financial markets are a type of loan to their issuer – usually a government or company. They typically pay interest at a fixed rate and the original loan amount is paid back on a set date in the future, to whoever holds the bond at the time.

A bond's yield is a measure of the overall return on capital that a holder can expect from it. There are various formulas for working it out, but broadly it's the interest rate paid by the bond expressed as a percentage of the bond's current market price.

It was a similar picture for the benchmark yields in the UK, Europe and other major markets around the world. Markets tend to think ahead though, and while interest rates may rise once or twice more this year, this is now largely priced into bond markets.

Ways to invest in bonds

It's possible to buy government and some corporate bonds directly. But if you're investing in bonds through Santander, it's likely you hold them in an investment fund. This might be alongside shares or other assets in a multi-asset or balanced fund. Or it might be in a fund that's dedicated to bonds. Either way, investment funds usually buy and sell bonds in the secondary market, with expert fund managers making decisions on the relative merits of individual bonds and assessing and managing the risks that any issuer may default. This is something you'd need to do yourself if you held them directly.

Light on the horizon

What might the settling conditions mean for your portfolio?

1. Income

Bonds once again have a role for investors looking for long-term income. For corporate bonds, the 'spread' over government bonds (that's the additional yield for taking the risk on a company rather than a government) has widened considerably over the past year, as investors have become more risk averse. This means a higher potential income available from corporate bonds in particular.

2. Diversification

The traditional diversification between bonds and shares, where each asset class offered something different to investors, broke down last year because both were hurt by high inflation. If inflation begins to ease this year, as many experts predict, this pattern can resume. Bonds should protect investors against a difficult economic environment, while shares are there for long-term investment growth. There's considerable uncertainty on the outlook for the year ahead, with recession likely across most of the major economies. In this environment, a holding in bonds may provide a ballast to portfolios.

3. Capital preservation

That said, not all bonds are created alike and there will be some potential challenges in the year ahead when it comes to capital preservation. Default rates for corporate bonds may rise for example as companies in certain sectors, such as retail, feel the strain of weakening economic growth. If you're invested in bonds through a fund, the fund manager will make decisions based on the fund's investment objectives. They may take a cautious approach to some higher risk corporate bonds, focusing more on those companies with strong balance sheets.

A new era?

Bonds are back, but the economic backdrop is different now. It seems unlikely we'll return to a time when interest rates are close to zero. After it comes down from recent peaks, inflation may also be structurally higher than in the past decade or so, as some of the influences of that period, such as globalisation, reverse. However, while last year's reset was painful, it does mean bonds may now return to their usual place in a portfolio.

It is important to seek advice and guidance from a professional financial adviser who can help explain how to build an appropriate financial plan to match your time horizons, financial ambitions, and risk comfort. If you already have a plan in place, or have already invested, it's important to allocate time to review it to ensure your plan remains on track and appropriate for your needs.

Article provided by Santander Asset Management UK for Santander investment customers.

Navigating the cost-of-living crisis

Despite challenging market conditions and the pinch many of us are feeling, there are sound reasons, if you can afford it, to keep on investing through thick and thin.

As inflation shrinks household budgets, bills soar and the economic outlook remains uncertain it may be tempting to pause or cash in your investments. You may even feel the urge to sell out completely, cut your losses and convert everything into cash.

This is your natural fight or flight instinct in action; it serves us well but can be unhelpful when it comes to investing. If you sell investments, any 'paper' losses become real. Holding the proceeds in cash is unlikely to return any significant growth. Buying your way back in once markets recover can then be costly. And remember the saying "It's time in the market and not timing the market".

Selling out can come at a cost to long-term wealth

Research based on S&P 500 Index returns from 1930 to the end of 2020 found that missing the 10 best days each decade instead of remaining invested reduced possible returns from 17,715% to 28%.

Despite the natural urge to sell when markets fall it also showed that the market's best days often follow its biggest drops, highlighting the potential negative impact of panic selling.[10]

10 CNBC – This chart shows why investors should never try to time the stock market, 24/03/21

Missing out on the best days is expensive and it also raises another factor: knowing when to move in and out of the markets is extremely difficult if not impossible for investors. Markets will often rally long before there's an improvement in wider economic data.

In the Global Financial Crisis of 2007/2008 markets bottomed out months before an economic recovery looked likely; during the pandemic, they turned eight months before a viable vaccine emerged. Staying invested for as long as you first planned is generally the best policy if you can afford to.

It's worth remembering that any money put into the market during a downturn is generally going in at lower prices. That means you're getting more for your money which then has potential for growth as markets recover in time. Last year saw share prices for some excellent companies knocked back 20-30%. In some cases, this was just about market sentiment – there had been little deterioration in the companies' profitability or cash flow.

Regular investing is a good habit

But is it worth pausing regular investments to provide some breathing space on household finances? Try to keep investing as long as you have any spare cash.

Why? Because the longer you invest for, the longer your money has to grow. For example, £150 per month growing at 5% a year could be worth £61,118 in 20 years' time. Reduce that to 10 years and it could be worth just £23,248. Another way of looking at it is, to reach £61,118 in 10 years with the same growth, you'd need to invest more than £395 each month.[11] Investing today is cheaper than investing tomorrow.

Regular investing is a good habit for your financial future, but once broken it can be hard to get started again.

Prioritise clearing costly debt ahead of investing

There are some circumstances where diverting money from investing can be appropriate. Debt is increasingly expensive. The era of ultra-low mortgages and borrowing came to an abrupt halt in 2022 and December saw the Bank of England increase interest rates to 3.5%.[12] If the choice is between investing and paying off costly debt, then reducing your debt burden may be a good idea.

These decisions, balancing today's need with your future needs, can be difficult. A financial adviser can help you work out the best actions for your own circumstances and your long-term plan.

A more sustainable future?

There are some potential environmental and investment upsides to the cost-of-living crisis.

The key contributor to the cost-of-living crisis across Europe has been rising energy costs in the wake of the conflict in Ukraine.[13] Governments have belatedly recognised the need for energy independence and security. This has focused investment into the long-term development of renewable and clean energy sources.

In Europe, the RePowerEU strategy has brought forward a package of measures and financial incentives to move Europe away from Russian fossil fuels and promote renewables.[14] At the same time, the Inflation Reduction Act in the US, has earmarked capital for green energy projects.[15]

Participating in this long-term energy transition is just one source of opportunity for investors now and in the years to come, with knock on benefits to our environment too.

11 The Calculator Site – Compound Interest Calculator
12 Bank of England – Bank Rate increased to 3.5% – December 2022, 15/12/22
13 Santander Asset Management – Market Outlook 2023, 23/11/22
14 The European Commission – RpowerEU: affordable, secure and sustainable energy for Europe, 18/05/22
15 McKinsey & Company – The Inflation Reduction Act: Here's what in it, 24/10/22

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