Surviving a Marxist experiment

Managing private wealth when wealth is the enemy

The Marxist dream is over for now. Only after a full-term parliament, with Brexit a done deal, can an overall majority for Labour be a distinct possibility. That's the message of the European elections *if*, as Lord Ashcroft Polls suggest, at least half the deserters from the two main parties have no intention of returning. As long as we remain in the EU, splits and tactical voting imply a coalition government and perhaps further erosion of the whip system. These are not the conditions for Momentum to acquire the power to push through an overt or hidden Marxist agenda. By 2022, much else will have changed nationally and internationally so momentum may have been lost for another generation or more.

Fowler Drew's approach to goal-based investment plans does not rely on taking a view. Clients, particularly those close to or already drawing from capital, want to be sure their plans are resistant to worst-case outcomes at the level of certainty they require. They want to know if plans made on the basis of a model of probable real returns are robust to a Labour Government which is not merely pushing for more redistribution within a mixed 'welfare/market' economy but willing to take extreme risks with the economy for ideological reasons. Many of its current leaders and key influencers have, after all, harboured a lifetime commitment to destroying the market economy on which our return modelling depends. For the purposes of this paper, we will refer to this version of a Labour administration as a self-professed 'Marxist experiment'.

The purpose of this paper is to test the robustness of current plans to a Marxist experiment and to examine what actions could be taken to the effects of changes in taxation or even exchange controls. This makes the possibility of a Labour government a stimulus to new financial planning even if the scope for forestalling actions is, as we believe to be the case, quite limited. We believe the adverse pre-tax portfolio effects are within the range of probabilities already captured in our modelling of goal outcomes. But that is not to say that clients will not want to change the tax and net spending assumptions, the required planning confidence for spending or the way they have hitherto traded off real outcomes and portfolio volatility.

A framework for thinking about the problem

We have brainstormed both the planning options and the portfolio effects of a Labour win at the next General Election, whenever it takes place. This has required a framework for thinking about the problem itself since the impacts, and their scale, on wealth owners are dependent on a series of conditions, not a single event:

1. Momentum continues to dominate Labour, or increases its grip such as by deselecting candidates
2. Labour wins an overall majority in spite of attempts to discredit it on the basis of a 'hidden agenda', more Marxist that just another redistributive manifesto along the lines of 2017
3. The NEC and Momentum have enough control over the Parliamentary Labour Party to prevent members crossing the benches to frustrate doing whatever it wants to do
4. The hidden agenda becomes a reality
5. The 'Marxist experiment' persists for long enough to do serious harm before that harm itself leads to it being overturned by markets or politics
6. Clearly, 5 is itself a key assumption, as the stated objective of socialists drawing on Marx (and aligning themselves with lifelong Communists) is a permanent undoing of the mixed or market economy. This is the worst possible result for the present owners of the nation's wealth.

Conventionally, this would be a problem dealt with by assigning individual and joint probabilities to the contingencies. But that's not how we like to approach 'known unknowns', as it relies far too much on individual judgement and not enough on *consequences*.

We already have two alternative frameworks we can apply: one for *portfolio probabilities* and one for *planning*. This paper is the product of applying those two ways of thinking about the problem.

Portfolio effects

How we think about the portfolio problem relies on two separate steps:

- stress testing real outcomes and
- visualising the experience of living with the risk before the outcomes are all known.

1. Stress testing outcomes

The first is essentially rational: our clients seem to be able to imagine, even without detailed budgets, where disappointment with spending outcomes ends and regret or hardship starts. But because we are inviting them to visualise life in terms of future spending, they are depending partly on what we say about average tax rates. These may need to be changed, at least for a period in the plan. We address that as part of the planning effects, below.

After that review, we still need to ask ourselves the same question: *is it worse than the worst pre-tax outcome projected for each time slice*, when assessing funding adequacy, the optimal approach to risk or the planned rate of draw? Unlike forecasts, these probabilities are based on historical stress evidence in any equity markets, without defining which, the particular origins or the inflation regime applying at the time. The idea is that anything that's happened before can happened again; anything that happened in one country can happen in another; it can happen in all markets at the same time. 'Are the effects in the model?' is a critical question for clients who will be drawing down, rather than contributing, during the period that bad outcomes are experienced.

Our belief is that the effects of a Marxist experiment, via expectations, on share price levels and exchange rates are within the current projections for plans, including in the presence of a draw rate close to the 99% confidence level for sustainability. What may need to change, therefore, is the required confidence a client is applying: they may need to move closer to an extreme, stress-resistant planned draw rate.

Impact of exchange controls

Whether the expectation effects on prices are 'in the model' also needs to consider the possibility that exchange controls are part of the Marxist experiment. Exchange controls, if applied to portfolio investment, and if anything other than temporary, would interfere with the implementation of the strategy. For portfolio-return projections, this could be as important a consideration as its effects on share prices and exchange rates.

Shadow Chancellor John McDonnell has spoken about the possible need to prevent capital outflows. Addressing the 2017 Labour Conference he said that a possible 'run on the pound' had to be anticipated and that the leadership had been 'war-gaming' what might happen 'when or if they come for us'. Capital flight has been seen as the enemy of worker reforms not just in the Marxist mindset but indeed in mainstream Trade Union policy throughout the existence of exchange controls. It does not even need the emergence of neo-liberal language to account for the international capital liberalisation that has occurred since the 1970s, quite independently of the UK's controls being lifted (liberalisation being what many on the left blame for the credit crisis). In the Marxist mindset, 'without capital controls, the rich will continue their onslaught against the working classes…The rich have shown they are already taking this struggle seriously. It is vital that the labour movement does the same.'[1] Capital flight, then, is seen as one of the possible impediments to the 'irreversible shift in the balance of power and wealth in favour of working people' that Corbyn has promised.

Capital liberalisation is of course embedded in the EU's internal market as well as its relationships with third parties. It partly explains the far left's perennial mistrust of the EU as a neo-liberal, 'free-market' conspiracy, a view expressed by Labour's current leaders as well as a number of Trade Unions. It is a reminder that the imposition of exchange controls may depend on an unmanaged Brexit having occurred first.

Imposing exchange controls also has implications for Britain's relationship with the IMF. If the Marxist experiment increases our dependence on 'the kindness of strangers' it might need to assume there will be no such kindness from the IMF, unless any controls were clearly temporary and part of a much broader crisis response. But if the cause of the crisis is government policy it is hard to see how the IMF could involve itself without the precondition of a reversal of that policy.

We have not been able to find any references in Labour statements or left-leaning think tanks to pre-emptive exchange controls, forestalling the possibility of a run on the pound. It is all 'when or if'. Nor have we found references to any Brexit dependency or to IMF attitudes. But to the extent a run occurs before an election, whether before or after Brexit, there is no scope for pre-emption other than the threat of taking powers to control or liquidate assets moved abroad. To do that would reveal the Marxist agenda more than Labour might wish to.

Nonetheless, we have considered what the effects might be on our clients' investment strategies.

How exchange controls operated from 1939 to 1979

When we endured exchange controls before the first Thatcher Budget, portfolio holdings already outside the UK (whether or not in a collective investment fund based in the UK or in a UK pension scheme) remained outside controls. But geographical diversification of both equity and bond exposures started out very small by today's standards (not least because of some wartime confiscation of foreign assets) and portfolios were much less efficient in terms of the risk for any unit of expected return. There were several key aspects to the regime.

- **Dollar premium pool** Foreign currency represented by the pre-existing stock of foreign investments could be bought from willing sellers and changed hands at a premium to the spot rate. Though many investors made money simply out of trading the so-called 'dollar premium', the premium was eradicated by the unexpected removal of controls in 1979.
- **Loans** For most UK institutional investors wanting to hold foreign investments, a preferred means was 'back to back' loans: an international bank took in a sterling deposit and lent an equivalent amount in foreign currency. Individuals might also have been able to obtain foreign loans, usually for property, on local security.
- **Cross-currency swaps** A variation on the back-to-back loan, but mainly applicable to companies rather than investment portfolios. The swap market developed in the 1970s in part because of exchange controls and swaps and futures are now a core element of capital markets.
- **Travel allowances** These were variously applied during the long period of exchange controls.

[1] James Kilby and Fiona Lali, In defense of Marxism, 18 October 2018

A reasonable working assumption is that exchange controls covering portfolio investments would freeze the existing stock of foreign holdings. In that case, clients' existing geographical exposure will not be part of an active strategy and new contributions, if confined to the UK, will gradually reduce their diversification.

This would act as a constraint on the mathematical optimisation process that converts our expected returns, risks and correlations into equity-portfolio weights. But it would not defeat the process. Constraints are always inefficient and we have avoided them but they are quite common amongst other managers who use optimisation to construct portfolios.

If there is again a premium pool, theoretically we will be able to allow for that in the model, as an additional cost and risk for overseas markets, but not as another risky asset in itself.

Impact on Risk Free assets

Unlike most wealth managers, our risk-control approach depends on separation of the portfolio between risk free and risky, return-seeking assets. How might the risk free component be affected by the Marxist experiment?

Clients should be very glad our approach to risk control does not involve any nominal bonds (those with no inflation protection), either as notionally risk free assets or as part of a diversification strategy (on the premise that bonds and equities are not normally positively correlated). Contemplating Corbyn should make it obvious to anyone that conventional gilts cannot possibly be seen as a risk free asset and also that the negative correlation with equities will not hold if both suffer flight.

Even without nationalisation adding to the bill, it is unlikely that any 'fully-costed' manifesto will in fact balance due to higher taxes alone and the burden will fall on gilt issuance. In 2017 Labour's manifesto assumptions about elasticity were widely criticised as unrealistic. Leakage is likely to occur via both individual behaviour effects and other policy effects eroding both the income and capital base.[2]

The Marxist experiment will face much closer scrutiny of its revenue-raising assumptions than was the case in 2017, when a Corbyn victory was treated as quite remote. This time a critical part of the message of Labour's opponents will be that there is no prospect of any significant reversal of the erosion of workers' living standards without the burden of taxation falling on the middle classes. The class struggle is not 95% versus 5% but sits well within the 95%: not so 'few' after all. Only the hidden Marxist agenda can be transformative for 'the many'. Either there is a hidden agenda or there is no significant change.

As to nationalisation, Labour has persisted in its manifesto argument that exchanging new gilts for equity will have no impact on gilt yields. The argument is seductive but false. Yields at any time reflect investor preferences for holding equity and bond investments. Other things being equal, bonds forcibly replacing equities will be dumped and replacement equities acquired *unless bond yields rise to compensate*. Bonds will always win this contest as government must fund its deficit. They 'crowd out' other investment, both secondary (equity preferences) and primary (new equity issuance). This held even with exchange controls.

What about the impact on ILGs? Whereas ILGs are risk free, there is uncertainty about future yields and these are highly sensitive to changes in conventional yields. Clients should also be glad, therefore, that our ILG exposure is limited to short durations and that we are not locking in negative yields for long durations. But our dynamic portfolios are still depending on the indexation providing protection against inflation, and that ILGs will be available throughout the life of our plans. Any government

[2] The ever-discrete Institute for Fiscal Studies commented on the tax-raising initiatives in the 2017 manifesto: 'Labour expects the policy to raise £4.5b. Based on the available evidence this looks a little on the optimistic side but it is entirely possible. However it is also possible that the policy would raise nothing'.

facing very high inflation will feel tempted to water down or remove the inflation guarantee, even if that is technically a default.

The next best thing to ILGs is rolling over cash, even if the inflation protection is weak[3]. This is already part of our risk free management at the short end and it would have to be extended to longer durations.

The 'game over' scenario

In terms of both exchange controls and a weak gilt market, we conclude we can still implement the model broadly as planned. The confidence levels in projected outcomes will be somewhat weaker if there are practical implementation issues. But that can also be allowed for. After all, there is effectively a fair amount of variance in funding positions that can already be thought of as largely eliminated if we were to think in terms of a confidence band of say 97-99%.

There is also the sixth and final contingency to consider: 'game over' for the capitalist system in the UK, either permanently or for the lifetime of our clients. Game over has always been referred to as a risk with less than 1% chance of arising. We don't plan for it because it's also game over for all the alternative investments a client might hold, including risk free assets. Like Pascal's Wager, there is no opportunity cost if your assumption of the system surviving is in fact wrong. The wager is entirely relevant in the face of the Marxist experiment.

2. Living with the risk

The second step in our thinking about the portfolio problem allows for the possibility that individuals cannot in fact be as rational as they might like to be. If they think they might not be comfortable or confident enough living with the volatility of the portfolio, they have to be prepared to accept lower outcomes for spending than if they could live with the risk. This tends to be a problem for younger clients, as they are the ones with high equity exposure.

The question we need to consider as a consequence of the possibility of a Marxist experiment is whether a client is likely to be less tolerant of downside risk in equities *if it arises in a highly-charged class-warfare context.* This might apply to anyone who feels they are the specific target of deliberate harm, particularly older clients, having more wealth (regardless of risk exposures) in the cross hairs and less of their expected lifetime lying in the more hopeful years after the experiment ends. This is something we will need to go through with clients individually.

Though outcome probabilities and tolerance of path risk together give us a good framework to help clients make decisions, we are conscious that sometimes clients want to take a view, on the basis not so much of missing a downturn (risk averse behaviour) but rather to take advantage of the downturn by buying more than they would otherwise be able to buy at lower levels (risk seeking behaviour).

Rather than talk them out of taking a view, we prefer to put in place a 'stop loss' strategy to get back to the model-following strategy if the tactic is not working out. The reason for doing so is familiar to some of our clients who, before coming to Fowler Drew, had backed a bearish view of markets and then missed out on years (in some cases) of positive growth. In some cases, they were right before they were wrong: they avoided some downside but as markets rose they were then reluctant to go back in.

Options offer another way to gain exposure to a payoff from an expected market effect. This will not hedge the full wealth effects over many years and should be viewed as a speculation rather than a

[3] Inflation protection for cash takes the form of market participants (UK and foreign) constantly re-setting their inflation expectations when considering the return they need, hence cash interest rates broadly follow inflation trends even allowing for monetary authorities' partial ability to impose rates.

hedge. Option costs will reflect the time value and the likelihood of a Labour win. The longer you anticipate the event, the more time value and the more expensive the option. The nearer the General Election, the greater perceived risk may offset the reduced time value. This is probably not going to be a cheap bet to make.

Financial planning

a) Idiosyncratic planning

From our account of our brainstorming of the possible effects on our modelling and the practical implementation of the model, we have already highlighted some tax implications we would expect to apply fairly generally. But there are other possible plan changes that are specific to each individual.

- We highlighted possible changes in risk tolerance, or the trade-off being made between the path of nominal returns and the real outcomes
- It is also possible that some clients will want to modify their spending in the event of a Labour government. This, however, might be balanced, if they expect to spend more on their children and grandchildren, perhaps to cushion them from the economic effects of those policies that turn out not to favour the young
- They might also want to allow for higher spending on the basis that their own inflation rates would be above-average, if spending is in areas of tension between public and private provision like insurance, healthcare and school fees that Labour appears to want to penalise and stigmatise.

b) Potential tax changes

1. Tax simplification

Let's start with some upside. A radical tax-reform agenda does not need to be Marxist but it is more likely to happen if it is. It will not necessarily be simpler but it could be, if only by scrapping many allowances and removing differences in treatment. This might even affect pensions, where the perverse regime of annual and lifetime allowances could be made redundant by any government wishing to drastically reduce the cost of tax relief.

2. Income tax and CGT

It could be argued that where clients are planning at a very high level of confidence in the sustainability of spending, there ought to be an equivalently prudent assumption of high tax rates, rather than actual current rates. (The rate itself, whatever its level, is a blend of income and gains and so a function of assumptions about the sources of draw.) Logically, worst-case CGT provision should also reflect worst-case returns and gains.

This is not the general approach we have taken, preferring to use current rates and not to make the level dependent on the returns at the selected confidence level for the plan. This can be changed. We can already use the 2017 manifesto as a guide to making sure our assumptions about spending are more robust to a Labour government. But we expect to need an even more prudent assumption to cover a more Marxist agenda.

As a general approach, we anticipate limiting ourselves to the former. We can also stress test individual plans for a more severe outcome, but in conjunction with possible changes to the net spending targets in that scenario – so client by client.

A critical assumption is how long we assume higher rates for, before assuming the pendulum swings back to a lower position on the so-called Laffer Curve[4]. Whatever the assumed period, we will treat the higher tax rates during that period as a permanent loss.

We have already made our tax inputs, and the basis of calculation, more granular in the latest version of the model, so it will be possible to vary the rates in every time slice.

3. Wealth taxes

Three options for taxing wealth have emerged in Labour circles, particularly think tanks, none being an adopted part of Labour policy to date:

1 Annual taxes set at a low rate (the standard approach in other countries with wealth taxes)

2 A one-of tax set at a high rate (20% being referred to)

3 Replacement of some national (as well as local) taxes by a Land Value Tax.

Whatever appears in its manifesto, the party will be closely scrutinised on the second as it is the most overtly Marxist signal that the class war is not just a war of words. John McDonnell may have set this hare running but the only attribution we can find dates from 2012. Addressing a Labour group, he praised the wealth tax theory of Professor Greg Philo, where 'you put 20 per cent tax on the wealthiest 10 per cent of the UK'. According to the Telegraph, referring to this in 2017, 'Mr McDonnell appeared confused by the figures involved, saying that "four fifths" of the national debt would be wiped out as a result of the "£800 million" that the windfall would raise, even though the national debt stands at £1.7 trillion'. The Sun has also referred to this one-off tax option but has not presented any evidence it is still being considered. This scare tactic ahead of any election is exactly what we should expect to see from critics of the Marxist experiment.

Much more interesting is Labour's interest in reform of land taxes as this concept is widely supported across the political spectrum. But because it applies to the very broad base of property ownership, often in the context of replacing council tax bands, it does not obviously form part of a focused transfer from the few to the many. Supposedly, for this very reason, John McDonnell has backed away from supporting a land value tax. But as a replacement for council tax, it could be widely supported in principle and the challenges to regular valuations can probably be overcome.

There is a much older approach to taxing owner-occupied homes that could be revived: applying income tax to the imputed rent. This, of course, is an underlying economic principle that is normally hidden but which we make conspicuous by converting all resources, including property, into a spending equivalent. Apart from raising revenue, taxing imputed rent has the appeal of making the economics of renting and owning indifferent to tax treatment.

IHT

The 2017 Labour manifesto envisaged halving the threshold for IHT. This illustrated the problem of restricting the targets for redistribution to the very rich when most personal wealth is held in the form of housing and when house prices vary hugely by location.

The manifesto was silent on the treatment of lifetime gifts. The Potentially Exempt Transfer approach to lifetime gifting is a curious anomaly in any inheritance tax regime, let alone a left-leaning approach to redistribution. A gift tax seems more 'on message'. A gift does not necessarily need to be treated any differently from the removal of wealth from the tax net by changing domicile: more scope for simplification.

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[4] The Laffer Curve describes the relationship between economic activity and the rate of taxation and suggests there is an optimum tax rate which maximises total tax revenue.

c) Forestalling and anti-forestalling actions

Action to avoid or mitigate tax impacts may be what clients are most interested in but that action has to be viewed in the context of new or existing legislative measures a government can take to protect revenue. The more Marxist the tax changes, the more Marxist the neutralising actions. We summarise our thoughts on both aspects below.

1. Change of residence and/or domicile

For those for whom this is a practical option, dominating family or other ties to the UK, shedding UK domicile could take them outside the inheritance tax net. Changing residence could mitigate the effect of income tax and capital gains taxes but not IHT, were they to return. But it is relatively simple to tax exit wealth on a change of domicile as a part-payment of IHT, or some other form of wealth tax, as do several countries. It is also simple to change the treatment of realised gains on transfer, which at present are protected as long as you remain non-resident for six years. It may even possible be possible to legislate for an assumed or asserted tax-evasion motive and apply a punitive tax rate.

2. Moving assets offshore

Marxist language can segue, without awareness of any contradiction, between 'moving' and 'hiding' but legislation will presumably always require a distinction. So the legitimate purpose of moving capital offshore is presumably to forestall exchange controls, whether on spending money, portfolio investments or foreign property acquisition, not to mitigate tax effects. In terms of tax, moving assets without hiding them achieves nothing.

Thought will need to be given to whether one of the standard vehicles for holding assets outside the UK, an insurance-company offshore investment bond, often in a trust structure, will continue to be treated differently, with deferral of liabilities and options to assign ownership. We also have clients with offshore trusts restricted to 'non-UK situs' assets which we may have advised can be met by an offshore bond, even if the trust itself has UK-resident trustees and if the holdings of the bond are London-traded ETFs.

3. New structures

We might expect innovative minds to come up with holding vehicles or product structures that are designed to mitigate Labour's taxes. Apart from the usual downside of high costs and low liquidity we have to assume these will also be in the sights of anti-avoidance measures. To the extent the scope arises because of differences in the treatment of income and gains, remember that that is something that may disappear anyway, as part of the 'simplification' of the tax system.

4. Gifting

Unless anti-forestalling measures are designed to penalise gifts made after a certain date but before the election, there is no downside to bringing forward gifts that you think would be made in the future. Though there may be increased tension with one's own depleted after-tax spending, it is an obvious way to maximise the utility of assets likely to be 'surplus', even after very prudent assumptions about taxation. As previously noted, it will also cushion the next generation against economic pressures arising from the Marxist experiment that could strike anywhere, including (or particularly) those it is designed to help.

5. Tax free cash

The ranks of critics of this 'generous concession' are not limited to progressives: the maths of the deferred recovery of tax relief at the point of earning, compounding at an interest rate equivalent to the fund's growth rate, are poorly understood by most people, regardless of their politics. The Treasury is probably largely responsible for keeping such calls at bay because it does seem to recognise that, without tax free cash, there would be zero economic incentive, not knowing future tax rates, to lock up money in a pension.

But in the Marxist experiment, there may be no affinity for pension saving incentives if they are largely viewed as the privilege of the rich. Besides, it would be wholly illogical not to see the incentive as being harmed by savers' expectations, created by its policies, of lower future returns. Investment flows in the Marxist language are not incentivised so much as directed.

There is therefore a case for bringing forward the taking of tax free cash. This will be stronger where it is also funding earlier gifting of (recalculated) surplus wealth.

6. Bringing forward income and gains

With relatively small changes in tax rates, the game of deferring or bringing forward is not necessarily worth the effort. But with large changes in prospect, there is a much stronger incentive for bringing income and realised gains forward, even if this calculation is one that calls for some assignment of probabilities.

The case may be particularly compelling for CGT, even where there is no intention also to bring forward the consumption (by spending or gifting). This is because it is likely Labour will want to boast about the apparent 'equalisation' of income and gains tax rates, having no compunction about the double taxation of gains arising from taxed savings from income.

7. Equity release

It is tempting to view borrowing in order to gift as a means of reducing the capital values exposed to any wealth tax. It does in fact have its own merit in maximising capital efficiency where several generations are viewed as a single entity, with pooled welfare. The largest increase arises where the same resource has greater utility for the beneficiary because of *when* it is received, such as if it allows a first property to be acquired. A gain in welfare can also arise from replacing a child's mortgage with one on less onerous and more certain terms.

A lifetime mortgage secured on property is also 'non-recourse': the lender cannot recover more than the property fetches at sale due to a 'No Negative Equity Guarantee'. This borrower-only option is currently not being correctly valued by lenders so there is a strong case for bringing forward the debt and locking in the 'incorrect' rate.[5]

Finally, there is more scope to lock in a fixed lifetime rate if you believe that a Labour government increases the chance that interest rates will rise.

[5] This is a window that may close quickly as the Prudential Regulatory Authority is already in discussions with lenders, following academic studies that suggest that, applying option-pricing theory, interest rates are as little as half the correct rate.