ISSUE 10 – JANUARY 2016

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WELCOME

Dear Reader,

Within the next one or two months, a ground-breaking study about the UK media will be published. It will deal with the media's treatment of "Brexit". Its main conclusion will be that there is a huge media bias towards the UK remaining in the EU.

Master Investor isn't a political magazine, nor do we usually take sides. In this case, however, we decided to take an unusual step. Just before Christmas, we launched a Brexit section on our website.

Our special focus for this section will be why the Brexit referendum matters to investors, what consequences a "leave" vote would have for financial markets, and how to best benefit from a Brexit, should Britain vote for it.

The British government recently admitted to not having any contingency plan for a potential "leave" vote. The only contingency seems to be David Cameron's statement that he'll want to hold on to his position as PM, even in the event that the vote doesn't go his way. Given that recent polls indicate there is growing support for a Brexit, it seems like the right time to create a space in British media where the entire subject can be looked at from the perspective of investors, savers, and pensioners.

The mainstream media doesn't allocate enough space to the financial aspects of the EU debate, which is why in this particular case I won't mind if we effectively become a forum for such discourse. In order to have a full and healthy debate ahead of what will arguably be the most momentous referendum since the 1973 vote to join the European Common Market, voters need to be aware of the possible implications for their wealth.

It's not yet clear whether a referendum will be in June, September, or possibly later. Westminster will no doubt make that decision whenever it feels that it's the most opportune moment for getting the "stay" vote that Cameron so much desires. The fact that Britain is the only European country holding such a referendum is a commendable development. Master Investor, in turn, will do its bit to ensure that some important points will be given the space and attention they deserve.

Best regards,

Swen Lorenz,
Editor, Master Investor

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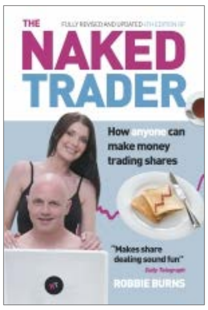

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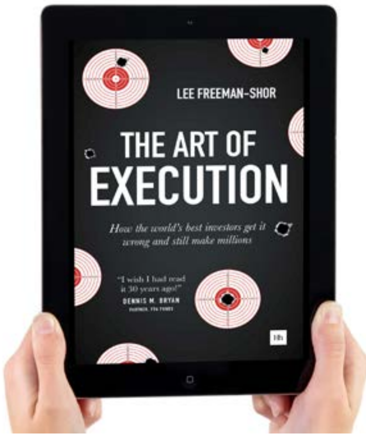

BY SWEN LORENZ

AROUND THE WORLD IN A DOZEN PROPERTIES (PART 10)

HOW TO BUY PRIME LEBANESE PROPERTY WITH AN 80% DISCOUNT

A collapsing oil price, the conflict in Syria, and the advance of ISIS don't exactly make for an inspiring story to invest in the Middle East. Yet times of crisis offer the biggest opportunities. What if the war in Syria came to an end in 2016? And what if you were currently able to invest into prime real estate in the region at just 20% of the current market value? This month's property story is for investors that like to take anti-cyclical positions.

Anyone who is old enough to have watched TV news during the 1980s is likely to vividly remember the destruction and devastation caused by the civil war in Lebanon. Beirut, the country's capital, had become a by-word for chaos. Large parts of its central business district had been bombed into oblivion, and what was left standing had bullet marks all over its walls.

Following the end of the 15-year civil war in 1990, plans were drawn up for rebuilding Beirut. During the 1960s, the city had rivalled places such as Monaco and Cannes, and the plans for reconstruction sought to bring Beirut back to its former glory. To make it all happen, a unique and (to this day) controversial decision was made.

Led by a billionaire politician, Rafik Hariri, the entire inner district of Beirut was dispossessed. All property owners instead received shares in Solidere, a company set up by Hariri and listed on the Beirut Stock Exchange. Solidere is an abbreviation for "*Société libanaise pour le développement et la reconstruction de Beyrouth*", French for "The Lebanese Company for the Development and Reconstruction of Beirut". The company ended up owning the entire 200 hectares that make up the central business district of Beirut.

With the financial backing from Hariri, who had made his money in construction in Saudi Arabia, Solidere set out to rebuild Beirut. Conveniently, Hariri's family also owned a major stake in Solidere. This obvious blatant conflict of interest wasn't the only controversy that the company had to deal with.

Property owners who saw their land title taken away in exchange for Solidere shares felt their properties were undervalued and Hariri had robbed them of their family heirlooms. Hariri, on the other hand, pointed out the practical nonexistence of a functional government after the war, and the near-impossibility to align all stakeholders – including property owners – with one unified and feasible vision. To his credit, subsequent studies agreed that Hariri's proposal to use private resources to plan and execute the rebuilding of Beirut was indeed the only viable option.

The controversy didn't stop there, however. The plans for reconstruction envisioned bull-dozing countless historic buildings and replacing them with the kind of modern architecture that can be found throughout the Middle East nowadays. Locals felt priced out of the market, arguing that the new buildings were for the "Khaleejiyi", using the colloquial term for Gulf Arabs.

Much of this criticism was no doubt justified, but plans went ahead

"THE CITY HAS NOT YET EARNED BACK ITS PRE-WAR TITLE OF THE 'PARIS OF THE MIDDLE EAST', BUT IT HAS SUCCEEDED IN CREATING A CITY CENTRE THAT BY NOW HAS BEEN FEATURED IN COUNTLESS TRAVEL MAGAZINES AS A MUST-SEE PLACE IN THE MIDDLE EAST."

regardless. Ironically, Hariri was not to see for himself how his masterplan eventually came together. He was killed in a 2005 car bombing, although his family maintained their role as large shareholders. Solidere's assets totalling $10 billion effectively represent 20% of the entire Lebanese economy, giving the family a powerful role in the future of the country.

Despite all the controversy, Solidere is today widely credited with successfully seeing through Beirut's rebirth as a bustling destination. The city has not yet earned back its pre-war title of the "Paris of the Middle East", but it has succeeded in creating a city centre that by now has been featured in countless travel magazines as a must-see place in the Middle East.

The masterplan process had been led by British architect and urbanist Angus Gavin, formerly of the London Docklands Development Corporation. As the Guardian once described it, Beirut is now "an odd mixture of careful urban design and preservation, dotted with showy outbursts by big name global architects. A good number of streets have been impeccably restored to their beaux-arts glory, with colonnaded pavements and beautifully carved stonework along cornices and window reveals, reviving the fusion of French colonial and Levantine vernacular." For better of worse, Beirut now has the usual rows of stores from Gucci, Virgin, and Rolex. Rents are sky-high, and locals have indeed been priced out of the market to a certain extent.

Solidere has even branched out to handle construction projects in other parts of the Middle East. However, 90% of its assets are still in Lebanon. It's as close to a pure play on the Lebanese economy and property market as you can get. Its shares have been traded on the London Stock Exchange as Global Depositary Receipts ever since the company was created in the mid-1990s. Anyone with a brokerage account can easily buy and sell shares in Solidere in London, offering a much easier option than physically buying property in Lebanon.

What's more, Solidere shares are currently trading at a huge discount to their underlying property value.

Following the initial success in rebuilding Beirut, the share price soared from $5 in 2004 to $39 in 2008. Since then it hasn't been trading anywhere near that price again. The global financial crisis and the ongoing political instability of the Middle East took its toll, and at last count the share was trading at around $10. The Net Assset Value per share was last calculated at $51 per share. Such a large discount to Net Asset Value is unusual, and offers investors the opportunity to buy into an asset on the cheap. Solidere debt gearing isn't particularly high, leaving the company largely immune from the financing issues thrown up by the financial crisis.

It is of course possible that the volatility of the Middle East could lead to the share temporarily trading even lower. However, in the long term, and assuming the Middle East doesn't descend into all-out chaos, the gap between the Net Asset Value and the share price is likely to decrease again. Investors might now have a similar opportunity to the one in 2004, when the share was undervalued and subsequently multiplied in value. Needless to say, such an opportunity comes with its own set of risks, which is why such an investment should never make up more than a small percentage of an investment portfolio.

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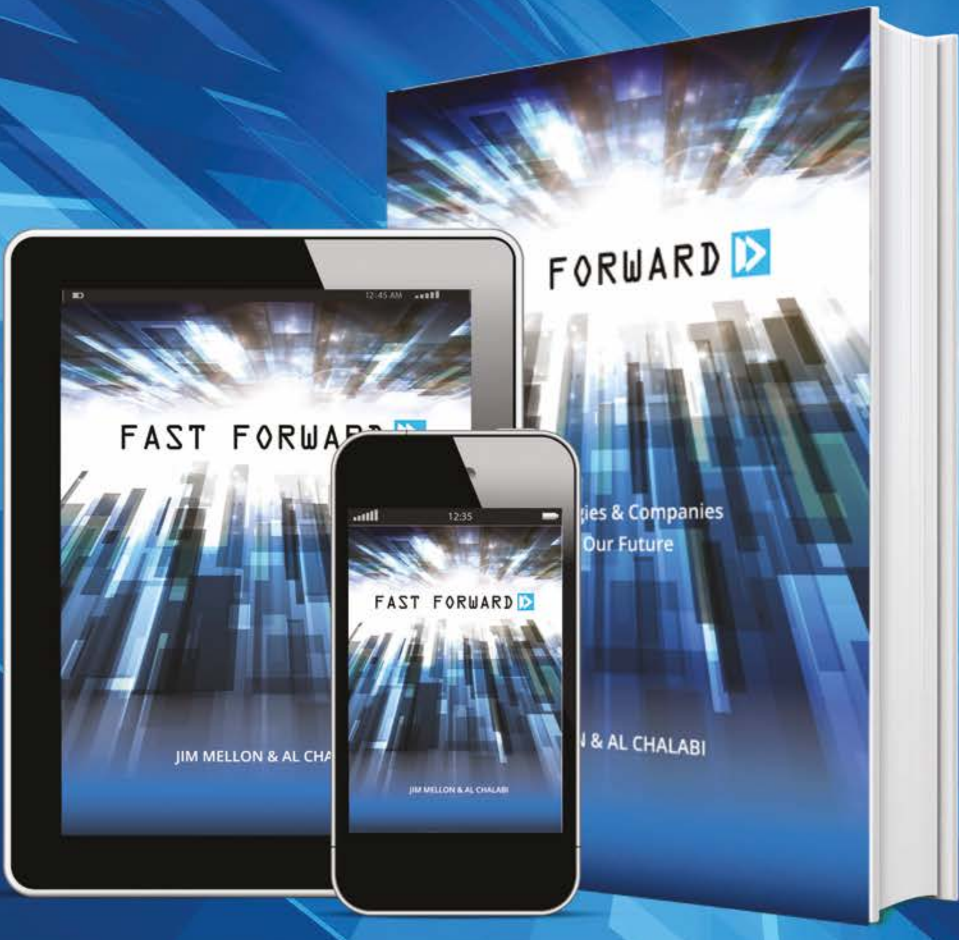

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BY JIM MELLON

MELLON ON THE MARKETS

Happy New Year to all you Master Investors out there! The start of the New Year has been good for those of us fundamentally worried about stretched valuations and a cloudy outlook.

China's ructions have caused some steep falls in most markets. It is worth noting that if January is a down month, typically the rest of the year is also down. Now that is a little bit of hocus pocus of course, because superstitious analysis of historical data is not a way to wealth. Except sometimes these sorts of predictions are self-fulfilling.

Most importantly, there isn't any particular reason that most markets should rise, but there are plenty of reasons to suggest that they should fall or tread water. The most important of these are: a) in Europe and the US, there is likely to be a deceleration or even fall (in the US) in earnings; b) this leaves valuations at stretched levels on any measure that you care to apply; c) dividends will come under pressure as companies, particularly in energy and mining, find debt service levels untenable (which is already happening in some cases); and d) currency volatility will cause earnings surprises on the downside to be exaggerated.

Last year worked out pretty well for us. The Swiss Franc (two tea bags) fell, the Euro fell, then rallied, the yen was neutral, Japan was up about 13%, the US market fell by 1% (with almost all of its gains concentrated in a few tech stocks, and 490 stocks in the S&P 500 falling), and the FTSE fell by about 8%. European stock gains were wiped out by the fall in the currency.

"THERE ISN'T ANY PARTICULAR REASON THAT MOST MARKETS SHOULD RISE, BUT THERE ARE PLENTY OF REASONS TO SUGGEST THAT THEY SHOULD FALL OR TREAD WATER."

So far, so good. Gold and silver weren't great, but the call to generally avoid emerging markets worked.

Now, for 2016 here are my predictions:

1. The US market falls further. Perhaps 5-10%. The crazy valuations of tech IPOs meet their day of reckoning. Some large biotechs that got beaten up in the last year, like Gilead or Biogen, recover sharply, but most biotech is blah. Agriculture stocks do well (think John Deere, Monsanto and Syngenta) as agricultural prices recover.

2. The UK does OK, as sterling falls somewhat against the dollar and further against the Euro.

3. The Italian and French debt crises-in-the-making become apparent to a wider audience than me. And yields on all Euro bonds go up – i.e. prices go down.

4. European stocks tread water.

5. Japan, spurred by rising ROE,


tons of oil
2015
2016

buybacks and improved corporate governance, continues to be the world's best performing market. Nikkei has 22,000 at least written on it. My picks include Fanuc, Hitachi, Mitsubishi Heavy and Honda.

6. China produces a modest positive return.

7. Vietnam is the world's best performing market, followed by Argentina and Brazil.

8. Russia continues to disappoint.

9. Africa stalls further and the idea of a growth miracle is debunked.

10. US treasury yields on 10 year bonds rise to 2.7%.

11. The Swiss franc falls further.

12. The Japanese yen strengthens to 110 -115 against the US dollar.

13. The AUD falls to 69 cents (I am resuming my bearish tack here).

14. The CAD rises to 1.29 against the US; the SEK is a buy (Swedish Krone).

15. Hilary Clinton wins the US election.

16. Brexit is close, but the muppets will vote to stay in (a very stupid move in my view!).

17. Gold and silver will outperform.

18. My favourite big company stocks that I can talk about, apart from the ones above, will be Rio, Peugeot, Amgen, and the JNUG ETF.

19. 12,000 people will register for the greatest investment show on earth, Master Investor on 23rd April 2016.

20. There will be a move to bail-in failing banks in the Eurozone – Portugal first, then Italy. This will dent Europe's economic recovery.

21. The migrant crisis will result in an effective closing of borders (destruction of Schengen).

22. Saudi Arabia will move closer to bankruptcy.

23. Corn, copper and lithium will be the best non-precious commodities to invest in. Iron ore will be flat.

24. Merkel will be ousted.

25. The Queen will abdicate.

So there you have it. And of course, I will be back with a lot of new forecasts/recommendations at the Master Investor show. I really hope you get your tickets early; there has been overwhelming demand for them – and I would love to see everyone there.

Happy Hunting!

Jim Mellon

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BIG IDEAS OF 2016

We asked a few of our writers to come up with some pearls of wisdom for readers to take into 2016. Here's a selection of what they came up with...

BY ADRIAN KEMPTON-CUMBER

IRELAND ETF

New Year's resolutions are as ludicrous as the idea of being 'nice' to people because it's the second half of December. If you didn't have the will power to do something last year, then a meaningless integer won't change that. I made my last New Year's resolution about 10 years ago. It's going well. It was to not make any more New Year's resolutions.

I've been asked to make a pick for 2016. To base that on a development in TA is quite hard to do at this time of year. Usually December tails off in terms of market action and is not the best time to be looking for signs. But people do seem to want to take stock just as their holiday break is over and they're back to work.

So with that in mind I'm going to use more fundamentals than I would usually. I wrote about Ireland back in the summer. I'd learned that the economy was booming and they were even paying relocation costs to encourage sections of the diaspora to return to the Emerald Isle, or at least the bit that isn't part of the UK. I say part of the UK, but not culturally, as the laws in the province make quite clear, they are living in a different UK to the one I live in here in London. It's still illegal to have an abortion for any reason (although lots of people have gotten away with terrorist atrocities, so apparently not so illegal to kill after the delivery), and gun laws are less strict, for example. Although I understand trade and business is carrying on as if all of Ireland were one country, and Dan Mulhall, the Ambassador of Ireland to the UK said exactly that at UCL last February.

A good way to check the pulse of an economy is to study its PMI. For those who aren't familiar that is the Purchasing Managers' Index. There are two reports: Manufacturing and Services. Basically a lot of questions are asked of Purchasing Managers in a range of companies across different industries and the results give an idea of their expectations. This covers things like orders, deliveries, supplies, input and output costs. An economy growing with the low commodity prices we are seeing is in a very good position. The November 2015 Ireland PMI reports what you would expect to see: slower suppliers' delivery times, increasing employment and new orders, among others. In fact in the Service Sector a record rise in employment was recorded along with a sharp rise in outstanding business. Employment in the Service Sector has increased every month for the last 39 months. Manufacturing output has been growing now for two and a half years. PMI is a leading fundamental.

When I wrote about Ireland in the summer we were waiting for an early entry to the breakout of the **iShares MSCI Ireland ETF (EIRL)**. We have broken above that price level now, which is why I don't particularly think there is a technical reason to enter this trade just now. A bounce off the resistance level just above 41, making it support, particularly if that were also a bounce off the Ichimoku cloud top, would be a desirable entry signal. That could be a reality in early- to mid-February if it happens.

Incidentally, there are often several PMIs to choose from. Markit and the ECB are also good for the EU but here I've used the Investec Irish PMIs.

BY RICHARD GILL, CFA

REVIEW YOUR PORTFOLIO

My big investment idea for 2016 is not a stock tip. Instead, it is a concept related to my review of investment book The Art of Execution, published in this edition of Master Investor Magazine.

> "I TAKING ACTION ON UNDERPERFORMING SHARES MIGHT SOUND SIMPLE ENOUGH BUT FOR MANY IT CAN BE A DIFFICULT DECISION TO MAKE DUE TO A NUMBER PSYCHOLOGICAL REASONS."

While they might not like to admit it, many investors have stocks in their portfolios which have just not performed as they would have hoped. This might be due to following a bad stock tip, a company profits warning, a sectoral decline, or many other reasons.

Bad stock purchases are a reality of investment. Everyone gets it wrong sometimes, including the professionals. What is crucial however is how investors deal with their underperforming situation.

So my big idea for 2016 is for you to review your portfolio and take decisive action on any underperforming investments. Why? Because, doing nothing when your shares are going down is wrong in all three potential scenarios: if the shares recover then you should have bought more; if they go down you should have sold; if they stay at the same level then you also should have sold due to the opportunity cost.

Taking action on underperforming shares might sound simple enough but for many it can be a difficult decision to make due to a number psychological reasons.

Some investors might fall in love with a stock and develop an emotional attachment because when they first bought it they thought it was going to bring them riches. If the investment story takes a turn for the worse you should be prepared to put emotions aside and take action – just like splitting up with a partner after a relationship turns sour. Others may blame a third party for their woes: a tipster for a bad recommendation, company management who have underperformed, or "Mr Market" who is apparently valuing the stock incorrectly. If an investment has turned sour investors must be willing to take the blame for it themselves, as they ultimately made the decision to buy in the first place.

Of course all losing investments should be reviewed in the context of what the investment story is at that moment in time.

If the fundamentals are the same but the price is lower why not buy more? But when you are reviewing your losers make sure you don't submit to confirmation bias. This refers to the tendency to only look for information which supports, rather than which opposes, your view. As investors we owe it to our wealth to also look for the downside argument, and use it together with the bull points in order to make a reasoned decision.

Remember that for an investment which has already gone down by 33% you will need it to rise by 50% just to break even. A 50% loss means it needs to double and a 90% loss means a 900% rise is needed to make your money back! If your stock has already fallen by such a dramatic amount you should be prepared to accept that it may never hit a turning point. Get out and move on.

BY VICTOR HILL

FORGET BUY-TO-LET, THINK AIRBNB!

I have a friend who is a barrister. She decided to follow the trend for buy-to-let. She bought an airy riverside penthouse somewhere down-river from The Tower of London. New kitchens and bathrooms were installed, new carpets laid and the appointed estate agency duly found a tenant.

The tenant, who vaunted himself on his Facebook page as *a lay preacher* never paid a single month's rent. Eviction proceedings were initiated and, after about a year, the matter came to court. But the estate agent advised the court that the landlord's rental income foregone had already been reimbursed to my friend by the insurance company – and the court refused to issue a notice of eviction.

Actually, my friend had never received a penny from the insurance company – the insurance payment had been paid to the estate agency, which denied having received it. So my friend, being of a legal bent, initiated proceedings against the estate agency. Just as this was about to go to court, the estate agency declared itself bankrupt. It then re-opened the next day under shimmering new colours and with a new name, the MD of the new entity being the brother of the previous entity's MD.

Meanwhile, eviction proceedings dragged on against the lay preacher. After two years of rent-free accommodation, the court then granted a notice of eviction. Bailiffs were appointed and I accompanied my friend, who needed moral (if not physical) support, on the fateful morning. We found that the bird had already flown; but he had left a memento of his tenancy: all the granite kitchen worktops had been smashed to smithereens, presumably with a sledge hammer. The police were uninterested in this matter, preferring to dedicate their energies to arresting an elderly lady in the locality who had not paid her TV licence.

(By the way, we discovered an extensive library of self-improvement books along the lines of *Unleash Your Inner Leader* – which I promptly conveyed to the local charity shop. It's nice to know that somebody benefited.)

airbnb

Another new kitchen and new bathroom later (plus completely new carpets, given the burn-holes) new tenants were found – this time privately. A lovely, genial couple with their own business, they seemed upwardly mobile, as betokened by their spanking new jet black Range Rover Evoque. Given the disruption associated with the on-going renovations, my friend offered them half-rent for six months.

After the six-month period the genial couple announced apologetically that they had gone bankrupt. My friend gave them a grace period to sort themselves out. After about three months, they informed her that, yes, they did qualify for Housing Benefit, but that, unfortunately they would still not have enough income to pay any rent. After another six they were re-housed by the Council, so my friend lost most of another year's rental income (this time uninsured).

With a busy career, my friend decided that there were better things that she could do with her time and money. She put the penthouse on the market. After the sale, net-net, she ended up substantially out-of-pocket, despite a modest capital gain.

If you are into buy-to-let, I hope you have better luck. But there is another option. That is to buy a property which is suitable for short-term lettings to (mostly foreign) visitors. This is especially viable in or around London, one of the world's must-see cities. Then let it out for two, three or even four weeks on *Airbnb*. This internet model is now well tested and, anecdotally, seems to have satisfied customers on both sides of the deal. Payment to owners is guaranteed on the day the happy holiday-makers/beautifully short-term tenants (whatever you want to call them) arrive, by pre-paid credit card. Holiday rents, on a weekly basis, far exceed residential rents though don't forget you'll need to clean the property when the vacationers leave. I know which option I'd prefer.

BY ROBERT SUTHERLAND SMITH

TIME: THE EVER ROLLING TIDE OF TIME BARES ALL ITS SONS AWAY...

We have now passed that time of year when we are bid, by good old custom and practice, to consider the unknowable thing: the future. Our future! We are all meant to be cheerful and optimistic about that! As we cheer in the New Year, the chimes of Big Ben solemnly toll out across the midnight air and airways, before vanishing into time, space and memory.

As the last seconds of another year fly into history and the past, we keep our fingers crossed! We raise a glass and sing the companionable words of Auld Lang Sine, powerless in the headlights of time, ceremoniously moving on. We might have preferred to remain in 2015 – just in case – but we cannot call that Old Year back. It has gone – and gone forever! We are scarcely able to control our own lives, let alone the juggernaut of Time: "The moving finger writes and having writ, moves on; not all thy piety nor all thy wit can call back a single jot of it."

Entering a new year means heightened uncertainty – a bit like walking into a minefield where we all struggle to be brave, not knowing where to put our feet. Was that struggle worst this year, or is it normally like that? We hopefully attempt to discern the best of all worlds awaiting us, our families, friends, and of course civilisation itself, but we do so cautiously.

The year 2015 was certainly one in which the world was seen to be heading for Hell in a handcart; a time when it was beset with problems to which there seems no remedy or solution. History is no longer dead. It is back in barbaric, medieval form. In Syria ISIS has put strange ideas into the minds of young men and women and there seems no easy way of getting them out again. You can blow up a fortification and kill a hundred men, but how do you kill ideas? The Pentagon has no weapon for that.

> **"OVER TIME, NOTHING REMAINS THE SAME – PARTICULARLY THE IDEAS PEOPLE CARRY UNSEEN IN THEIR HEADS."**

To those who despair about this, I point out that the remedy lies in time and experience. Over time, nothing remains the same – particularly the ideas people carry unseen in their heads. Take the example of Iran. Our view of it is defined by the Grand Ayatollah Khomeini who returned to depose a Persian Shah to found the puritanical Shea Islamic State of Iran: no music; the curbing of social freedoms, particularly for head-covered women with limited liberty. Remember the girl jailed for going to a football match? All of which is the long lasting product of the mind and ideas of the Grand Ayatollah Khomeini, unsmiling, religiously functional and as adamantine as flint. He died long ago but his monument, the Shea Islamic state, still stands.

Interestingly, his grandson, also an imam and successor to the Khomeini spiritual inheritance, has entered onto the Iranian political stage as a potential candidate for the position of the Ayatollah of the Iranian Islamic Republic when the current incumbent goes. And here's the irony. Time and experience has made him much more of a social liberal and reformer who espouses the right to listen to music, the right to greater social freedoms, and (most notable of all for an Islamic state) greater rights for women. Time and its tides do indeed alter the internal landscapes of our minds. Time cures everything.

BY JAMES FAULKNER

UNLESS THE SITUATION CHANGES, HOLD ON TO YOUR WINNERS

Given the potential barrage of headwinds facing equities in 2016, stock selection will be crucial for a successful performance. One of the ways in which investors can, to some extent, insulate their portfolios from wider macroeconomic headwinds is to focus on companies that are performing strongly in a niche environment with a favourable backdrop. Such companies, should you be lucky enough to find them, can often continue to perform well whatever the weather in the wider economy.

A good example is **Tristel (TSTL)**, which is a company I have often spoken favourably of, both on the Master Investor site and elsewhere. Tristel specialises in infection, hygiene and contamination control products used by organisations in healthcare, pharma, personal care and animal care. It is in a sweet spot right now because of the growing threat from multi-drug resistant bacteria and the diminishing efficacy of antibiotics, which are bringing cleanliness in healthcare into sharp focus.

The firm has all the hallmarks of a strong company. These include a market-leading product, high recurring revenues, strong and predictable cashflow, high barriers to entry and a strong balance sheet. While Tristel already has a strong record of consistent growth, it has only begun to scratch the surface in terms of the market potential for its products.

Most interestingly, it is due to submit an application to the FDA in June 2016 to gain access to the US healthcare market. Should approval follow (anticipated a year later) research house Equity Development reckon it could add c.100p per share to its valuation.

In addition to this, there is scope to roll out Tristel technology to the household cleaning products market. A partnership with an FMCG company such as Unilever or Reckitt Benckiser would be the most likely option. I would wager either of these companies would be willing to pay handsomely in order to claim that, for example, their products 'kill all known superbugs'.

"GIVEN THE POTENTIAL BARRAGE OF HEADWINDS FACING EQUITIES IN 2016, STOCK SELECTION WILL BE CRUCIAL FOR A SUCCESSFUL PERFORMANCE."

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BY BILL BLAIN, STRATEGIST, MINT PARTNER

PORTFOLIO POSITIONING GOING INTO THE NEW YEAR

"My global outlook for 2016 is for broadly steady but slow growth – the new normal – but a nervous and skittish market over-reacting to news flow. My biggest threat for this year is a positive upside economic surprise – stronger than expected US growth!"

When Master Investor's editor asked for comments on "Portfolio Positioning" for 2016, my immediate reaction was panic. Outlook articles are an opportunity for economic shysters to garner eternal market glory by guessing the big threats for the coming year. But, equally, such comments are hostages to fortune. Who knows what might really happen? In a world fixated by financial threats, it's very difficult to find something new to pontificate about that hasn't already been said!

New-year to year-end is an arbitrary period, but the associated festivities and the Mythic-Celtic-Psycho-babble that surrounds "new beginnings" mean we ascribe enormous importance to January 1st predictions. They rather set the tone for the coming year. My first comment would be forget New Year, and worry about the importance of positioning portfolios on a constant basis as the news occurs, rather than on any set timeframe.

Of course, the proper way to protect from market risks would be to constantly consider all the macro factors – such as the China economy, US growth and commodities, and then overlay the various micro themes. Let's assume you are already doing that... The trick is not to simply follow the herd!

"RELAX – ALTHOUGH THE NUMBER OF THE YEAR HAS CHANGED, NOT MUCH ELSE HAS!"

On a dynamic basis, the New Year has not started well. The first market day of 2016 opened with a 7% crash in China, pummelling global market sentiment. Over the first few days of the New Year, the financial media was full of doom and gloomsters predicting worse to come. How should serious investors position for such a nervous environment?

Relax – although the number of the year has changed, not much else has!

Stock ructions in China, ongoing tension twixt Iran and Saudi, North Korea exploding a hydrogen bomb, busted European bank bonds, EM crisis, oil prices in freefall, crashing commodities and missed inflation targets should simply remind us 2016 is likely be yet another "same as, same as" kind of year where nervous markets will continue to react badly to uncertainty and fear of unknowns.

Get over it. Strip out the daily noise and try to discern underlying themes that set markets.

I'd focus on "Normalisation" as my mantra for the coming year. Will the US Fed's decision to gently raise interest rates support growth or kill it stone dead? I suspect the former. My global outlook for 2016 is for broadly steady but slow growth – the new normal – but a nervous and skittish market over-reacting to news flow. My biggest threat for this year is a positive upside economic surprise – stronger than expected US growth!

Although asset prices are inflated, that's because of non-market factors. We are not in a period of

"MY BIGGEST THREAT FOR THIS YEAR IS A POSITIVE UPSIDE ECONOMIC SURPRISE – STRONGER THAN EXPECTED US GROWTH!"

"BONDS ARE GOING TO BE INTERESTING. NO LESS A GLOBAL AUTHORITY THAN BLACKROCK SAY IT'S GOING TO BE A DIFFICULT YEAR."

irrational exuberance. Underlying sentiment will remain cautious – although we're now into the rising US rate environment, there are, as yet, few discernible signs of real economic growth. The first week of the year saw the worst US manufacturing demand in six years. It will take time to convince markets things are getting better!

And while the US is normalising, the rest of the world remains addicted to intervention. The China slide in the opening days of 2016 was addressed in the "same old, same old" way – government institutions were instructed to start buying, and some $19.9 billion of short-term money was pumped into the market by the Bank of China to quell pressures. It's hardly the stuff of an unfettered invisible hand.

I've heard some extraordinary expectations for stock markets this year. Some analysts are blithely predicting 10% plus returns. I can't see it. Unless the current miserable economic data suddenly turns even more spectacularly positive than I expect, I can't see any reason to justify much higher stock valuations. The truth is global stocks have still to correct the distorting effects of years of Quantitative Easing – which is what I mean by Normalisation. Government purchases of bonds pushed interest rates to zero, which had the effect of pushing stocks higher as yield tourists sought returns outside of fixed income.

Japan stocks did rather well in 2015 – but on the back of government directed pension fund buying and the devaluation effects of the lower yen. China stocks are maintained by government fiat. European stocks rose last year – and I'm not convinced I really understand why the prices anticipate growth.

US corporate results hardly seem to justify high expectations. What will happen to these markets if the support of governments was not there? In the case of China, freefall; in the case of the US, I'm beginning to see a stock market that reflects the underlying economy, and if that economy grows, then stocks will deservedly rally!

Bonds are going to be interesting. No less a global authority than Blackrock say it's going to be a difficult year. But in what way? We're expecting a modest bear flattening in the US – meaning 30-year bond rates will rise a little while the sell-off at the short-end will be more pronounced. That will cause modest losses, but not a bloodbath.

European bond markets are set for an interesting year. Despite continuing to miss ECB inflation targets, I suspect Draghi's cupboard of QE surprises is pretty-much empty. By failing to deliver yet more QE stimulus by buying even more bonds and financial assets, he disappointed markets in December – promising much, but delivering little. That's been his modus operandi from the get-go, but now I get the sense that the ECB's options are limited. Despite the economic pall that hangs over Europe, we may still see weaker European bonds (meaning higher yields) as Draghi's repeated promises to "do whatever it takes" run into political roadblocks. He's already done enough with near-zero rates, but to maintain these requires the maintenance of the polite fiction he can deliver on all these promises.

Europe will face many challenges in 2016: pressures from immigration, immediate political crises (such as Spain trying to construct a government), and the looming uncertainties of a BREXIT vote, to name but a few. As a result, I'm thinking European bonds look... problematic... And bear in mind, if the US fails to deliver real signals of burgeoning growth, then the dollar rally will stall, leaving Draghi's hopes for European recovery on the back of a lower Euro in tatters.

The other major asset class to consider is the broad world of commodities. Just watching the TV over the holidays was enough to convince anyone the world's weather has gone mad – with profound implications for agricultural commodities. We know the planet has just experienced the strongest El Nino event in the Eastern South Pacific – meaning a La Nina will follow. These both trigger predictable weather effects that can be hedged.

Meanwhile, while the market remains convinced raw material prices are wholly dependent on China, don't forget other emerging economies have arisen that are cheaper producers and are set to replace the Middle Kingdom as the world's factory floor. A weaker dollar – further reducing commodity prices – could well see stronger growth. Oil is potentially a game changer – higher oil prices could prove the inflation spur so many central banks crave. They should be careful what they wish for – they might just get it. If the Middle East squares off between Saudi and Iran... watch prices. Even a modest oil spike to $70 dollars (where we see the true marginal cost of US production) could create an unexpected stagflationary cocktail.

Aside from the broad themes of how nervous markets settle and approach normalisation, what other trends can we expect in the coming year? What more can I add to the many articles already festooned across the market media speculating on all kinds of looming financial disaster, and dredging through the detritus of nonsense that passes as informed market opinion these days?

In terms of risks for 2016 I've read it all. From an eruption of Mount Vesuvius to a UK housing collapse, revolution in Saudi Arabia to a Unicorn meltdown in US markets. And why not, these are all possible market events in the coming year. My own threat board includes Flying Saucer Invasion (why not?) and China Part 2.

In terms of positioning my portfolio for both the known "unknowns" and the "no-see-em" threats of the coming year, I am reminded of two pieces of sage advice given to me by successful long-term investors: 1) if you don't know, don't go long or short, and 2) there is no point worrying today about something you might have to worry about tomorrow.

Good luck for 2016!

About Bill Blain

Bill Blain is a leading market commentator. After 25 years as an investment banker, he took up broking in 2007 and now provides guidance across asset markets.

"IN TERMS OF RISKS FOR 2016 I'VE READ IT ALL. FROM AN ERUPTION OF MOUNT VESUVIUS TO A UK HOUSING COLLAPSE, REVOLUTION IN SAUDI ARABIA TO A UNICORN MELTDOWN IN US MARKETS."

BY RICHARD GILL, CFA

SMALL-CAP CORNER

FOLLOW THE FUND MANAGERS FOR A PROFITABLE 2016

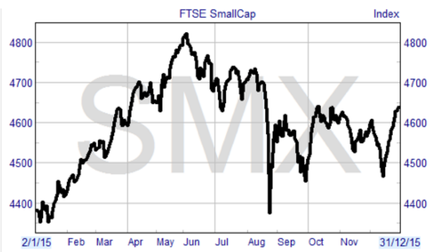
As one year ends and another one begins, it's time to look at what UK small caps delivered in 2015 and what 2016 is set to bring.

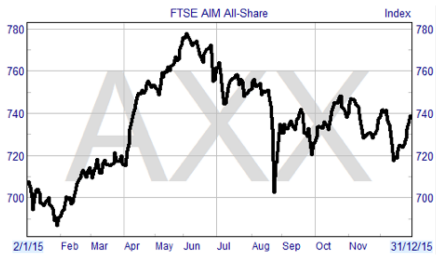
On the face of it, small caps had an OK year in 2015. The FTSE AIM All Share Index ended the year up by a modest 5.24%, with the FTSE Small Cap Index up by a slightly higher 6.23%. While these indices both outperformed the FTSE 100, which fell by 4.92% on the back of the commodity sector slump, the mid-cap FTSE 250 beat them all by delivering an 8.36% gain over the year.

Digging deeper into the numbers, however, it's clear that small-cap investors did not have such a great 2015.

Firstly, while the AIM and Small Cap indices ended 2015 in the black, gains of around 5/6% are somewhat short of the expected returns for small caps given the high risk involved. In comparison, some five-year retail bank bonds are currently offering 3/4% for little to no risk.

Secondly, taking AIM as a proxy for small caps, the wider All Share index was substantially driven by a good performance from higher market cap companies, with smaller market cap firms generally performing poorly. The AIM All Share is a market cap weighted index, meaning that those with a larger valuation have a more pronounced influence on its returns compared to smaller ones. In 2015 the top 50 AIM companies (AIM 50 Index) delivered a market cap weighted gain of 18.57%, with largest constituent **ASOS (ASC)** up by 34%, thus driving the market as a whole and making up for the poor performance of smaller firms.





Source: Sharescope

Name	Capital (£m)	Price change (%)	Sector
Pantheon Resources	280.8	833.33	Oil & Gas Producers
Andalas Energy and Power	8.4	609.09	Alternative Energy
Formation Group	22.6	510.17	Real Estate Investment & Services
Oracle Coalfields	24.2	416.67	Mining
Daniel Stewart Securities	15.1	364.29	Financial Services

Table: 5 biggest AIM winners in 2015

Name	Capital (£m)	Price change (%)	Sector
PeerTV	0.2	-99.92	Technology Hardware
Motive Television	0.3	-99.67	Media
Caza Oil & Gas	0.6	-97.05	Oil & Gas Producers
Rose Petroleum	2.7	-95	Oil & Gas Producers
Golden St Resources	0.7	-94.12	Mining

Table: 5 biggest AIM losers in 2015

Equal weightings

My own analysis of AIM looked at all companies which were listed on the market for the whole duration of 2015. This eliminates firms which were newly listed during the year, those which left the market and also those which went bust, giving the analysis a slightly positive bias. Out of the 994 AIM listed companies left we have only 374 that

"A CASUAL DART THROW AT THE AIM MARKET AT THE START OF 2015 WOULD HAVE MOST LIKELY PICKED A LOSING STOCK."

Fund	2015 performance
MFM Techinvest Special Situations	34.7%
Standard Life Investments UK Smaller Companies	28.2%
Franklin UK Smaller Companies	25.6%
Liontrust UK Smaller Companies	23.5%
Threadneedle UK Smaller Companies	23.3%

Data source: Trustnet

finished the year up, eight were static and 612 ended the year down. So a casual dart throw at the AIM market at the start of 2015 would have most likely picked a losing stock.

What's more, an equal weighted index of these AIM stocks would have shown a loss of 3.76% over 2015.

But as ever there were some big winners during the year, with Pantheon Resources striking oil and soaring by 833%. While Andalas Power & Energy (formerly CEB Resources) gained 609% the shares remain suspended from the market, as do those in fifth highest riser, Daniel Stewart. Overall, 48 companies saw their shares more than double.

At the other end of the scale 49 AIM stocks dropped by 80% or more, with over half of these being in the beleaguered mining and oil & gas sectors.

Into 2016

So the data suggest that, as ever, there are big gains to be found in small caps. But AIM remains a stock picker's market. Who better to take guidance from for the coming year than the best performing small-cap fund managers of 2015?

Using data from Trustnet's UK Smaller Companies category the five best performing small-cap funds of 2015, out of a universe of 49, were the ones shown below. All significantly outperformed the average gain of 14.1%.

Here follows two small-cap stocks which some of these top performing funds are betting big on in 2016 or have recently been buying shares in. They are both interesting "special situations".

REDHALL GROUP

A recent addition to the best performing small-cap fund of 2015 – Techinvest Special Situations – is **Redhall Group (RHL)**, the manufacturing and specialist services business. The company has had a very tough time since the recent financial crisis, with the shares currently trading at just 2% of their 2008 peak on the back of troubles in its nuclear business, production issues, contract delays and a string of associated profit warnings. But following recent actions taken by management Redhall is now a much more streamlined business and an interesting turnaround situation for investors.

Redhall Group plc

The beginning of a major restructuring began in December 2014 with the launch of a strategic review by CEO Philip Brierley. The former Commercial Director of the group, Brierley was promoted in June 2014 after the previous CEO resigned following a profits warning. Several other management changes also took place during the year to refresh the board.

The strategic review revised Redhall's focus on higher margin manufacturing work and opportunities in the nuclear, specialist infrastructure and oil & gas industries. The decision was also taken to exit low margin contract operations and to remove a layer of divisional management, with both expected to significantly boost margins. The changes were largely completed by the end of the 2015 financial year in September and as a result "substantial improvement" in profitability and earnings is expected from 2016 onwards.

The next major step in the turnaround came in May last year when Redhall disposed of its loss making engineering contracting subsidiary RESL to fully listed Cape for £6 million. This was in line with the strategy to focus on higher margin business and reduced net debt by £5 million. Finally, September saw the firm raise £5.5 million via a placing and open offer, albeit at a 50% discount to the previous day's closing share price. Several directors also took part in the fundraising. This came along with a £3 million debt-for-equity conversion and in total reduced net debt by £8 million.

"FOLLOWING RECENT ACTIONS TAKEN BY MANAGEMENT REDHALL IS NOW A MUCH MORE STREAMLINED BUSINESS AND AN INTERESTING TURNAROUND SITUATION FOR INVESTORS."

As it stands Redhall now operates through two divisions.

Manufacturing comprises the businesses of Booth Industries, Jordan Manufacturing and R Blackett Charlton, which mainly focus on the nuclear, defence, decommissioning and infrastructure sectors. The firm has completed many jobs on the high profile Crossrail project and major clients include Sellafield, Rolls-Royce and Renishaw.

Specialist Services consists of the operations of Redhall Networks, Redhall Jex and Redhall Marine. These have activities in the installation and maintenance of telecommunications network infrastructure, design manufacture and installation of process lines in food & pharmaceutical markets and specialist surface finishings to Astute class submarines.

Numbers

The first set of numbers following the recent restructuring covered the financial year to September 2015. Revenues from continuing operations for the period were down by 22% to £44.7 million as a result of contract delays and the effects of the oil & gas sector downturn. The operating loss was moderate at £0.7 million, down from a profit of £1.6 million in 2014 but in line with expectations. At the period end the order book stood at a modest £21 million.

While the profit & loss figures were hardly inspiring, the balance sheet was significantly stronger at the period end compared to 12 months previously, with the effects of the restructuring taking net debt down from £16 million to £5.5 million. Supporting the business are £12.2 million of banking facilities, which were refinanced during the year and are now secured until December 2018. There is also the matter of a £2 million pension deficit.

Going nuclear

Redhall enters 2016 with the worst times seemingly behind it. The significantly strengthened balance sheet should improve client confidence when bidding for new contracts and the market seems to like the firm's clear strategy to win higher margin business. All in all Redhall looks in the best shape it's been for years.

While being unpredictable in terms of timing, deals in the nuclear industry for defence, decommissioning and infrastructure work look like the firm's best hope of flourishing in the medium/long-term. Having seen setbacks over recent years, last year's agreement between the UK government, EDF Energy and China General Nuclear Power over the new nuclear plant at Hinkley Point in Somerset is a boon for the industry. Also encouraging is that Redhall has recently seen a significant increase in manufacturing tenders, particularly for longer term nuclear opportunities, with around £150 million of such bids submitted in the final quarter of 2015. Although these are mainly for manufacture from 2017 onwards, some potential projects extend for 10 years.

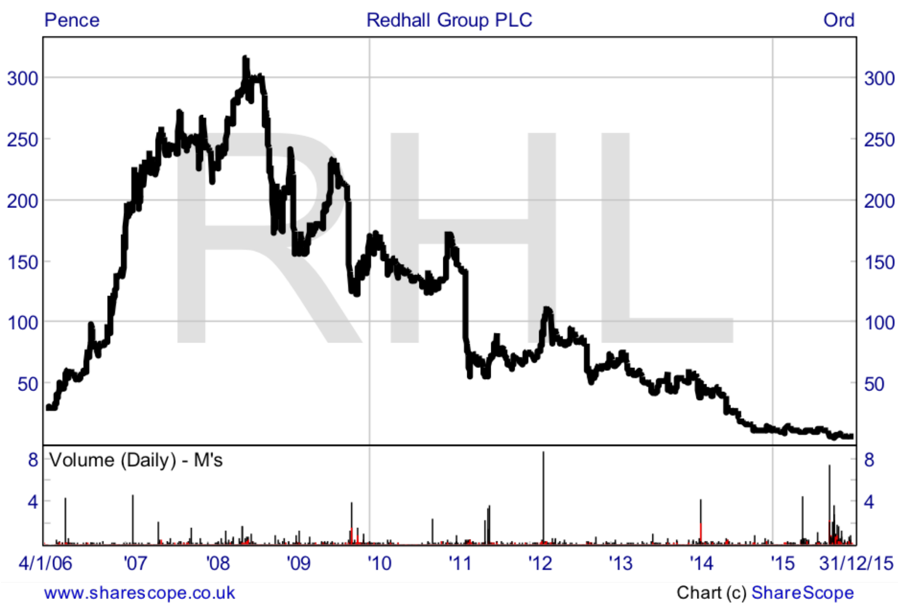
"ALL IN ALL REDHALL LOOKS IN THE BEST SHAPE IT'S BEEN FOR YEARS."

Assessment

Broker WH Ireland has a 10p target price for the shares, which according to the broker's base case scenario trade on a multiple of just 5.5 times its 2018 forecasts. Granted that is a long way off but the broker also sees significant further upside should any big nuclear deals be secured. However, there is no prospect of a dividend for a few years at the very least.

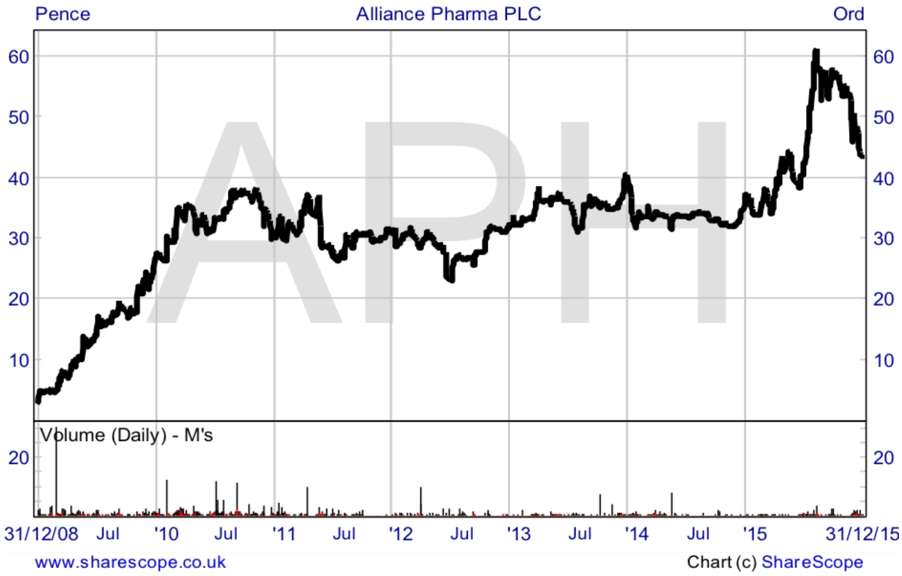
In terms of risk the firm's exposure to the depressed oil & gas market is a negative, further delays in the development of the UK nuclear industry is a concern and the combined debt/pension deficit position may make some investors wary. And as the Chairman commented in the last results, "*The key to the next phase of the turnaround at Redhall is achieving an improved order flow in its core businesses*." Investors are expecting, if not demanding, that the company reveal some decent contract wins. That will have to happen before the share price advances significantly.

Back to the fund managers and I note that the Downing UK Micro-Cap Growth Fund, the best performing small cap fund of 2014, along with the Downing ONE VCT, bought a 14% stake in Redhall in the September fundraise. It is the Micro-Cap fund's largest holding at 7.2% of the portfolio, with a recent fund newsletter commenting: "*We believe that the entry price for the fund (5p) can provide significant potential for upside over the medium-term.*"



Overall, while Redhall needs to prove it can once again deliver steady profits, I believe that the turnaround situation merits a speculative buy.

ALLIANCE PHARMA



A recent addition to the Franklin UK Smaller Companies Fund is **Alliance Pharma (APH)**, the specialist pharmaceutical company. Shares in the firm have performed terrifically well since the beginning of 2009, rising 14 fold on the back of the company's shrewd "buy and build" acquisition strategy and solid track record of delivery.

Founded in 1998 and listing on AIM in 2003, over the years Alliance Pharma has built up a portfolio of medical devices, prescription and consumer pharmaceutical products. The business model is liked by the market as the firm buys in already established products, which negates the need to go through expensive (and often futile) research and development activities.

By November this year Alliance had acquired, via direct ownership or licence, the rights to more than 60 niche pharmaceuticals which it sells directly to hospitals, to wholesalers and via a network of global distributors. Key products include dermatology range **Hydromol**, stoma care product brand **Opus**, and **Lypsyl**, the well-known brand of lip balm to which the firm acquired UK & Ireland marketing rights in 2013. All products are manufactured by specialist third party suppliers.

Financial results over the past few years have been solid, with excellent operating cashflow being delivered. However, earnings growth has been stagnant, with EPS having fluttered between the 3.4p-3.8p mark every year since 2011. But things look set to get more exciting for investors as just before Christmas the company completed, what looks set to be, a transformational acquisition.

Big deal

In Alliance's biggest ever deal by some distance, the firm bought the dermatology focussed Healthcare Products business of fellow AIM listed company Sinclair IS Pharma for a total consideration of £132 million. The transaction, classed as a reverse takeover due to its size, was funded via a £78.5 million placing and £54.2 million of new loans. With it came a portfolio of 27 complementary products which, similar to the existing Alliance portfolio, contain a mix of growth products and more established, steady brands. The growth brands include scar gel **Kelo-Cote**, burns treatment **Flammacerium** and mouth ulcer treatment **Aloclair**.

The Healthcare Products business made revenues of £43.3 million in the financial year to June 2015 so in effect doubles the size of Alliance Pharma. It also enlarges the geographical scope of the business. While strengthening Alliance's presence in key European countries, such as France and Italy, the deal brings exposure to territories such as Algeria, the Philippines and Indonesia, as well as the US and Brazil – countries where management see good opportunities for growth. Overall, the deal is expected to be significantly accretive to earnings in 2016, it bringing a forecast £5 million of synergy savings along with historic annual EBITDA of £9 million.

Assessment

While having a good seven year track record shares in Alliance Pharma have actually lost around a third of their value since peaking at 61p last August. Much of the decline came on the back of the acquisition news, which is not surprising given the size of the deal and especially given the placing was completed at a c.20% discount to the previous day's closing price.

Currently trading at 42.875p and capitalised at just over £200 million, I see value in Alliance Pharma. Before the acquisition the markets were looking for earnings of around 3.6p per share for 2016, putting the shares on a multiple of 12 times. For such a solid business that looks reasonable value and even better value given that the Healthcare Products business is expected to be earnings accretive this year. Assuming the forecast dividend of 1.1p per share is paid for 2015 there is also a fairly decent yield of 2.56% on offer. The firm's track record suggests that further steady dividend rises are likely. I also note that following the deal non-exec Nigel Clifford and his wife spent a combined £30,000 buying shares in the company at a price of 44.95p.

ALLIANCE

To conclude, I believe that the markets are quite rightly concerned about the risk of successfully integrating the Healthcare Products acquisition given its size. On a price of 14.7 times historic EBITDA the deal also looks rather pricey (although the multiple falls to 9.4 times if we assume that the full cost savings are realised). The increase in debt is also a concern should the acquisition not go to plan – the net bank debt to EBITDA ratio increased from 2 times at the end of June to an expected range of 2.54 to 2.82 times post the deal. However, I would note that historically the firm has a very good track record of successfully combining newly bought businesses.

It is down to investors to trust Alliance Pharma management to once again deliver value.

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BY VICTOR HILL

OPPORTUNITIES IN FOCUS

2016: THE YEAR OF LIVING DANGEROUSLY

2016, The Year of the Monkey, will be a capricious, unusually nervous year, full of danger and foreboding, not just confined to the financial markets.

As ever, nothing is foretold, and no outcome is inevitable. Most people have little concept of how much their lives are driven by *Chaos Theory*. This idea suggests that the same parameters, fed into the same equations, can yield multiple results which are *all mathematically correct*. (You might have heard of *The Butterfly Effect* which conjectures that the flapping of a butterfly's wings in the Amazon rainforest might precipitate, say, a storm in India one month later).

So the same set of circumstances can result in different outcomes. That said, if one could re-run those circumstances again and again in a laboratory, certain outcomes would begin to seem more likely than others. But nobody knows exactly how things will turn out. The medieval theologian, Aquinas, doubted that even God could foretell the future. Though true, some people are better than others at guessing the odds than others.

But let's keep this practical. In the next 10-15 minutes of your valuable time, I will focus on some key trends that may frame your thinking in the year ahead. Good thinking (instincts, if you will) can save investors from unnecessary losses – and might even make them money. So, without further ado, let me outline six things that you should be concerned about and two things for which you should rejoice during 2016. That makes eight things: the Monkey's lucky number.

Cause for Concern One: Whispers of war will get louder

Simply put, going into 2016, the world is probably nearer to mass conflict than at any time since the Berlin Wall came down 26 years ago. I am not saying there will be a war soon – but that the risk of a major war between big powers (rather than just a proxy war between two clients) has risen significantly – and that this will become apparent.

Historians who debate the inevitability of the outbreak of WWI in August 1914 often come back to the fact that the conditions for that war had been around for some time. The assassination of the heir to the Austrian throne in Sarajevo on 28 June 1914 was the spark which lit a flame – which then became an inferno. Would the imperial dynasties of Austria, Germany and Russia have survived for decades longer if the Archduke had cancelled his visit that day? That question is called a *counterfactual* by historians and philosophers alike. The point is that things could have turned out differently, though absolute monarchy was still probably doomed.

Most of the decision-makers of today grew up in the Cold War (1945-91) during which the rivalry between two superpowers created a rigid stasis in the world order. Then they acquired responsibility in the Post-Cold War world in which the USA was the sole superpower and, acting in concert with its allies (collectively known as "the West"), imposed a *Pax Americana.* (Arguably, the *Pax Americana* came to an end in Iraq. As Chairman Mao replied, when asked whether the French Revolution had been a success: *it is too early to say*.)

2016

"GOING INTO 2016, THE WORLD IS PROBABLY NEARER TO MASS CONFLICT THAN AT ANY TIME SINCE THE BERLIN WALL CAME DOWN 26 YEARS AGO."

The global economic and financial architecture set up at the end of WWII – based on the World Bank-International Finance Corporation (IFC), the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade – which morphed into the World Trade Organisation (WTO) in 1995 – has continued to be the foundation stone of the world economy. Until now, that is.

This Post-Cold War era is now under challenge. There is not one single dynamic but several in play, which interact in subtle ways. The first is the inexorable rise of China, the country that will overtake America as the world's largest economy in about ten years' time (depending on which forecasts you believe). The second is the attendant rise of revisionist powers like Russia and Iran which simply do not accept an international order which they believe was constructed solely for the benefit of America. The rise of new global institutions – such as the Chinese-backed Asia Infrastructure Development Bank (AIDB) – reflects this. The third is the contamination of Islamic fundamentalist (or more accurately, supremacist) ideology in its many manifestations, not least as suicidal terror cells embedded within Western societies. The fifth is modernist Marxist-oriented critique of the Western economic and social model which I analysed in my essay The Marxists Are Back in the October edition of the MI magazine. This critique is a complex fusion of post-Credit Crunch disgust for financial capitalism and end-of-time environmentalism rooted in the notion that *only Greens can save the world*. Incidentally, since I wrote that article, an electoral alliance between Mr Corbyn's Labour Party and Ms Lucas' Green Party has been mooted openly.

"IF THE AMERICAN-LED WEST FALLS IT WILL BE PARTLY BECAUSE OF EXTERNAL FORCES THAT OVERWHELM IT; BUT ALSO BECAUSE IT HAS CEASED TO BELIEVE IN ITS OWN EFFICACY."

If the American-led West falls it will be partly because of external forces that overwhelm it; but also because it has ceased to believe in its own efficacy. The European branch of the West will lose faith first because it suffers from mass unemployment and its tax-and-spend welfare model will become increasingly impossible to sustain. Uncle Sam, of course, is made of sterner stuff.

Add to this the dangers arising from global warming, in particular the increased incidence of flooding in some parts of the world and the increased intensity of drought in others. In fact, water shortages will be a major theme in the years ahead. HRH Prince Charles expressed the view, much mocked in the media, that climate change was the trigger that unleashed the civil war in Syria. I think that HRH is right that *global warming* – though much of the science peddled by activists is highly questionable – will be a catalyst for further geopolitical upheaval going forward.

Consider a litany of just some of the momentous recent geopolitical events.

16 November 2015: President Hollande of France declared that *France is at war* in response to the Islamic State attacks on civilian targets in Paris on 13 November. The French air force began bombing IS targets in Syria immediately thereafter, joining the American-led operation. Further to a vote in the House of Commons on 02 December, the British joined in too.

24 November 2015: Turkish F-16 fighters shot down a Russian Su-24 fighter bomber which had allegedly made an incursion into Turkish airspace. I explained why I think this was a pre-meditated Turkish provocation of Russia in my MI blog piece of 26 November, War on Terror II: End of Days.

26 November 2015: Russia retaliated for the Turkish attack by deploying S-400 anti-aircraft systems in Syria which analysts consider the most advanced in the world. Russia also imposed export and travel sanctions intended to damage the Turkish economy. Russian tourists spend almost as much money in Turkey as they do in Egypt. Further utterances by President Putin – not least allegations that the Turks are buying oil from IS – suggest that Russia is hell bent on revenge.

26 November 2015 and then 02 January 2016: China announced a comprehensive reorganisation of its military command structure. Moreover, it has sought agreement to establish its first overseas military base. The base will be in Djibouti in the Horn of Africa, where the French and the Americans already have important bases. China is reportedly building a base near the Japanese-controlled Senkaku Islands, which it claims; and reefs in the Spratly Islands (South China Sea) have apparently been weaponised and foreign shipping ordered to stay clear.

"WHAT IS VERY LIKELY IS THAT INCREASED POLITICAL RISK WILL ATTENUATE MARKET RETURNS GOING FORWARD IN A WAY THAT HAS NOT BEEN APPARENT BEFORE IN THE POST-WWII ERA."

21 November 2015: Ukrainian saboteurs blew up power lines to Crimea (now annexed by Russia), causing a power blackout. On 28 November 2015: the *Donetsk People's Republic* (a pro-Russian part of eastern Ukraine) cut off coal exports to Ukraine in retaliation. Now, Russia might once again cut off gas supplies to Ukraine. The Ukrainian government in Kyiv still aspires to re-establish control over its renegade Eastern provinces.

23 December 2015: The Taliban took Sangin, Helmand Province, Afghanistan. Helmand, where about 450 British service men and women gave their lives over 2007-2013 to bring the rule of law to one of the most desolate outposts of one of the poorest nations on Earth, is now back to where it was before the US-led invasion of 2001.

02 January 2016: Saudi Arabia executed 47 dissidents, amongst whom Sheikh Nimr al-Nimr, the prominent Shia cleric who was, amongst other things, an *opponent* of violent extremism. The government of Iran, which has appointed itself the defender of the Shia, foretold that there would be *dire consequences*. In fact, Iran and Saudi Arabia, which represent opposite ends of Islamic orthodoxy, and which are natural antagonists, have been fighting a bloody proxy war in Yemen throughout 2015. King Salman, who ascended the Saudi throne in January 2015, seems to have racked up Saudi involvement here. Saudi Arabia, of course, is an "ally" of the West, while Iran is an implacable enemy of Israel.

One more spark, one more flame. One such possibility is China-Taiwan. Tsai Ing-wen, the woman about to become the leader of Taiwan, a self-proclaimed *Thatcherite*, intends to declare Taiwan's total independence from China when she gets to power. China's official position is that such a move will be met by force. America is committed to defend Taiwan. So the flashpoint *could occur* within months – a Sarajevo moment.

But then again there probably won't be a *Sarajevo moment* in 2016 – no Archdukes will be gunned down and, in all likelihood, no empires will clash. But, as the plate tectonics of the emerging new world order compress and geopolitical tensions grow, so the significance of apparently marginal events will leverage. What is very likely is that increased political risk will attenuate market returns going forward in a way that has not been apparent before in the Post-WWII era. Consider a defence play in your portfolio. **BAE Systems PLC (LON:BA)** is already in recovery mode.

"THE WORLD IN 2015 WAS DELICATELY POISED BETWEEN INFLATION AND DEFLATION; IN 2016 IT WILL GENTLY TIP IN THE DIRECTION OF DEFLATION."

Cause for Concern Two: The USA will become politically more unstable

Never underestimate the achievement of *The American Century*. It changed the lives of everyone on Earth through its innovation, technology, dynamism and sheer fun. Not a single inhabitant on this planet was uninfluenced by America, and in my view, that influence was overwhelmingly beneficial.

The American Century began in 1917, with America's entry into WWI. It is about to end.

America is still the global hegemonic power: by far the Number One economy with a military that enjoys a crushing dominance, in every category of warfare. Right now, America could confidently fight a war against the *Bad Boys* that I wrote about last year (China, Russia and Iran – in MI's August magazine, [Should We Ever Invest in Bad Boys?]) combined, and still not lack hardware. Its military technology is decades ahead of China's.

So America in 2016 is not the Ottoman Empire in 1916. But as *Time Magazine* put it in its 2015 end-of-year edition: *Abroad, America's once predominant influence is fading fast*. Americans feel this more intensely than anyone else.

This change of mood is having unforeseen consequences. America, once politically-speaking the most stable and conservative nation on the planet, where politics were as staid and dependable as the *Office of Management and Budget*, has spawned a lunatic fringe. And they might even take power...

Donald Trump makes Nigel Farage look like a mannered, and somewhat nuanced, sophisticate. (After all, Nigel is a kind English gentleman – though possibly a cad; but then some people like cads.) And yet, as I write in the first days of the New Year, Mr Trump is still the favourite to clinch the Republican nomination for the US Presidential Elections of 08 November 2016.

The most worrying thing is that there are kernels of truth in what Mr Trump says. For his supporters in the middle-American white working class, he is a voice crying in the wilderness saying things that need to be said but which no one else has the courage to say. And the heart of his economic programme – increased minimum wage, lower taxes on the low-paid, stealth taxes on the rich – could have been written by George Osborne.

I personally don't believe that Mr Trump will get the Republican nomination because the mandarins of the GOP know that his candidature would hand over Black America, the Hispanics and liberal White America to Hillary Clinton. But even if Senator Rubio or Senator Cruz takes the ticket (either could mobilise the Hispanic vote), Mr Trump's voice will continue to be heard in Republican circles. Mr Trump might even get a job in a Republican administration. Homeland Security?

American public opinion is polarising between the Northern urban liberals who broadly support the Democrats and the Southern and Central rural conservatives who broadly support the Republicans. (Of course, politics is never that simple in America.) And this is reflected in the declining consensus in Washington. Expect more government shut-downs, sudden changes of policy, stalemate in Congress and increased confusion as to how America should project its power. All this leaves more room for big-time policy mistakes.

Cause for Concern Three: The Unholy Trinity of Deflation, Zero Interest Rates and Insipid Growth will endure indefinitely

The world in 2015 was delicately poised between inflation and deflation; in 2016 it will gently tip in the direction of deflation. Central banks will have run out of ammunition. Although much fuss was made about the Fed's decision on 15 December 2015 to raise rates from nothing to a crotchet more than nothing, we are still in a world of near-zero interest rates. If there were a prospect of sustained growth

"EUROPE IS A GRAND OLD ARISTOCRATIC LADY – A LADY VIOLET FOR YOU DOWNTON FANS – STILL LIVING IN SOME STYLE, ALL DRESSED UP AND EATING FORMAL MEALS, PATRONISING NEIGHBOURS WITH TART PUT-DOWNS; WHILE HER FINANCIAL STANDING REMORSELESSLY DECLINES RELATIVE TO THE HOI-POLLOI DOWN THE ROAD."

of above-average levels with associated credit growth and moderate demand-pull inflation, monetary policy might be tightened with positive consequences for investment. But that is not going to happen in 2016.

In fact, deflation, and its terrible consequences, will probably be the main economic headache for the rest of my lifetime: especially for debt-laden governments.

Cause for Concern Four: The Debt Time Bomb in the West will finally explode

Debt-to-GDP ratios in the Eurozone countries are still rising. For that matter, the ratio is due to rise in the UK this year to about 83%, although Mr Osborne assures that it will be down to 71% by 2020-21. So after 10 years of Coalition and then Tory governments, the UK Debt-to-GDP ratio will be higher than the 67% bequeathed to us by Mr Brown in 2010!

Actually neither Europe nor the UK, with the possible exception of Greece, has actually endured anything like real "austerity" as yet, whatever Ms Sturgeon says. Structural deficits – that's the amount by which deficits grow even in years of economic growth – are due to rise in Europe due to unfavourable demographics, for which read the inexorable growth of retired people on generous state pensions. The problem of unsustainable recurring deficits has still not even begun to be addressed.

Greece, anyway, will need another bailout this year. And French national finances are not looking good. Just as one day the Chinese might stop buying T-Bills and the plug will be pulled on the USA, so one day even sooner European pension funds, if they are sensible, will abjure negative-yielding European government debt.

Even modest deflation will quickly destroy the residual credibility of European government finances. Imagine the political fallout when a European government, having run out of cash, begins to pay pensioners with negotiable IOUs. As the Chinese curse goes: *may you live in interesting times*.

Cause for Concern Five: The EU, beyond reform, will dig its own grave

The real problem with the EU is that its members' economies have not grown since the Euro was launched in paper form in 2002. It is not growing now, and it is unlikely to grow at anything like the pace of its rivals in the foreseeable future. Yet no one at the EU level and few national governments are prepared to enact the necessary structural reforms to kick-start a new era of growth.

Even the European Commission is talking about an era of *Secular Stagnation* in which zero-to-low economic growth combines with Thomas Picketty's increasingly unequal capitalism[i]. And, according to the annual report from the Centre for Economic and Business Research (CEBR) published just before Christmas, both France and Italy, on current growth forecasts, are likely to be kicked out of the G10 by 2030.

Europe is a grand old aristocratic lady – a Lady Violet for you *Downton* fans – still living in some style, all dressed up and eating formal meals, patronising neighbours with tart put-downs; while her financial standing remorselessly declines relative to the hoi-polloi down the road. She is totally convinced that she is superior in class and culture, that she is wiser and wittier than they, so why should she conceivably change her ways?

Cause for Concern Six: Stock Markets will go nowhere

Consider that the FTSE-100 Index hit its hitherto all-time high of 7,000 on Millennium Eve, 31 December 1999, but then went south for the first three years of the new century, reaching less than half that level during the Second Gulf War in March 2003. It recovered, somewhat, thereafter but was then blown out of the water by the Credit

Crunch of 2008 and the nasty recession which ensued. After three or more years of recovery, the London market clambered back to reach the iconic 7,000 mark in March 2015 and spent most of April in record territory, only to fall back to below the 6,000 level subsequently. It finished 2015 at 6,242, about 5% down on the year.

Now you might argue that the FTSE-100 is a rum measure of UK economic success as its performance has been hampered, especially in 2015, by some dodgy foreign miners and commodity companies like **KAZ Minerals PLC (LON:KAZ)**, **Glencore International (LON:GLEN)** or **Lukoil (LON:OAO)** and their ilk, the one-year charts of which look like one of those aqua-park death slides.

But the decline in commodity prices, especially oil which continued to decline last year to around the US$40 barrel mark, *should have been* great news for manufacturers, retailers and consumer staples. Yet they all stalled too.

If one looks abroad there is the extraordinary case study that is the Nikkei-225. Notoriously, the leading Tokyo index reached its zenith of nearly 39,000 on 01 December 1989, whereupon it began a 20-year decline. During the summer of 2012 it began to recover from lows of below the 9,000 mark and at the beginning of 2016 it stands at around 19,000 – still less than one half of its historic peak. Few Japanese investors have retired on their stock market gains.

"THE OUTLOOK FOR EQUITY MARKETS IN 2016 IS NOT DIRE; IT IS JUST INSIPID."

Equity investors are constantly reminded that *past performance is not a guide to future return*. But what they should be compelled to baa like sheep is: *stock markets do not follow national economic growth metrics*. Not even on a lagged or adjusted basis. This is because, for a start, only a portion of the total national economic assets are valued by the stock market. (By the way, with the rise of the private equity sector, more old firms have been de-listed than new firms have been listed in the first 15 years of the 21st Century, so the total number of listed stocks (barring investment trusts) has actually fallen in both London and New York). Second, corporate earnings are much more volatile than national growth statistics. And third, equity itself is only one asset class which competes with others for investors' cash (not least private equity). There is some evidence, for example, that pension funds have been reducing the proportion of their portfolios allocated to equity.

The outlook for equity markets in 2016 is not dire; it is just insipid. I foresee some scope for solid gains on the back of good earnings data (aided not least by cheap oil), but that all of this will be attenuated, if not asphyxiated, by increased geopolitical risk, by firming expectations that we are nearing the downturn in the economic cycle, and by (probably unjustified) fears that interest rates are about to rise.

When the FTSE-100 reached 7,000 on 31 December 1999, the Bank of England *Repo Rate* (as *Bank Rate* was then called) stood at a historically "normal" 5.5%. When it breached 7,000 in the spring of last year, the Bank Rate was still at 0.5%. In orthodox economics, lower interest rates, all things being equal, should imply higher stock prices, since the *opportunity cost of capital* – the discount rate used to derive the present value of future dividend pay-outs and capital gains – will also fall. Yet here we are, super-low interest rates notwithstanding, sitting on a loss over 15 years! Something has gone seriously awry.

> **"BY ONE ESTIMATE, LIFE EXPECTANCY IS RISING SO INCREDIBLY QUICKLY, THAT FOR EVERY DAY THAT YOU SURVIVE FROM TODAY ONWARDS, YOUR LIFE EXPECTANCY WILL BE EXTENDED BY ANOTHER HOUR."**

Ah, but some savvy investors will say: no one has ever made money with a long-term buy-and-hold strategy – successful fund managers buy winners and sell losers, so who cares about the index? Except that as we all know deep-down (don't we?), no fund manager can outperform the market in the medium to long-term. Sooner or later, outcomes regress to the mean. (Ask Warren Buffett). On the basis of the evidence, we have to face up to the fact that stock market returns in the 21st century will far underperform those of the 20th century. And, arguably – statistics are tricky – 20th century stock market returns underperformed those of the 19th century. I'll speculate on why this might be so another day.

Reason to Rejoice One: We are getting healthier and are living longer!

You are probably going to live longer than you think. That is good news – even if you have to postpone retirement. But you will hopefully be fit enough to work, at least part-time, well into your seventies and beyond, so why not share your accumulated wisdom and skills? (Actually, most people will "work" (as defined by time spent in the office) no more than 20-hour weeks by then, except politicians, investment bankers and other workaholics.)

By one estimate, life expectancy is rising so incredibly quickly, that for every day that you survive from today onwards, your life expectancy will be extended by another hour. That is amazing! Of course there may be snares: dementia/Alzheimer's for one. But some scientists are cautiously optimistic on the dementia front. I am not qualified to judge on this: just Google, if you are so inclined, "Astaxanthin".

Data mining in healthcare has hardly even begun: soon most of us will have smart watches which are wired up to a central processor which monitors our blood pressure, cholesterol, the lot. Here in the UK, our beloved National Health Service would save a lot of money and get better results if it deployed Cortana[ii] -style personal nurses who recorded our most intimate health parameters. (OK, there would be confidentiality issues – there always are.) A world in which prevention trumps cure is now within sight.

Reason to Rejoice Two: Technology is making us wiser, richer and more efficient

Expect Artificial Intelligence (AI) to loom larger in 2016, but in my view, there is nothing to worry about, and much to hope for. There will be some really clever machines in your household very soon, and they will be no more likely than your spell-checker or your satnav (both basic forms of AI) to harm you.

Note that in the tech sector, companies which have articulated a commitment to AI have fared better. So **Microsoft (NASDAQ:MSFT)** was up 18% in 2015 and **Google/Alphabet (NASDAQ:GOOGL)** up nearly 60%; while **Apple (NASDAQ:AAPL)** was broadly flat on the year. For clever people who understand technology and biotech, there are still great opportunities out there.

Facebook (NASDAQ:FB), up nearly 25% in 2015, is bringing people of very different cultures together only to discover that, despite all, they share much in common. Yes, I curse the tendency of guests to gaze into their hand-held devices during dinner. But, within seemly boundaries, let's share our thoughts and prayers across the oceans.

Despite all the doom and gloom, expect to hear much more during 2016 about man's future conquest of space. A final prediction: this is the year when the big space agencies, working together, will announce a target date for a manned mission to Mars. I hope that I will live to see the day that they land on the Red Planet. And it's entirely possible.

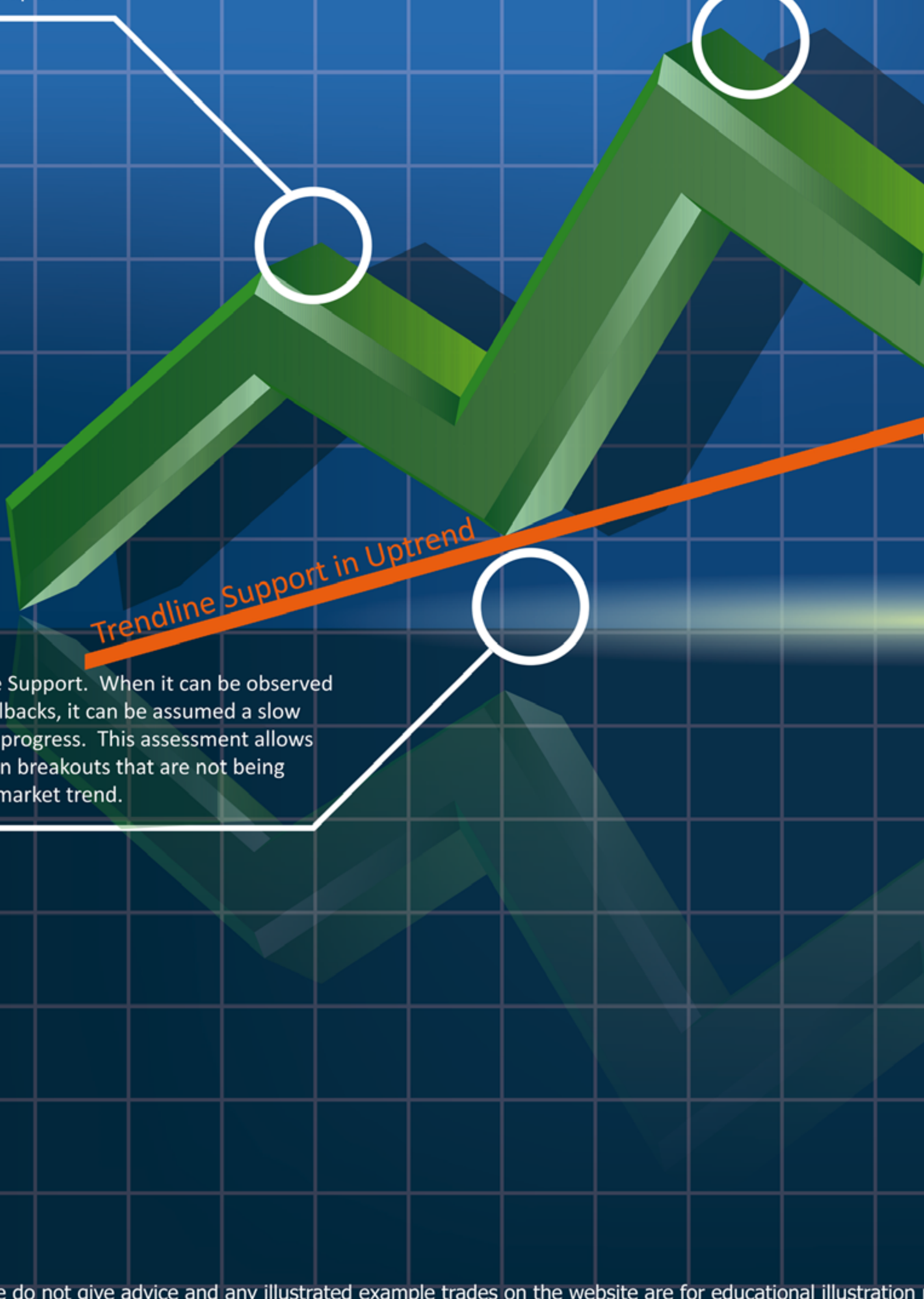
i See: ***When 'Secular Stagnation' meets Piketty's capitalism in the 21st century: Growth and inequality trends in Europe reconsidered***, **by Karl Pichelmann, Economic Papers 551, June 2015.**

ii **Users of Windows 10 will be familiar with Cortana.**

Newsflash! Uptrends don't come in a straight li
The market can go down. The prices are a bit to
to be a buyer now. The easy money has already
made at this point. We BUY LOW and SELL HIGI
A good time to take some profits.

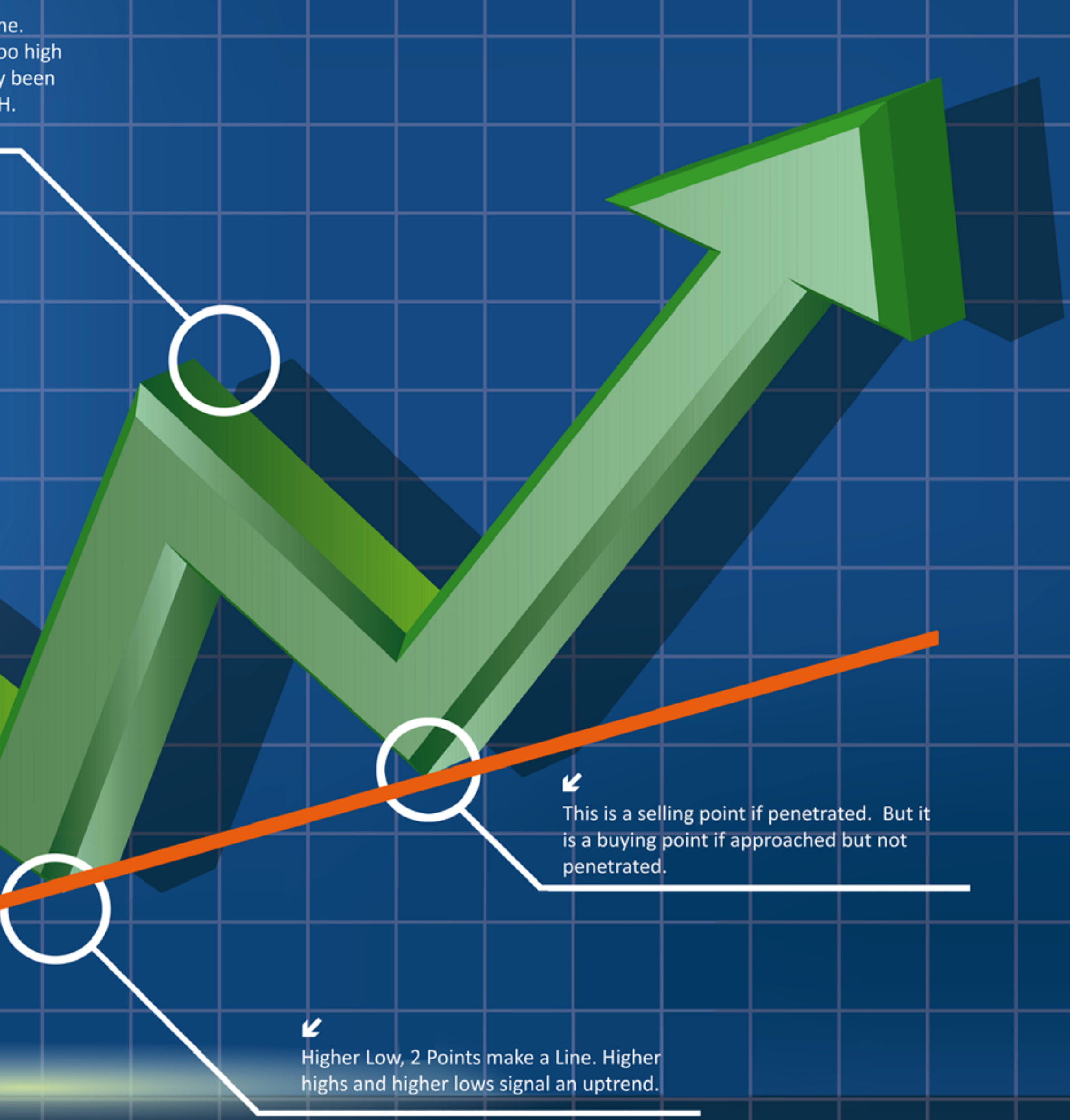
Good sell points are when the market nears the top of the channel...a fall to the bottom of the channel is VERY likely at some point.

Clear and Strong Uptrend. An up trendline is a straight line which slopes upwards and is drawn to touch successive low points in an uptrend.



Lowest Low, Start of Trendline Support. When it can be observed that the Bulls step in after pullbacks, it can be assumed a slow steady uptrend will remain in progress. This assessment allows for taking advantage of pattern breakouts that are not being disrupted by a change of the market trend.

Note: Our website guide is purely educational in nature, we do not give advice and any illustrated example trades on the website are for educational illustration



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BY NICK SUDBURY

FUNDS CORNER

FUND PICKS FOR 2016

At this time of year the financial press is always littered with predictions about which areas of the market are going to produce the best returns. It can be interesting and instructive to look at the different views, but it's important to remember that nobody is infallible and well thought-out forecasts can quickly be overtaken by an unforeseen turn of events.

Perhaps the best place to start is to look back at 2015 to see how the different sectors performed last year. According to FE Trustnet, there were only four areas where the average fund return was in double figures over the twelve months to the end of December. These were: European, Japanese and UK Smaller Companies, as well as the broader Japanese equities sector with the returns ranging from 14.8% to 19.2%.

At the other end of the spectrum there were 10 sectors that produced negative average fund returns with the worst being Global Emerging Markets, Specialist and Global Emerging Market Bond. These produced losses of between 10.2% and 5.1%.

The Smaller Companies funds tend to be more risky but can generate the strongest returns when their local markets improve, as was the case in the UK, with their counterparts in Europe and Japan benefiting from the massive programmes of Quantitative Easing (QE). Emerging Markets were the biggest casualty because of the fall in the price of raw materials due to the slowdown in China and the strength of the US dollar on the foreign exchanges.

Take profits and re-position your portfolio

The fund-of-funds team at Hawksmoor have recently rebalanced their portfolios so that they are ready for 2016. One of their new additions is the **Aberdeen Asian Income Trust,** which invests in high yielding shares in Asia Pacific ex Japan. This is an area that really struggled in 2015 with the sector producing an average loss of 3.3%. The fund is managed by Hugh Young, who has an excellent track record although his quality-growth style has recently fallen out of favour.

Aberdeen Asian Income's largest exposures are to Singapore, Australia, Hong Kong and Thailand. Historically it has traded at a small premium to NAV, but with the shares down about 40% since May 2014 they have been pushed out to a 7% discount. Hawksmoor, who are contrarian investors, see this as a great buying opportunity for a long-term position and have the added comfort of a 5.4% yield.

Another interesting move was the decision to reduce their exposure to the top performing **Standard Life Investments UK Equity Income Unconstrained** fund, with the proceeds being reinvested in **Fidelity Enhanced Income.** This is basically a switch away from the UK mid-caps to the blue chips, which have lagged behind their smaller peers.

The more drastic decision was to sell their holding in **Artemis Strategic Assets,** despite their continued faith in the manager, William Littlewood. His fund has large short positions in Japanese government bonds and the bonds of several European countries, which could work against him given the large programmes of Quantitative Easing in these locations.

A cautious view of 2016

Darius McDermott, MD of Chelsea Financial Services, believes that it is time to baton down the hatches, as 2016 could be pretty volatile if the US and UK start to raise interest rates. The two regions he is most confident about are Europe and Japan, as both are benefiting from monetary stimulus in the form of QE.

> **"DARIUS MCDERMOTT, MD OF CHELSEA FINANCIAL SERVICES, BELIEVES THAT IT IS TIME TO BATON DOWN THE HATCHES, AS 2016 COULD BE PRETTY VOLATILE IF THE US AND UK START TO RAISE INTEREST RATES."**

His preferred funds in Europe are **BlackRock Continental European** and **Threadneedle European Select,** while in Japan he highlights **Schroder Tokyo** and **Neptune Japan Opportunities.**

McDermott is wary about the prospects for bond funds and expects prices to fall as a result of the increase in interest rates. Because of this he suggests going for a fund with a decent yield to give yourself a chance of making a positive total return. Potential candidates include: **Invesco Perpetual Corporate Bond, Baillie Gifford High Yield** and **TwentyFour Dynamic Bond.**

His favourite area of the market is the Targeted Absolute Return sector, whose members have the potential to produce positive returns in all market conditions while diversifying a wider portfolio. He especially likes **Henderson UK Absolute Return** and **Smith & Williamson Enterprise,** which combine long and short equity positions. Lower risk multi-asset alternatives include **Church House Tenax Absolute Return Strategies** and **Premier Defensive Growth.**

Investing for income

Eugene Philalithis, a multi-asset portfolio manager at Fidelity, expects economic growth to remain stable in 2016, although market volatility could pick up as a result of higher interest rates in the US or a slowdown in China.

Against this sort of backdrop he likes the **Henderson Strategic Bond** fund, which has an unconstrained approach to investing in government, investment grade and high yield debt. It has £1.4bn in assets under management and has built up an excellent track record with an attractive 4.5% yield.

> **"TOM STEVENSON, INVESTMENT DIRECTOR AT FIDELITY INTERNATIONAL, PREFERS EQUITIES TO BONDS BECAUSE OF THE PROSPECT OF HIGHER INTEREST RATES."**

Income investors willing to take on more risk might prefer the £153m **JPM Global High Yield Bond** fund. This has 500 different holdings based on a bottom-up stock selection approach with the managers supported by a team of 9 credit analysts. It has an impressive yield of just under 7%.

On the equity side Philalithis suggests **Invesco Perpetual Global Equity Income.** The fund invests in dividend-paying shares from around the world with the managers sticking to companies with good cash flow and sustainable distributions.

It is a concentrated portfolio of 54 holdings that include the likes of BT, British American Tobacco and Legal & General, with the largest geographic allocation being Continental Europe at about a third of the assets. The fund has a decent track record and is yielding 3.35%.

His other suggestion is **Artemis Income,** which has delivered solid long-term returns by investing in UK companies that are able to generate sufficient free cashflow. It is a large fund with £6.8bn in assets under management and has a competitive dividend yield of 3.77%.

Global possibilities

Tom Stevenson, investment director at Fidelity International, prefers equities to bonds because of the prospect of higher interest rates. He particularly likes **Rathbone Global Opportunities,** which is a global growth fund with a bias towards the US market that he thinks should do well given the strength of the economy.

Stevenson also recommends the **Fidelity Moneybuilder Dividend** fund where the manager takes a cautious approach and looks for 'safety of income at a reasonable price'. This is an important safeguard given that some companies may have to cut their dividends in 2016.

Another income option is the **SLI Ignis UK Property Feeder** fund. Stevenson thinks that commercial property will continue to offer attractive relative returns despite the strong recent performance and likes the high starting yield with the prospect of rising income over time.

His other tip is **Schroder Tokyo.** Stevenson has been positive about the prospects for Japan for some time and describes it as a compelling investment because of the undemanding valuations and the new focus on shareholder returns.

Contrarian ideas for the brave hearted

The investment trust team at Winterflood Securities have highlighted three contrarian ideas in areas that have been out of favour with investors. This sort of approach carries a high degree of risk, but has the potential to deliver impressive returns if the markets rebound.

Their first suggestion is **Edinburgh Dragon,** which invests in Asia Pacific ex Japan and is trading at more than an 11% discount to NAV, the widest it has been for five years. The fund is managed by Aberdeen Asset Management and typically invests in high quality Asian businesses, but has suffered as a result of its underweight position in China.

"NOBODY KNOWS IF CHINA WILL BOUNCE BACK IN 2016 BUT IF IT DOES JPM CHINESE SHOULD BENEFIT, ESPECIALLY IN VIEW OF THE 15% DISCOUNT TO NAV AND 12% GEARING."

Another possibility is **JPM Chinese,** which has a decent long-term track record but has underperformed its MSCI China benchmark over the last 12 months. Nobody knows if China will bounce back in 2016 but if it does JPM Chinese should benefit, especially in view of the 15% discount to NAV and 12% gearing.

Their other contrarian idea is **JPM Emerging Markets.** It is run by an experienced manager who is backed up by a well-resourced team, but has underperformed in 2015 and is trading on a much wider discount than normal.

Mick Gilligan, head of fund research at the broker Killik & Co, also likes the Emerging Markets. He says that the region has suffered six consecutive years of declining GDP growth rates and that if it manages to stabilise it could signal an important turning point.

His preferred option is **Lazard Emerging Markets,** which uses a relative value philosophy to identify companies with good profit potential that are trading at lower valuations. This could offer an attractive source of long-term returns.

Another fund that Gilligan likes is **Scottish Mortgage,** which is the largest investment trust trading on the London Stock Exchange. The managers have put together a highly concentrated portfolio of companies that will benefit from transformative change in areas such as e-commerce, social media, healthcare and energy.

Scottish Mortgage has a fantastic long-term track record with a 10-year return of 250%. Its largest holdings include the likes of Amazon, Facebook and Alphabet, which have had a strong run but still offer a lot of upside potential.

BY FILIPE R. COSTA

ECONOMICS CORNER

WHAT CAN WE EXPECT FROM 2016?

We're now at the beginning of the year: a time when investors, analysts, journalists, and politicians make a series of predictions for the year to come. Most of them will prove wrong, as the many interactions between all the variables involved make it impossible for a human being to predict what is going to happen. Financial theory says that, most of the time, all that analysts do is recycle their past expectations; but reality shows that the past falls short of telling the full story, and they just miss the target. I myself am no oracle or soothsayer. So rather than wading in with price targets, I shall simply explore a few outcomes based on recent economic and political developments. Some will materialise, others just won't; some are pretty serious, others are wrapped up in some fantasy. But all of them tell a story about the real world in which we live.


25%
10%
90
2016

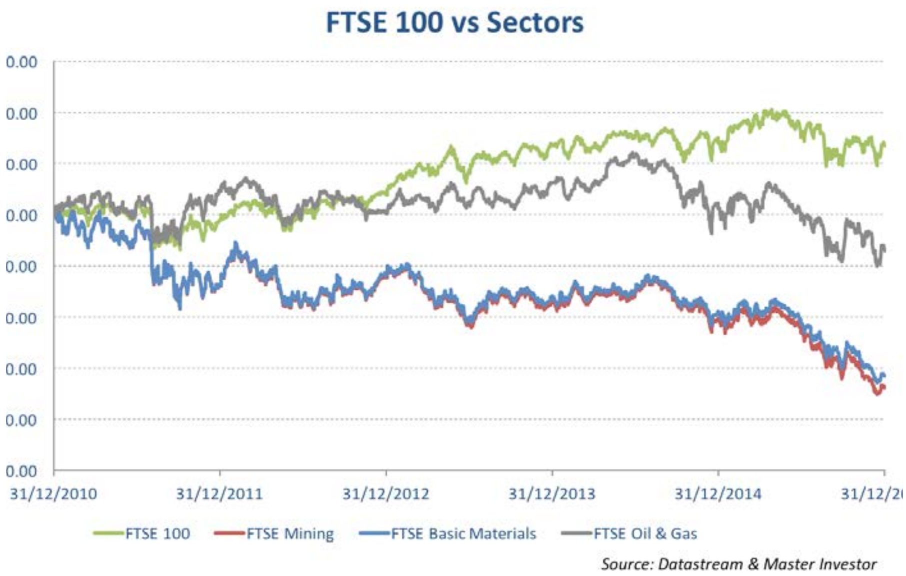
We are in a time of change. The past few years came with a few extremes, particularly in terms of monetary policy. The theoretical zero lower bound (ZLB) that policy makers marked as a floor for interest rates was tested in many European countries and the new normal is now a negative lower bound. At the same time, the relationship between the expansion of money and inflation seems to have broken down – otherwise the world would by now live under the hyperinflation umbrella that branded the Weimar Republic. But this is not a time to celebrate, as the negative effects stemming from extreme monetary policy may be lagging and show up only after the policy is put into reverse. With the FED having hiked its key interest rate from 0-0.25% to 0.25-0.50% at its December FOMC meeting and with policymakers at the committee predicting a few more hikes for 2016, this is the time when the mettle of financial markets will be tested. Can markets still rise without life-supporting policies? With trillions of dollars pumped in the direction of bonds and equities during recent years, we don't really know whether the current price level is the result of real improvement or merely financial disconnection. As rates increase, corporate America will need to show profits – otherwise the market will suffer from the lack of FED support.

> **“THIS IS THE TIME WHEN THE METTLE OF FINANCIAL MARKETS WILL BE TESTED.”**

A reversion in monetary policy will certainly be a key point in 2016 but not the only one. With the UK and Continental Europe lagging behind the US in terms of monetary policy, the divergence in monetary policy is expected to increase. This may contribute to a continuing rise in the dollar and to a deterioration of profits in the US, which may serve as a delaying factor in the path the FED is expecting to follow over the next two years. That's one of the main reasons why investors predict a much smoother rate increase than the FED does. Betting on this divergence will be an investment theme for 2016.

A point of real concern is China. The world's second largest economy is no longer able to grow at double-digit rates simply by investing in infrastructure. The Chinese government is determined to jump to the next level of country development, through turning its economy into a consumer-oriented one, while in the process allowing it to abandon manufacturing and embrace services. That can only be taken with a grain of salt by all those emerging economies depending on their raw material exports to China. A changing China is a changing world, which means world growth and the commodities market will be in the spotlight in 2016.

Speaking of commodities, Jim Rogers is certainly puzzled with the inversion of the super cycle. Oil prices sank 35% and hit 11-year lows in 2015. Russia entered a massive recession, and not even the super-low cost producer that is Saudi Arabia could escape the carnage. While trying to bust everyone, the Saudis are also hurting themselves and having to tap their sovereign funds to finance day-to-day expenses. Investors are predicting oil prices to at least stabilise around the current levels, if not improve a little. But if such a prediction doesn't materialise, world growth may be worse than expected and several redistributions of income may occur. India and Japan will certainly come off as heavy winners in this game, but I'm not sure about the UK, for example, where the FTSE index is full of resource-based earnings.



Source: Datastream & Master Investor

Finally we should also not underestimate the effects of a few political matters on the regional and global economy. Brexit is one of those sensitive matters that may end with a severe impact on the future of the EU and the UK. Another important matter is the changing political landscape across Europe. The austerity solution to the crisis is becoming part of the past, as it wasn't able to deal with the many problems faced by the Union as a whole and by its members separately. Greece, Portugal and Spain all went through elections that saw austerity-backing governments voted out. If the wave comes to the core of the Union, we may observe important changes in the direction taken by fiscal policy, which may ease the excessive reliance on monetary policy.

When the rates rise

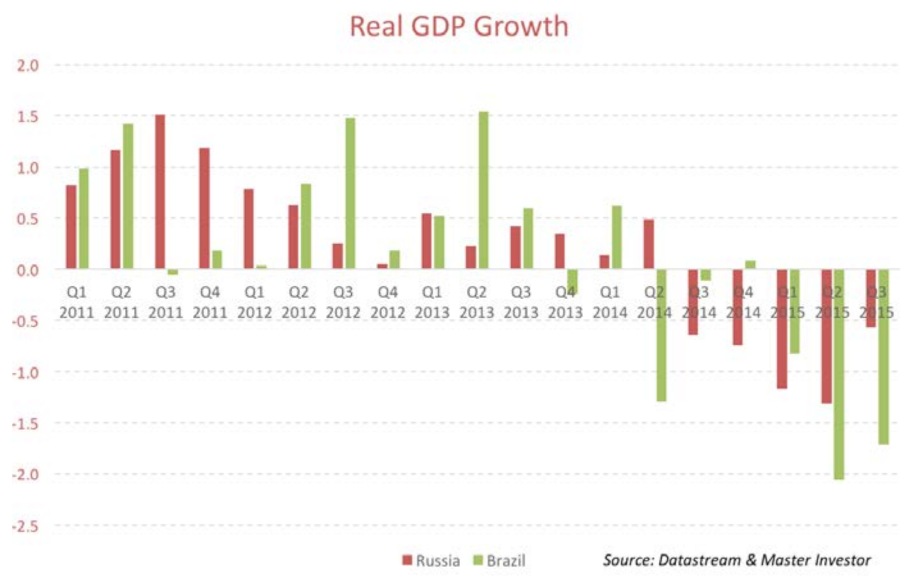
It took years for the FED to start normalising its policy after cutting its key rate to the 0-0.25% range in 2008. Unlike what happened during prior crises and recessions, this time the FED had to cut rates to zero and inject a few trillion dollars into the economy through asset purchases in order to boost the economy towards growth. But even though seven years has already passed, the US economy is clearly short of boom territory. The US economy is growing and the job market seems to be on track again, but there is a widespread feeling that the improvement is mild and could derail at any moment, in particular if the FED presses the brakes too fast. The headline numbers in current data seem strong, but hide a few weaknesses. An example is the unemployment rate, which currently stands at 5.0% after having peaked at 10.0% during the crisis. The headline number seems near full employment. If the economy continues to improve (and because it may be near full employment), wages will start growing, which is needed for inflation to perk up a little and consumer spending to grow. But something doesn't stack up here: wages are not growing and companies are not investing. This observation suggests that the real unemployment rate may be higher than the numbers show. When taking into account the decline in the labour force participation rate observed during the last few years, an adjusted number for the unemployment rate could be more realistically near 8.7%, which would explain why there are no wage pressures at this point (for more check my previous article). This simple fact may lead to delays in rate hikes from the FED in 2016. I would not be surprised if there is only one rate hike and the FED funds rate is still below 1.00% at the end of 2016, which contrasts with FED policymakers' projections of 1.375%.

In Europe rates are certainly not expected to rise in 2016. For now the ECB is following the same path as the FED did before 2013. The ECB is still expected to increase the pace of asset purchases. The divergence in monetary policy between the FED and the ECB may help the ECB delay such an increase, but if commodity prices continue to decline and translate into very low consumer price growth, then the ECB may still need to loosen its policy, possibly by increasing its monthly asset purchases to €75/€80 billion. If that happens, I wouldn't be surprised if the ECB expands its target purchases to corporate bonds. Such a move would prevent the central bank from having to cut its deposit rate too much. But not all would be happy with this scenario. Switzerland would be pushed

"I WOULD NOT BE SURPRISED IF THERE IS ONLY ONE RATE HIKE AND THE FED FUNDS RATE IS STILL BELOW 1.00% AT THE END OF 2016, WHICH CONTRASTS WITH FED POLICYMAKERS' PROJECTIONS OF 1.375%."

into further trouble if the SNB needs to cut its rates again. Demand for CHF 1,000 notes may quickly increase and money could vanish from banks. Many economists and academics will once again suggest a cash ban as the best solution for monetary policy to regain effectiveness.

The BOE is expected to remain halfway between the FED and the ECB. Rate normalisation is already on the cards but is not expected to start until later in the year at the earliest. Again, commodities prices will play a central role in the path taken by the BOE. Given the current situation, the likelihood of no hike in 2016 is greater than that of a hike.



China and other emerging economies

Analysts have been predicting a hard landing for China for many years. That is not going to happen, as the Chinese economy still has a lot of margin to grow and the government holds enough firepower to avoid any major derailing. It is just a matter of allowing for a structural change from an investment-based economy to a more consumer-oriented one. At a time when world growth is mild, the impact from China may be substantial, particularly in countries that rely on commodity exports. Brazil is one of those countries that have been suffering. It takes too much time to reduce the size of projects related to raw materials exploration. Prices will continue to adjust down, but will start normalising at some point in the near future. The negative impact on emerging markets may be approaching an end.

Equities

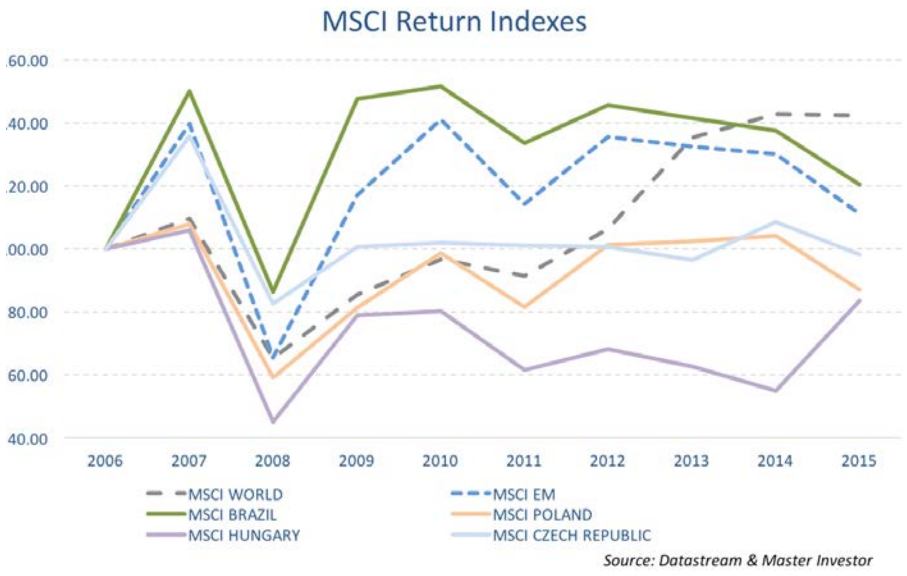
As rates start normalising, expensive stocks will become vulnerable and value investing will become the norm again. For the last few years, following momentum strategies has paid off handsomely. That's because while central banks were injecting liquidity into the market, investor sentiment was rising, attracting ever more investors to the market. A feedback effect is responsible for the momentum effect. But as momentum starts retreating, there is a return to fundamentals and stocks with very high valuations will be discarded by investors.

In 2015, while the S&P 500 and the Dow 30 declined 0.9% and 2.2% respectively, the Nasdaq 100 rose 8.4%. Recent academic research shows that equities that are smaller, younger, more volatile, unprofitable, and non-dividend-paying, are more difficult to value and thus more exposed to sentiment. Equities quoted on the Nasdaq market better fit such a description than equities in the Dow. With interest rates near zero, speculators tend to push Nasdaq equities above the overall market. But as soon as rates start increasing the Nasdaq may see its gains reversed and it may underperform other indices.

Nevertheless, in aggregate, US equities still look overvalued. The Shiller CAPE ratio shows a reading around 25x, which is much above its historical mean of 16.6x. With analysts expecting sluggish earnings growth for US companies and with many risks accumulating due to a potential dollar appreciation, I would say that investors are better off looking elsewhere for equities. With that in mind, and following the CAPE indices published by Star Capital, there are two major countries that currently look extremely undervalued: Russia (4.7x) and Brazil (8x). Russia was battered by the decline in oil prices and by the sanctions applied in the advent of the Crimea war. Brazil was hammered by the slump in commodities and many internal scandals. I believe there has been overreaction in both cases and that the worst is already behind. Equities in both countries appear a good medium term investment.

"IN AGGREGATE, US EQUITIES STILL LOOK OVERVALUED. THE SHILLER CAPE RATIO SHOWS A READING AROUND 25X, WHICH IS MUCH ABOVE ITS HISTORICAL MEAN OF 16.6X."

But it is not only in BRICS that opportunities exist. In a year many predict will be stronger for the emerging world than for developed countries, it is in Emerging Europe that opportunities lie. Hungary (8.2x), Czech Republic (9.9x) and Poland (10.0x) all seem undervalued, by CAPE ratios.



Brexit

One of the most important risk events to occur in 2016 is the referendum on Britain's place in the EU. If Britain were to face the Brexit, a lot of volatility could be observed in financial markets. I believe that leaving the EU is not the best option for the UK. The country benefits from the common market and has been able to retain much of its sovereignty. Unlike what happens with Sweden, Switzerland, and Denmark where monetary policy is dependent on the ECB's actions, the UK retains the independence of its central bank, which gives the country an extra cushion against negative impacts coming from the Eurozone. But if Britain leaves, it may end up with less independence, more market turbulence and it may very well see the City of London lose influence to Paris or Frankfurt. In the end, the UK would depend on the common market, without taking part in the decision process.

Commodities

Unlike what many were led to believe, commodity prices do not go up forever. Price is the best mechanism available in a free market for agents to adapt their actions. High prices allow for other suppliers to join the market and to increase the speed at which demand replaces its reliance on such products (substitution). Low prices attract higher demand and make producers more efficient. There are forces pushing for mean reversion. In 2015 OPEC tasted its own medicine. Years of high prices attracted new suppliers from the nascent fracking industry and allowed demand to find a few energy alternatives. While Saudi Arabia may try to push prices down to eliminate its competition, I am no longer sure if they can push them higher again. OPEC has been significantly weakened and the demand faced in the future will be permanently lower and more sensitive to prices than before. At the same time, as soon as prices start rising again, there is a battalion of new companies waiting to re-enter the market. The bearish oil market is here to stay for a while. We just don't know whether the market has already found a floor or not. If not, raw-material producing countries as well as resource-based equity indices like the FTSE 100 may continue to suffer in 2016. While 2015 has not been the best performing year for equities, the core European countries closed with decent gains. The same isn't true for the FTSE 100 which closed the year with a 4.9% loss.

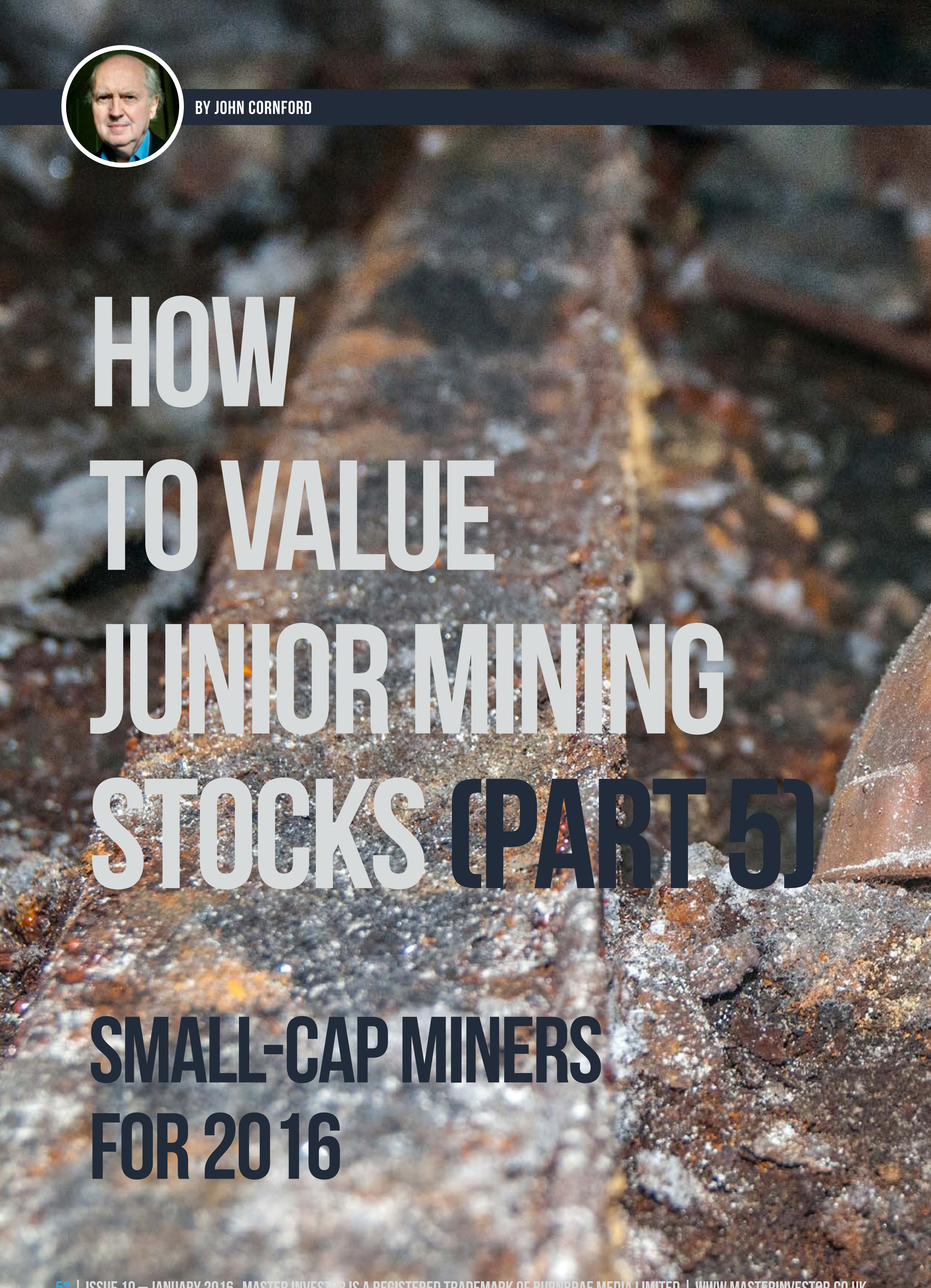
Japan

Japan is a training field for Abe's archery. The Prime Minister, now in his third year in power, has been trying everything to drive the country back to growth and to boost inflation, but not even the bold policy followed by the BOJ was able to permanently boost prices and GDP. Japan's problem is demographic. Its working age population declined by nine million between 1995 and 2014 to its current level of around 78 million. The population is ageing fast and can no longer drive the same kind of real growth it has driven in the past. Abe is so desperate for growth and inflation that his next arrow may even feature immigration. He could open Japan's doors to the refugees that are desperately trying to enter Europe and give them a fresh start. That is the fastest route to a solution!

A few final words

Of course, it is impossible to predict what is really going to happen in 2016. What is for certain is that we are living in an age of extremes. On one hand, we have been testing the limits of monetary policy to generate growth and inflation; but on the other, we just don't know if that was enough. At a time when the FED is reversing its policy and hiking its rates, there is a fear that financial markets may not keep the same price levels as before and that a few distortions created across the years may now start showing up. I would say that momentum is fading and that value will be crucial going forward. Investors now need to become much more selective than before as it will start paying to diverge from the herd. Opportunities in Brazil, Russia and emerging Europe look more promising than the US market.

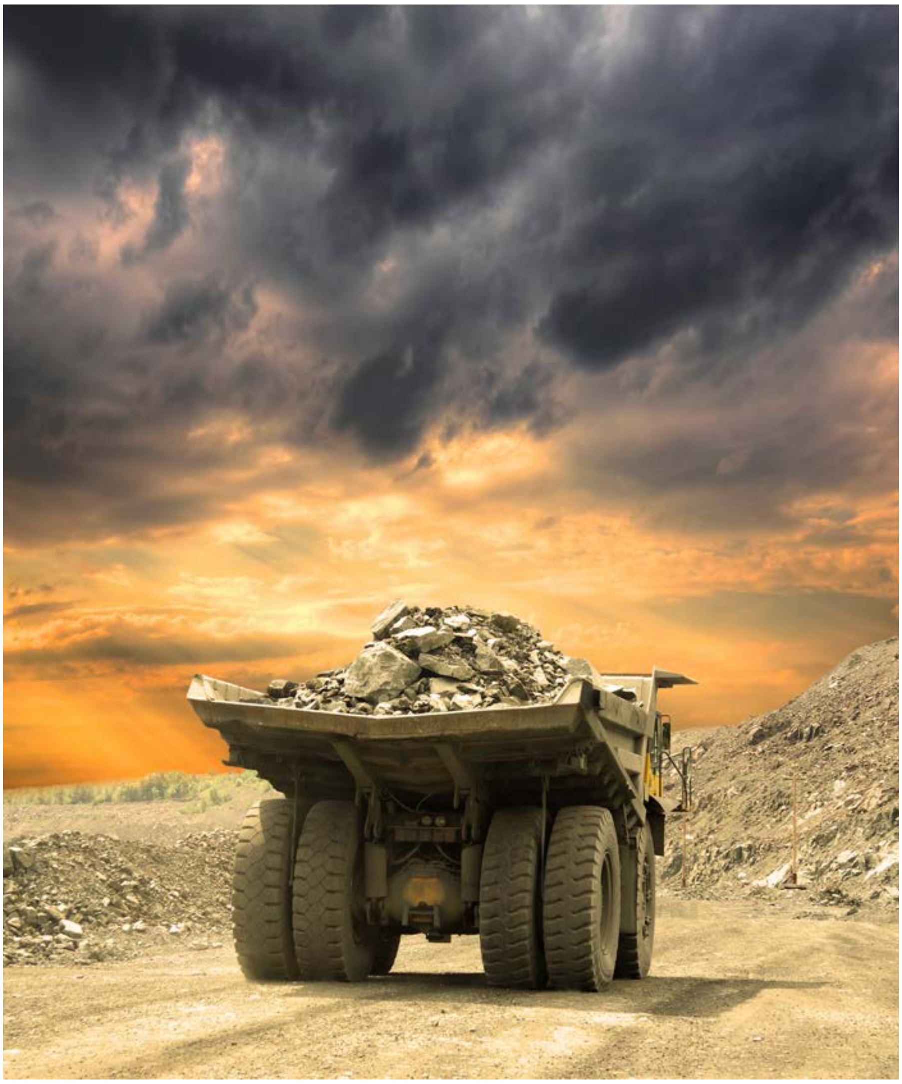
"WHAT IS FOR CERTAIN IS THAT WE ARE LIVING IN AN AGE OF EXTREMES."



BY JOHN CORNFORD

HOW TO VALUE JUNIOR MINING STOCKS (PART 5)

SMALL-CAP MINERS FOR 2016



> **"ON BEING ASKED TO SUPPLY A MINING NAP, I'VE PRETENDED NOT TO HEAR."**

So ends a disastrous year for Mining. But what can we realistically expect from 2016? Probably another disastrous year, to believe most pundits. The last few months have seen gold weaken further, even if not yet terminally. Funding has also continued to dry up, and with it comes the postponement (and possible eventual demise) of a number of projects. The trend in commodity prices generally seems to have frightened lenders away even from the apparently economically attractive **Paragon Diamonds** (even though immune from industrial and low-end consumer demand at risk from any global slowdown) who, despite de-listing, says it is still trying to secure funding (seems a candidate for a streamer – see our blog). Meanwhile, news on **Hummingbird's (HUM)** funding for its low cost Yanfolila project still hasn't arrived. Latest in a catalogue of woe is the inability of **Zincox (ZOX)** to raise the funds needed to rescue its already up-and-running and apparently attractive zinc recovery project in Korea.

Lydian International (TSX:LYD) however still lights up the gloom with recommendations from most North American analysts while we await details of its equity issue to fund Amulsar. Additionally, those coal to power hopefuls I featured over the last two months show intermittent signs of life. **Ncondezi Coal (NCCL)** shares have breathed a big sigh of relief after China re-iterated its commitment to its Tete power project, but the market still worries about the relatively minor short-term funding needed to keep the plc going. But it's hard to see that the value of its ownership of the coal that will feed the power station won't flow through to present shareholders in some form, whatever happens.

Other developments on the funding uncertainty front include the latest news on **Kefi Minerals' (KEFI)** apparently very profitable and almost funded Tulu Kapi project, which still hasn't spurred the shares above a market cap a mere 1/20th of the 'project NPV'. This is simply because we still don't know the details of the promised 'streaming' element nor the share of the project shareholders will be left with after funders take their cut. I am intrigued by the following sentence: "The finance plan is being refined to protect the project and all its undertakings against fluctuations in gold price." Well, well, well. I wait to see what conjuring trick that could turn out to be.

So overall, on being asked to supply a mining Nap, I've pretended not to hear. I've never been keen on Naps anyway. I don't quite see why to expect a share, chosen from a limited field of the seemingly attractively priced, at a time when every Tom, Dick and Newspaper Harry is rummaging in the same lucky dip and helping puff the Santa and New Year Rally, to outperform for the rest of the year. In other words I don't think many opportunities are growing on trees at any one time – except now and, very occasionally, again. It seems to me that a more sensible investment tactic is to keep a wide universe of shares on radar, and only pounce when, if you're lucky, a juicy plum falls, unpredictably, out of the tree. But, then, I've always been regarded as a contrarian – wrongly so, because I don't deliberately go against the grain of opinion for the sake of it. Rather, when I conclude that most opinion about a share seems to accord with my view, I prefer (because foolishly motivated by a challenge – witness a few marital disasters) to pass by on the other side and check to see why the market might be wrong about some waif and stray. Such an attitude only appeals to long-term focussed institutions, however. Momentum Investors won't be interested.

"AS THE DOLLAR IS THE CURRENCY FOR COMMODITIES WORLDWIDE, THOSE PRODUCED AND TRADED ELSEWHERE WILL APPEAR TO FALL IN DOLLAR TERMS."

"So, a Mining Nap Guv? Nah! Don't go there this time o' year."

In any case, it's not a Share Nap a mining investor needs in times like this. It's a Commodity Nap. Mining shares are, quite rightly as my value calculations show, dominated by their commodity prices, and who at the moment dares forecast them?

Are we heading for a world recession, caused by too much borrowing inhibiting those 'animal spirits' which in normal times stimulate consumers and companies to spend? Here, the oil price might be a better indicator of the world's underlying health than other commodities.

But on the other hand the glut might reflect not just short-term Saudi Arabian machinations, but the absence so far this winter of the usual Northern Hemisphere surge in demand for heating fuel.

So, are oil and metals prices reflecting an underlying global slowdown, or are they just being decimated by short-term panic? That the giant Anglo-American is laying off nearly two thirds of its workforce suggests the former.

But we mustn't forget the baneful influence of a strong dollar. As the dollar is the currency for commodities worldwide, those produced and traded elsewhere will appear to fall in dollar terms. International traders and investors in metals stockpiles or futures will sell if they expect dollar strength. Untangling this effect from real underlying demand from China and the Eurozone, and from underlying physical supply, seems to have wrong-footed many metals analysts during 2015, with prices continuing to fall in the face of their expectations (in some cases) for supply deficits. Ever since 2008, for instance, a supply crunch has been forecast by every major bank for zinc starting around now, when some major mines' resources run out and they close. Yet the price continues to move lower.

Are any commodities immune? Perhaps not in the short term. (Although it is intriguing that the lead price, for years correlated with zinc with which it is usually mined, has ticked up sharply recently all by itself.) But even copper, thought to be most affected by a slowdown in China, is still forecast to move into a supply deficit within a few years.

The 'hot' lithium sector, however, is thought by precious metals specialist Sprott to be overblown, with the accepted strong demand growth more than capable of being matched by a few giants in Latin America. (Although, as ever, there are niches where certain grades of lithium from elsewhere are more suited to the batteries forecast to be needed by China's government push for more electric bikes and cars.)

What about uranium? Uranium is yet another commodity that has for years been forecast to rise in price as the shortfall between demand and production being filled by de-commissioning Russian nuclear weapons comes to an end. Its slowly recovering price was dealt a major blow in 2011 by the Fukushima disaster and the subsequent knee-jerk panic closure and deferment of nuclear generation in Germany and China. Now, the panic is slowly subsiding and China's major nuclear power expansion is back on track. The uranium price has to follow eventually. (I shall shortly be evaluating one company that may be of interest on the blog.)

And then there's gold – the most difficult commodity of all to disentangle from underlying physical demand and supply pressures, and from its integration with government reserve policies and a paper and derivatives market said to be many, many times larger than that for physical gold alone. It is such an imbalance that encourages the more apocalyptic forecasters to suggest that the inevitable implosion of unsustainable interest rates and QE will produce the mother-of-all gold bull markets. Meanwhile, a more level headed Sprott suggests that gold just might have reached bottom.

"OK Guv! Just one Mining Share Nap."

Still developing **Sirius Minerals (SXX)** is one of the few UK based miners of a potential size to attract a much wider range of investors and institutions and to join the major indices. (Sirius has said it wants to move up to the main market.) As I write, a key piece of the investment jigsaw is expected in the form of the economics to be published in January as part of the definitive feasibility study for its potentially giant potash mine, onshore (and offshore under the sea) in Yorkshire. For the first time analysts will be able to make rough estimates of its value. (Although, naturally, most of those will be bogus – i.e. based on the NPV without allowing for the financing uncertainties that need to be taken into account in whatever financing structure is agreed upon for the estimated £1.5 billion up-front capex.) So watch this space, where I hope to evaluate this situation more fully next month, or meanwhile on the blog...

BY SAMUEL RAE

CURRENCY CORNER

MY TAKE: AN ACROSS THE BOARD LOOK AT 2016

2015 was a wild ride. Europe was dogged by weak constituent economies. The US Federal Reserve finally gave in to mounting pressure and raised rates – albeit by a nominal amount. China showed the world that – as expected – it is not unwilling to take drastic measures to protect its domestic economy. Commodities collapsed across the board.

As we head into 2016, uncertainty is rife. Will the US economy respond positively to the hike, or is there a risk that its impact on spending could induce contraction? Can the German economy continue to prop-up the single currency region? Will domestic policy in China fuel expansion in developing Asia?

On a more micro level, how many oil companies and miners will go out of business? Has the US biotech sector seen an end to its bull run, and what impact might revised policy on drug pricing have on research and development in the space? Then there's the little matter of the new US President.

The answers to all of these questions will shape 2016, so let's look at a few.

First then, the US. Readers will no doubt already be aware of the recent hike. The Fed needed to do something to show it still has a grip on US monetary policy, and failure to take action wasn't really an option, so the 25 basis point hike was no surprise. Many are concerned, however, that it could weigh on US consumers' propensity to spend, and that, in turn, this could lead to a reduction in capital expenditure in the private sector and an associated rise in unemployment. I'm pretty confident this won't happen. Yes, the US economy is fragile, but its dollar is strong, and election years generally boost sentiment. So long as the equities markets can hold up – and there's no reason this won't happen providing the Fed takes further hikes slowly and steadily – the US economy should be OK. Domestic strength, the likelihood of some more hawkish action and a long awaited return to inflation give me a bullish US dollar outlook for the next twelve months.

"DOMESTIC STRENGTH, THE LIKELIHOOD OF SOME MORE HAWKISH ACTION AND A LONG AWAITED RETURN TO INFLATION GIVE ME A BULLISH US DOLLAR OUTLOOK FOR THE NEXT TWELVE MONTHS."

On the other side of the Atlantic, however, my views reverse. Germany will no doubt have a great year – and long DAX looks like one of the most secure allocations in the markets at present – but Spain, Portugal and Greece (to name just three) continue to struggle. The ECB will probably have to expand its QE programme before the end of the first quarter, and recovery in Europe's weak employment rates is a long shot for before the end of the year. As mentioned, I am long German equities, but very much bearish on the Euro.

I'm pretty confident oil will bottom out around its current price. It's not economical for producers to keep pumping at these rates, and while this doesn't seem to matter to the middle east, it very much does in the US. Producers are already cutting superfluous operations, and medium-term organic supply and demand dynamics should boost prices. I'm betting we will spend most of the year in the $40-60 range. This bias also reflects my opinion on the wider commodities markets. Gold, softs and industrial metals should all pick up as the year matures.

Japan is very much on my radar this year. The nation has struggled recently (well, for the last thirty years as well), but Shinzo Abe's three arrows programme should finally start to make itself felt this year. A very specific area I am keeping an eye on is the stem cell space. As of late 2014, Japan has some of the most progressive laws in regenerative therapy, and biotechs can now get a therapy approved based on tiny phase II trials (normally approval only comes after extensive, and costly, phase IIIs). For this reason a number of mega caps are setting up shop in Japan, and chances are we will see some blockbuster (billion dollar plus) stem cell therapies hit the market this year. On many different levels, this stands to benefit its domestic economy.

And to finish, what about closer to home? The UK is currently, and quite literally, battling its way through one of its all-time worst storms, but I see a brighter quarter as we head into the start of the year. Unemployment is at its lowest levels since the recession, and consumer sentiment is strong. The situation in Europe may weigh on the UK a little, but not nearly enough to stem growth in my opinion. My medium-term bias is long UK equities, with a focus on financial tech, and long sterling as the Bank of England takes a more hawkish stance on its policy.

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BY ADRIAN KEMPTON-CUMBER

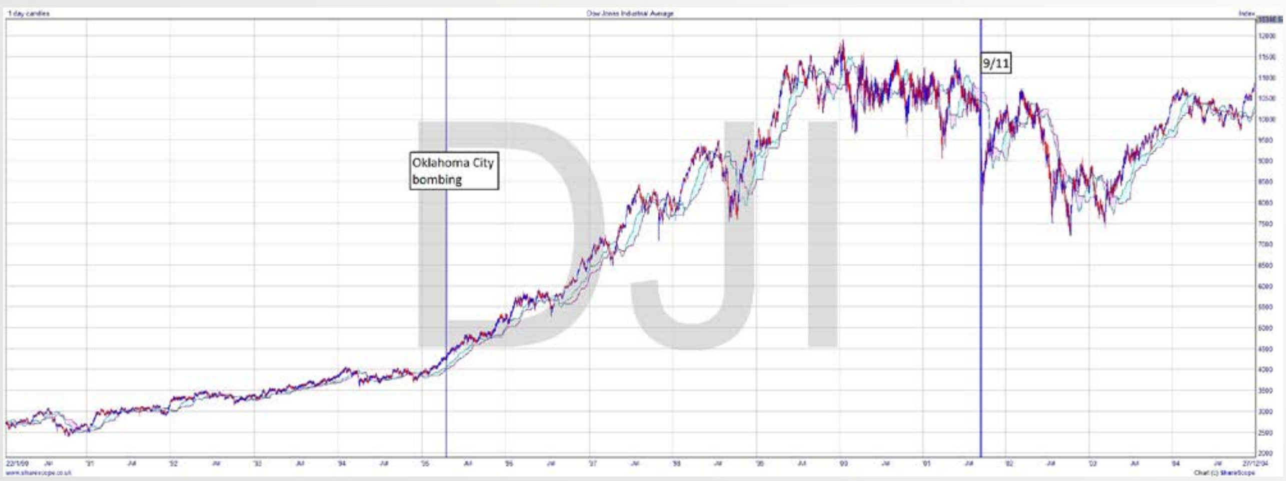
TECHNICAL ANALYSIS CORNER

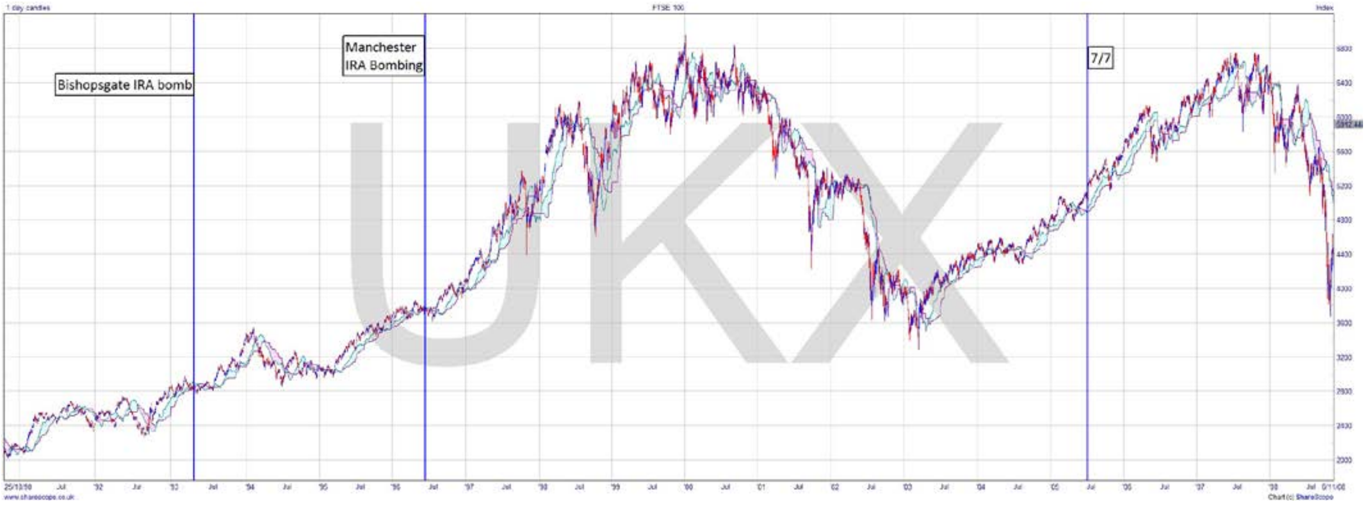
CAN THE MARKETS BE TERRORISED?

One of the unfortunate things about 24 hour news is it goes on for 24 hours and has to be filled with something. The news tends to come from places where the news networks have a crew, and that are emotive to the viewing public they 'serve'. This gives rise to the phenomenon of patriotic reporting. The notion that a story is more or less interesting because there are people you don't know from some part of the country you happen to live in is nonsense. But people are programmed to think it does.

You may remember the Channel 4 comedy series Drop the Dead Donkey. Originally it was to have been called 'Dead Belgians Don't Count', but political correctness put paid to that. Once a story does get onto the headlines, if it's dramatic and 'breaking', then it'll be on heavy rotation, maybe even 'live coverage'. I'll bet nothing ramps up the viewing figures more than a terrorist incident somewhere you may have been, if not on your doorstep.

Statistically, you're still more likely to die from being crushed by a large piece of furniture than by a terrorist, but for some reason the terror seems more immediate and takes the top spot for fear. People aren't generally cowering at the thought of an amorous Anwar jumping their bones. Given that, it would seem logical that since financial markets are based on sentiment, they would be particularly affected by domestic terror attacks.





I often describe Americans using a Douglas Adams reference from Hitchhiker's Guide: Paranoid Androids. They're worried, if not neurotic, about everything. Thus, one might reasonably expect that the terror attacks in Oklahoma back in '95, and more recently 9/11, would have had a dramatic effect on the markets. Particularly since public participation in US markets is high.

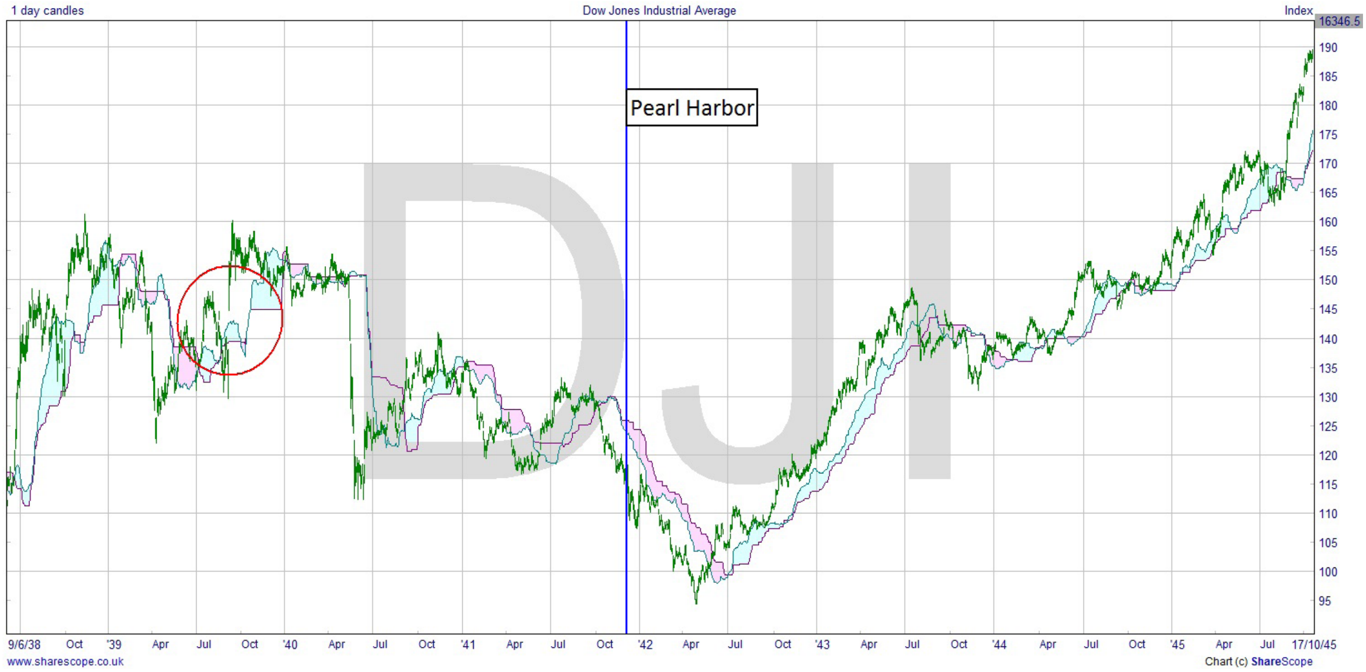
> **"STATISTICALLY, YOU'RE STILL MORE LIKELY TO DIE FROM BEING CRUSHED BY A LARGE PIECE OF FURNITURE THAN BY A TERRORIST."**

I've annotated a Dow Jones chart with the dates of the attacks clearly marked. Starting with Oklahoma, it made absolutely no difference at all. The trend remained almost embarrassingly intact. Granted it was a maverick act, and not part of some bigger threat, but it did represent the first occasion in modern times that the US stopped feeling quite so untouchable and beyond harm.

9/11 is a little more dramatic, but let's examine what happened in the market around that time. We can see the markets fell after the attack, but it's not any more significant than some of the other falls during the months either side of the attack. In fact the reversal signal was highly visible months before September. The market behaves fairly predictably, and eventually bounces off previous lows to start the new bull market in '03. During the weeks after the attack the Dow even had a decent rally, so the markets weren't really that spooked.

We see a similar situation in the UK. Most of us will remember the IRA. They've gone into pharmaceuticals and training now, but throughout the '70s and '80s they were far more pro-

lific than their Brit-hating successors. Did you know the IRA even threatened to kill comedian Dave Allen for his religious jokes and sketches? Terrorists have no sense of humour! And that sounds an awful lot like a fatwa. I've marked two big IRA bombs and 7/7. Again we see a quite minimal effect for both of the IRA bombs, if any. But even 7/7 doesn't make a dent in the rally that started back 2003. Perhaps it's the Great British resolve. Foreign friends of mine here in London were amazed how matter of fact we Brits are in these kinds of situations – on discovering a road or a station closed we just calmly set off in a different direction. Perhaps



"A YEAR OF OPPORTUNITY AWAITS... JUST STICK TO THE TECHNICAL ANALYSIS AND EVERYTHING ELSE WILL TAKE CARE OF ITSELF."

this kind of stoicism stems from the Blitz spirit collective memory.

I've also looked at the CAC40 and the recent attacks in France. The Charlie Hebdo attack had no effect on the market. Neither did the Bataclan attack. The market stays true to the developing chart patterns.

These are just attacks though. Surely there would be more of a reaction if a war broke out. I looked at the Dow during WW2. Pearl Harbor happened when the market was in decline anyway, but it didn't buck the steady downward trend very much. The interesting thing is what happened when Britain declared war on Germany in 1939. I've circled it so it's easy to see. That gap up, that's the first trading day after the declaration of war! A few months after Pearl Harbor and the US involvement in the war the Dow had rallied to recover the value lost since 1938/9.

So is there anything we can gain from this? Yes. Firstly, markets are often counter-intuitive. But the main point to pick up on is that the markets exist outside of the political world to a greater degree. We're in the business of seeking opportunities for price corrections and new normals. Since we don't mind which direction markets are moving, it doesn't really matter what's going on. And certainly markets are no observers of political correctness. They don't go down as a mark of respect for the dead!

As it's a new year, one thing I can say is that I expect there to be much more civil unrest in Europe in the coming year. The pressure cooker of the former Yugoslavia could blow at any time – probably around Kosovo. Greece is still in disarray after the financial crisis. Turkey's President Erdogan said he wants to model Turkey more on his all time fave regime: their erstwhile ally, Hitler's Germany. Turkey has the bargaining chip by taking refugees and heading them off on their way here. Perhaps the subtext is if we don't let them join the EU, then they'll march into Greece, Hitler style, just like they did with Northern Cyprus. Erdogan's storm troopers are presently gaining experience in the East against ISIS, or Douche Bag, or whatever they're called this week. I expect any elections to swing to the right. And of course we've a US presidential this year. There could even be some action in the Orient as China seeks to lay claim to all the disputed islands within its reach. Not to mention some they've made themselves. All of that says roller coaster to me. A year of opportunity awaits...

Just stick to the Technical Analysis and everything else will take care of itself. News is noise. There's that great quote by American newspaper publisher, William Randolph Hearst: "News is something somebody doesn't want printed; all else is advertising." From company results to new alcohol limits, something else to remember when you're next lying to your doctor about your lifestyle, it's all noise. The only real news is natural disasters and genuine surprises. But they've got to be pretty big surprises, as we now know that even declarations of war don't have much influence over stock prices in the big scheme of things.

In a future article I shall look at how to make profits in times of natural and other disasters. (It's only morally wrong if you actually caused the disaster, by the way.) There was a couple taking a selfie with that Dubai hotel inferno way in the background. Bit of a hoo-ha about it being the "most inappropriate selfie ever". Incidentally, I always hate statements with the word "ever" in them. Seriously though, it's a photo. Rubber-necking is a recognised career path in the US, from ambulance chasing lawyers to news choppers. Our desire for news ruins lives, not the odd selfie in arguably poor taste.

BY CARL SHAVE OF JUST MORTGAGE BROKERS

TOUGHER TIMES AHEAD FOR LANDLORDS

Buy-to-let landlords are set to endure a tougher time obtaining a mortgage in the coming months. Following repeated warnings from the Bank of England's financial policy committee, the Treasury is preparing to hand greater powers to the Bank of England in order to enable the latter to regulate the buy-to-let market more effectively.

The Chancellor, George Osborne, made the decision in an effort to prevent landlords from increasing average house prices and threatening financial stability.

The buy-to-let sector grew dramatically last year, with lending rising by 10% in the first nine months alone. This is part of a wider growth within the market, which has seen landlords make an estimated £180bn in capital gains over the past five years. A number of lenders, including Barclays, have tightened lending criteria, with the industry norm of requiring rental income to exceed 125% of interest payments (calculated at a mortgage rate of between 5% to 6%) increased to 135% for all new applicants.

With such important changes being introduced, it seems increasingly likely the buy-to-let market, which has been growing so dramatically, is set to level off.

“WITH SUCH IMPORTANT CHANGES BEING INTRODUCED, IT SEEMS INCREASINGLY LIKELY THE BUY-TO-LET MARKET, WHICH HAS BEEN GROWING SO DRAMATICALLY, IS SET TO LEVEL OFF.”

This is compounded by the fact that tax relief for wealthier buy-to-let landlords will be gradually cut to a flat rate of 20% from 2017 (compared with the 40% or 45% that landlords currently enjoy). As expected, the change has been fiercely contested, and is far from popular with those affected. Some landlords, unwilling to adjust their strategy, are threatening to leave the private rented sector entirely.

Changing Trends in the Buy-to-Let Market

Much has changed in the buy-to-let market since the credit crunch, and with sustained government scrutiny this looks set to continue. Many specialist buy-to-let mortgage providers have fallen by the wayside following the financial crisis, having chosen to no longer accept new business. However, with the big growth in the sector, some have returned and other new challenger banks have also entered the fray.

Lenders looking to grow their buy-to-let mortgage books are seeing

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much greater competition in mortgage deals. And with the steady decrease in mortgage rates over the last 12-24 months, investors have benefited from some very attractive loans, and in turn, very good rental yields.

Although certain lenders have adjusted how they calculate the maximum loan amounts permitted, low borrowing rates for the foreseeable future mean landlords will continue to see value from buy-to-lets.

Other Challenges to the Buy-to-Let Market

The buy-to-let market has enjoyed a golden spell recently, with interest rates at an all-time low and landlords reaping the benefits – part of the reason for the changes being introduced by the Chancellor. However, new challenges are on the horizon, besides the measures that will come into effect with the Bank of England's new powers.

Perhaps the most significant is the additional stamp duty charged on rental properties and second home purchases, which will take effect from April 2016.

The Chancellor announced in his Autumn Statement that an additional 3% in stamp duty will be payable on buy-to-let properties across all bands. For example, a property worth £275,000 will be subject to stamp duty of 8% rather than 5%. So the calculation for a landlord would be £125,000 at 3% plus £125,000 at 5% plus £25,000 at 8%, which equals £12,000, rather than the current £3,750 – an increase of more than 200%.

David Cox, Managing Director of ARLA (The Association of Residential Letting Agents), has been damning in his evaluation of the stamp duty changes. "When the rabbit was first pulled out of the hat, we said these changes would be 'catastrophic' for the rental sector, and this has been echoed by letting agents across the country," notes Cox. "The new stamp duty increases will make owning Buy-to-Let unprofitable for a lot of landlords, and certainly make new investors think twice about purchasing a Buy-to-Let property."

Much of the discussion surrounding the future of buy-to-let centres on the intent of property investors. As a long-term capital growth tool, the buy-to-let market is still relevant and makes sense as an investment. However, it's a different proposition for those looking for a short-term source of income. Those relying on income generated by their properties should approach the market with caution.

"THOSE RELYING ON INCOME GENERATED BY THEIR PROPERTIES SHOULD APPROACH THE MARKET WITH CAUTION."

Buy-to-let is an unpredictable source of income, and with the challenges the market now faces, it's likely the marketplace will become more unpredictable, at least in the short term. But what are the long- and short-term effects of the buy-to-let shakeup likely to be?

Effects in the Long and Short Term

The new criteria being introduced by lenders will no doubt have far-reaching consequences for landlords and the effects will certainly be felt. In the short term, larger deposits are likely to be required, which will see the market stumble while it adjusts. Having said that, although very low interest rates continue to give little encouragement for people to save money, value will probably still be found in investing in property.

In the longer term, the effects of such changes will perhaps be felt more by tenants of buy-to-let properties. Rents are likely to increase across the board, in order to compensate landlords for the extra costs from the new tax relief laws and new lending criteria. Does this long-term analysis answer the question as to whether buy-to-let properties are worthwhile?

It's hard to judge. While value in the buy-to-let market for landlords is unlikely to be dramatically damaged in the short-term, the effect on tenants may be significantly more damaging. Landlords are, after all, dependent upon tenants to help the market thrive, but with costs rising, tenants may be tempted towards buying instead of renting.

The knock-on effect of such a movement could see the mortgage market grow while the buy-to-let market suffers. Equally, the buy-to-let market may continue to thrive, as it has in recent years, but this depends on how much rental rates rise.

With stamp duty also set to be an important contributing factor to the future of the buy-to-let market, everyone within the mortgage and property sector will be waiting to see how the recent changes will affect both landlords and tenants. With costs rising in the short term, the buy-to-let market seems set for a dramatic shakeup.

About Carl Shave

Carl is a seasoned commentator on financial matters and one of the minds behind Just Mortgage Brokers (www.justmortgagebrokers.co.uk). He has worked in the Mortgage Industry for over 20 years, first working for a high street lender and then departing to setup and run his own branch of mortgage brokers 15 years ago.

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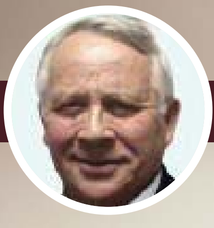

BY ROBERT SUTHERLAND-SMITH

THE LIMPOPO DISPATCHES

A FRESH LOOK AT THE BANKS

In the spirit of King Solomon and ferment coconut juice, the British ex-pat resident community along the Limpopo judge that banks look cheap in terms of the valuation of their assets, earnings and dividend prospects. Before reaching that judgement, they paint a picture of British banking that is warts and all in its composition. Never forget the warts!

Here beneath the magic of the moonlit landscape of the Limpopo, I contemplate that other landscape of big ideas – as one always does at this time, when one year is gathered into the arms of history and another is born. As we all know, the biggest market story in our helter-skelter lives over the last seven years has been that of banks as the masters of our universe came close to destroying the world. That was a destructive Star Wars event, which prompts us to keep certain crucial questions about banks in full focus! Those questions include the following: What are they for? Can they be reformed? Are they now to be relied upon as equity investments?

Here, beneath the stars of the Limpopo, the witchdoctor, the Scottish missionary, the old actuary known only as 'Number 5' and myself – coconut shells of delicious fermented jungle juice in hand – have been thinking for our dossier on banks, bankers and banking. And here is our report compiled for the readers of the Master Investor Magazine as our seated, coconuts high salute to a brave New Year and a brave new world.

I

Free at last! Have the banks, after years in the wilderness worshiping false idols, reached the Promised Land? More importantly, have we, the still austerity bound guarantors of those perfidious banks?

Recently, the Bank of England produced the results of its latest stress test on banks. This time they were modelled on the impact of major "systemic" banks' capital adequacy in conditions of an economic reversal in the Far Eastern markets.

With the exception of **Standard Chartered (STAN)** and the **Royal Bank of Scotland (RBS)** the major banks (which constitute the British banking system and so constitute its systemic risk) were judged to have passed the test of a hypothetical collapse in the Far Eastern economies within the economic and financial gravitational pull of China. The system, we are informed, demonstrated that most big UK banks have adequate capital to come though such an event, without calling on the British public to bail them out again.

Capitally adequate?

It seems that Britain's and Lombard Street's finest exhibit conditions of capital adequacy, meaning that investors have been treading on firm ground in the last year. We thank the Lord for that – particularly those of us who have had some bullish investment comments to make about them in recent times. As a post script, Standard Chartered has made good its capital deficiency with a rights issue – something that has been on the cards for most of this year. Hip, hip, hooray! One might expect cheering crowds to assemble along Cheapside, as they once did, for a returning,

"IT SEEMS THAT BRITAIN'S AND LOMBARD STREET'S FINEST EXHIBIT CONDITIONS OF CAPITAL ADEQUACY, MEANING THAT INVESTORS HAVE BEEN TREADING ON FIRM GROUND IN THE LAST YEAR."

risk taking Henry V after Agincourt who had got the money back to pay off his massive debts by actually conquering France (or more precisely the property of the King of France) against the odds. Although Harry had broken up the Crown Imperial and flogged it off the merchants, it was still one of the most highly geared ventures in history.

Changed hearts?

Returning to the subject at hand, there are some pressing questions to attend to. First, the banks may have accumulated sufficient capital, but have their hearts been changed? Second is the inferred capital adequacy, adequate to all reasonable possibilities of economic accident in the Far East?

On the matter of a change of hearts – and sticking to the biblical Old Testament metaphor – have our bankers actually now read and accepted the Ten Commandments and stopped worshipping golden calves? The biblical allusions are no mere literary conceit but a serious invocation of the history and earlier traditions in British banking. (Those traditions lasted until the arrival of the 'Big Bang' that blew apart the structural Victorian foundations of our then banking system. The Big Bang totally transformed the more limited and generally more useful objectives and ethics of UK banking management up to that point.)

Banks originally came into existence to do a simple and useful thing: to accept deposits of surplus cash (often that of farmers after the harvest money had come in) and to lend it prudently to those in need of working capital in a growing manufacturing economy.

Self evidently, the depositors then as now, wanted to lend their surplus cash to men of perceived probity, restraint and morality – unfashionable virtues and qualities seldom spoken of now. In bustling nineteenth century England of Scrooge and Marley it was far easier to find such people than it is now.

You can't get the staff!

It is a simple fact of history that there were more such people then than now. The English Reformation gave us the Religious Society of Friends, better known as Quakers. They grew fabulously rich not by deceiving or misleading their fellow citizens but by being branded as honest, reliable and fair dealing. Unsurprisingly, they came to dominate the banking and money markets just as they came to dominate other industries. Such rectitude seems novel now in our own time, to judge from the sustained flood of banking crimes, regulatory misdemeanours and financial penalties we have grown accustomed to reading about. Maybe the disappearance of public executions and transportation to Australia made a difference, but we shall never know for certain!

Banks and those who run them are, like other institutions, products of their age and time. Banking, like much other commercial and industrial activity in nineteenth century Britain, became notably the profession of Quakers because they were trusted absolutely, having mined their business ethics from their disciplined, demanding and selfless religious beliefs. They therefore became the most trusted and admired business community in the Kingdom. By putting ethics first, profits came later. They became the UK's bankers and money dealers of choice, even if very few people wished to become non-smoking, teetotal Quakers who always told the truth.

> **"THE POWER OF MODERN, NEBULOUS BRAND IMAGE MAKING HAS NOTHING TO COMPARE WITH THE QUAKERS' WELL TESTED REPUTATION FOR HONESTY, RELIABILITY AND FAIRNESS."**

The brand is not what it once was!

The power of modern, nebulous brand image making has nothing to compare with the Quakers' well tested reputation for honesty, reliability and fairness. One does not have to be of a non-conformist, religious disposition oneself to see the utility value in that.

Those who ran the banks up to the time of the 'Big Bang' may have ceased to be Quakers, but they did inherit the Quaker traditions of doing business as their own custom and practice. What the Quakers practiced in the 19th century became the standard ethics of financial markets, where men were so trustworthy that you could deal simply on their word. They could be largely trusted to act honestly as overseers of ethical institutions that by and large,

did the same. That was good, because it only left errors of lending judgment to worry about – and banking has always produced a lot of those.

We cannot replicate history. Banks are no longer run by Quakers but by ambitious, modern, money making men who too often worship money and proprietary self interest above customer service – as is amply demonstrated by recent banking history. This is the age of Quaker-less individualism; it is the age of business schools and conspicuous consumption, beyond the dreams of avarice. Such avarice can lead to the destruction of shareholder value on a massive scale, as in the great banking crisis of the first decade of the twenty-first century that brought us, slowly, questioningly and painfully, to where we are now.

II

The short basic, stubby, finger in our eye fact, is that the people who run our banks now bear little resemblance to the kind of people who ran the clearing banks up to the Big Bang. A number of our big systemic banks have also kept "casino" investment banking operations, as they are generally and popularly known.

Those banks that maintain investment banking operations (as **Barclays (BARC)** and **HSBC (HSBA)** have although they themselves did not need to tap the authorities or taxpayer for funding in the great banking crash) increased the very thing they do not want: higher levels of regulatory capital requirements. Weighted by the perceived risks and probably the sheer size of a balance sheet, capital requirements protect depositing customers from escapades like the bundling up and selling off ("securitization") of poorly valued property loans, which some US banks took on their books for short-term profit (sometimes hiding them in off balance sheet "conduits"), before spreading them around the global banking system like a plague. It killed off entire the corpus of the world banking system's trust between bank and bank. Once that had gone, even top quality loans were suspect. Trust had perished almost everywhere. Unfortunately, investment banking is capable of more such dangerous enterprise.

III

The failure of government to make existing big banks divest themselves by law of their investment banking activities is a historic and significant failure of political will. In the US after the great crash of 1929 Congress was able to legislate for that with the Glass Steagall Act of 1933. Such legislative action now seems no longer possible. The bankers have fought off that reform, it seems. In that respect, bankers remain in principle the masters of the universe – or at least that portion of it which calls itself Western and democratic.

The alternative, the so called 'ring fencing' of deposit taking and related lending operations – to avoid another catastrophic banking crash, at some unspecified time in the future – is both philosophically and structurally weak. Philosophically and psychologically, ring fencing implies a lack of trust in a bank's management, particularly where a board is dominated by investment bankers rather than the risk averse, deposit taking and lending kind.

Why then not legislate to require that deposit banking activities are independently incorporated, thereby yielding a banking system that consists of two different kinds of banks, each with a different ethos and set of objectives and a different working relationship with taxpayers and governments? It is a good question!

> **"THE FAILURE OF GOVERNMENT TO MAKE EXISTING BIG BANKS DIVEST THEMSELVES BY LAW OF THEIR INVESTMENT BANKING ACTIVITIES IS A HISTORIC AND SIGNIFICANT FAILURE OF POLITICAL WILL."**

That is why the enforced farewell of "Saint" Anthony Jenkins from Barclays, and the background and style of the man who replaces him, is of much comment. It is also why observers fret over the banking industry's apparent foot dragging over the ring fencing of deposit taking and related lending activities. They seem to evidence a desire for a more nominal fence, about as substantial as those famous old Chinese walls in merchant banking, which amounted to no more than a self denying ordinance. Even if we ever once believed in such ideal human conduct then, it is impossible to believe in it now!

Consequently, much depends on the strength and quality of regulation, which is inevitably intermediated by politics and lobbying. There is still that old revolving door between politics, banking and regulation. Regulators are appointed by politicians, often from investment banks, as poachers turned game keepers. Some think that too

neat an arrangement which takes too little account of human nature, which is of course infinitely variable, volatile and ingeniously self serving. (It was a failure to understand human nature that led to the great banking crisis in the first place.) Sagaciously, global investment banks also recruit from former prime ministers and senior politicians. It looks too much of a club to induce complete calm in the minds of the citizenry, as we watch the antics of banks over the establishment and degrees of control over ring fenced deposit taking operations. Will it be a ring fence or another revolving door of influence and control? Similarly, as I understand it, those "living wills" – to prevent the need for tax payer's money, if the system implodes – have not yet been fully implemented in the UK. Investors and voters need to be kept abreast of such developments.

The fact that banks are now stress tested on a regular basis is an advance for human kind. But even that can be tentative! Was the latest test sufficiently demanding? It does not seem to have envisaged a Chinese economy that actually experiences recession for a year or so. If that were a possibility, then the latest bank stress test does not seem to take account of it.

My point is that banks still have that alluring, explosive, gelignite potential which share valuations should take into account. Why cannot banks be defined by and clearly analysed by a set of limited, core activities? This is, after all, the age of private equity! Why cannot investors choose to invest in either deposit taking banking or, as an alternative, investment banking? For the sake of risk measurement and clarity of decision taking, investors should have that freedom.

Thankfully, to a measurable extent, they now have it. The investor is offered a choice between HSBC and Barclays on the one hand, which still have investment banking arms, and RBS, Lloyds (LLOY) and the new small creditor banks, all of which appear to have reverted to the old clearing bank model.

This is not a polemic against banks as a legitimate asset class for investors; it is merely a call for recognition of the blurred and blurring facts of investor life. Banking is too big a component of markets to be neglected by the sceptical thoughts of sceptical minds. It constitutes too big a slug of market capitalisation and store of value for that luxury.

IV

The investment case for banks

Despite the background reservations outlined above, banks look good value on the basis of the usual yardsticks of valuation. First, all the big banks are now selling at way below the net asset value of those assets attributable to ordinary shareholders – i.e. if you buy bank shares now, you pay less than the net asset value per share. That suggests that buyers of shares are currently being asked to pay nothing for future earnings, and actually getting some bonus net assets to boot.

The other attractive feature of banks is that their net assets have mostly increased at various rates of growth since 2012. The last balance sheet net asset value figure for Barclays showed that net assets had increased by more than a fifth on the figure published in December 2012. In the case of HSBC, the net asset growth was about 8.5%; in the case of Standard and Chartered (before the benefit of the new rights issue capital) it was 3%; and for Lloyds it was about 16%. RBS seems to be the only bank that has seen shrinkage of its net equity base. Since the end of 2012, RBS equity fell a reported 16%. Little wonder then, it was judged not to have had enough capital in the last Bank of England stress test.

The other factor that makes banks now appear to be better investment material is the better understood economics of the Chancellor's last budget. Basically, his economic growth formula depends on the UK consumer plunging back into debt as the Chancellor attempts to reduce the Nation's debt a little. Banks should continue to do well on credit card and similar finance. It is a policy that could end in tears, but only if the consumer does continue to expand his and her personal borrowing in the first place.

"DESPITE THE BACKGROUND RESERVATIONS OUTLINED ABOVE, BANKS LOOK GOOD VALUE ON THE BASIS OF THE USUAL YARDSTICKS OF VALUATION."

Furthermore, if interest rates are to increase in the medium term, this should be beneficial to bank profitability, as it has been in the past. And finally, if we have reached a point where demands on banks to increase their capital has peaked for a while, that means that banks have greater scope for increasing dividend payouts.

Banks may continue to have explosive qualities but it looks as if this uncertainty may be reflected in their share price valuations.

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BY FILIPE R. COSTA

THE GREATEST INVESTORS & TRADES

SHORT-SELLING AS VALUE INVESTING

"I knew the problems inherent in being on the short side, but even when a stock was running up, it didn't bother me much. I knew I was right."

— Jim Chanos

An Asymmetric Market

As an investment strategy, short-selling is by far the toughest strategy to deploy. Unlike what may appear to be the case at first glance, going short is not the opposite of going long. First of all, there are some assets that cannot be shorted. Examples include houses, cars and works of art. Second, even for asset classes where short-selling is possible, it is often easier to purchase them than to sell them short, as restrictions and bans are not uncommon. But, even if those issues could be overcome, going short would still not be the opposite of going long, as the risks involved are different, with short-selling being by far riskier. We could think about the profit-loss profiles, for example. While a long trade involves unlimited profit on a limited loss, the short trade involves limited profit on an unlimited loss. But, that is just the start. We should also remember that there is a massive skew in the market and in investors' attitudes. The market trends upwardly over long horizons, which means that on average a long position stands with a positive expected value and a short position with a negative one. Therefore, time plays favourably for long investors and unfavourably for short-sellers. Investors and analysts are also skewed due to emotions: investors are optimistic and attracted by the crowd; analysts are

overconfident. They both predict average returns and earnings for equities that are above their natural long-term average, pushing prices above fundamentals, sometimes for long periods of time, and making short-selling riskier. Even in the absence of sentiment, the market shows no symmetry. While a value investor explores mispricing through buying undervalued equities, he just refrains from taking action on overvalued ones. For all these reasons we find short-selling to be a rare investment theme. Many hedge funds use it as a hedge or to build market neutral positions, but only in a few cases does it serve as their main investment strategy. In the end symmetry doesn't exist in the equity market.

The reader is certainly by now thinking: *What does all this have to do with Jim Chanos?* Jim Chanos is one of those rare exceptions who have made a living shorting overvalued securities. As an analyst he seeks out mispricing, in particular during the irrational exuberance that inflates prices above intrinsic values; and as an investor he takes short positions in overvalued equities through pursuing a value strategy that can be seen as the opposite of what Warren Buffet does. This is what makes Chanos different from the others. He


10%
15%
20%
40%
60%
80%
100%

is not an ordinary short-seller; he acts as a value investor, selling what is expensive and holding his positions over long periods of time until mispricing is eliminated. By this token, we could say that Chanos' investment theme is no different from Warren Buffet's, David Dreman's, or even Ben Graham's. It's just that he explores the toughest side of the investment equation.

"WE COULD SAY THAT CHANOS' INVESTMENT THEME IS NO DIFFERENT FROM WARREN BUFFET'S, DAVID DREMAN'S, OR EVEN BEN GRAHAM'S. IT'S JUST THAT HE EXPLORES THE TOUGHEST SIDE OF THE INVESTMENT EQUATION."

In our last edition, we covered the "greatest trade ever", which was executed by the unlikely Paulson/Pellegrini duo, who reaped billions in profits from the housing collapse. Their top-down analysis helped identify market mispricing and how to profit from it. In this month's edition we explore how Jim Chanos uses financial statements to identify aggressive accounting. His bottom-up analysis has been contributing to market efficiency, through identifying price/value disconnection. While earning just a small fraction of the profits Paulson and Pellegrini did, Chanos's trade on Enron and Tyco's stock is of the highest importance in teaching a lesson or two about financial markets: an asset price is not always the efficient outcome that results from the interaction of rational agents, but sometimes an inflated figure that is highly skewed by the interaction of human beings, which are often guided by emotion and attracted by the crowd. Irrational exuberance can often last for extended periods of time. Opportunities then arise.

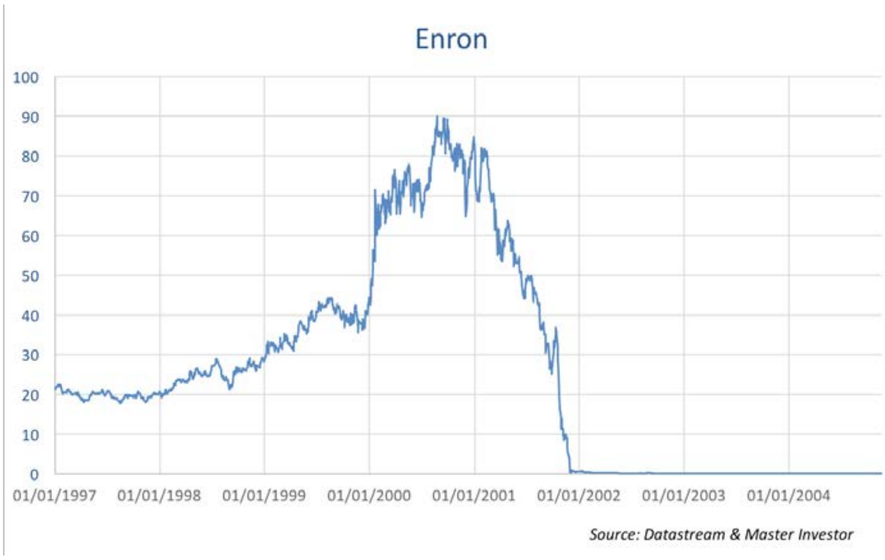
The Enron Case

Enron was a high-flying American energy, commodities and services company that met its end on December 2, 2001. The company collapsed in one of the biggest accounting scandals in financial history that shocked the whole world while resulting in the bankruptcy of Enron and its accounting auditor firm Arthur Andersen. Enron's collapse also resulted in the arrest and conviction of the company's CEO Jeffrey Skilling and its founder Kenneth Lay, and convinced authorities to approve new legislation to avoid future scandals at other companies.

Investors used to love Enron. After all, we can't blame them, as the company had been beating analysts' earnings estimates for sixteen straight quarters. The company was becoming bigger and bigger, with its name appearing among other giants of the sector. By the end of 2000, Enron's stock was priced at $83 and its market capitalisation exceeded $60 billion. The future looked so bright that investors were willing to pay six times the company's book value and 60x its earnings. But Chanos was not buying that. Sixteen straight beating quarters was a strange statistic for him, which when mixed with many other dubious features on the company's financial statements, made the case for an epic short. Something was not right.

A story published by Jonathan Weil about energy companies using accounting schemes triggered the attention of Chanos. Weil was claiming that some energy companies were reporting unrealised non-cash gains as earnings, as they were exploiting GAAP vulnerabilities. Chanos and the whole team at Kynikos Associates LP (his investment advisory business) employed their full abilities looking at Enron's financial statements seeking out the full story. While digging into Enron's financial statements, one of the analysts at Kynikos said that the company looked more like a hedge fund in disguise than an energy company, such was the number of future delivery contracts and related businesses found in the financial statements.

While investigating Enron, Chanos found that there was heavy insider selling, the financial position of the company was deteriorating, 80% of profits were being allocated to energy trading, and return on capital was around just 7% while the cost of that capital was exceeding 10%. At the same time, Chanos was unable to figure out what Enron was doing and how the company was making money. That was a vivid red flag for someone telling his ana-



Source: Datastream & Master Investor

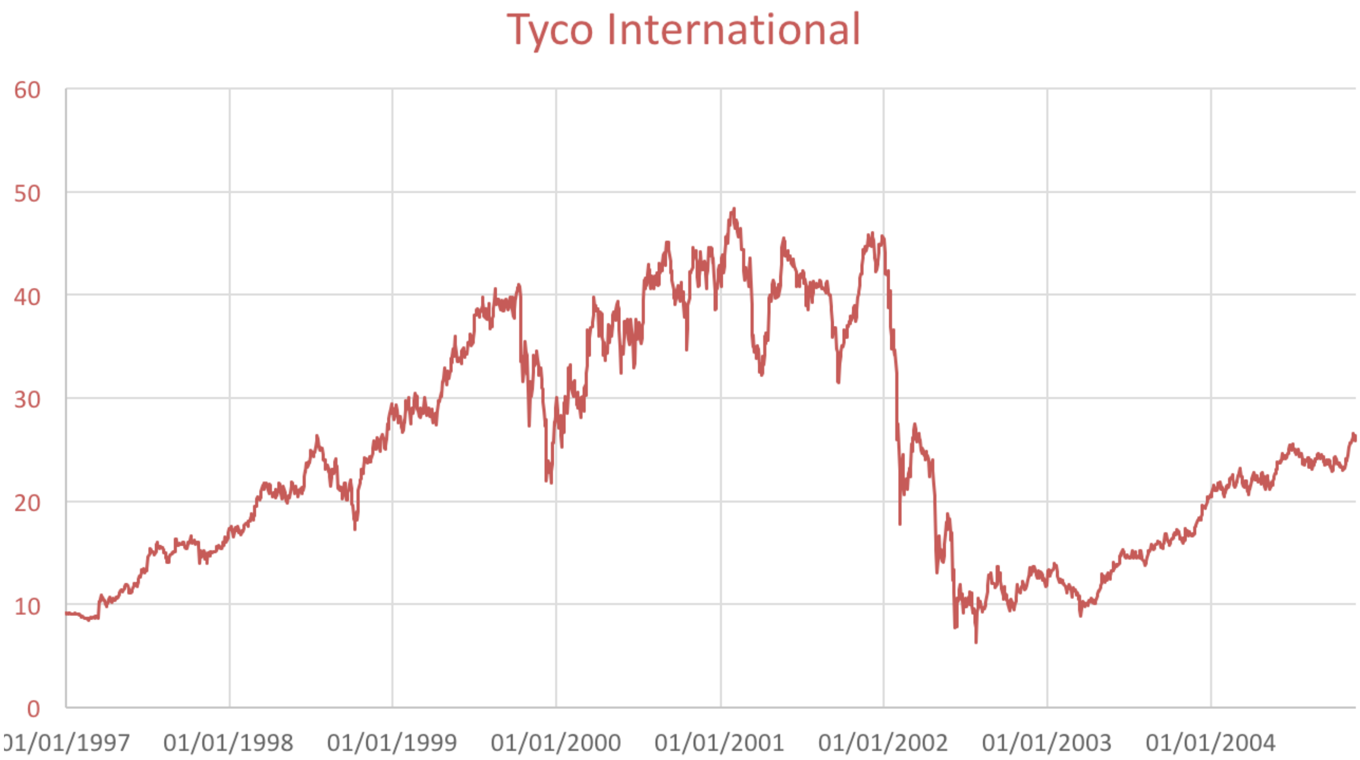
"CHANOS WAS UNABLE TO FIGURE OUT WHAT ENRON WAS DOING AND HOW THE COMPANY WAS MAKING MONEY. THAT WAS A VIVID RED FLAG FOR SOMEONE TELLING HIS ANALYSTS THAT 'IF YOU CAN'T FIGURE OUT WHAT A COMPANY DOES AFTER THREE READINGS OF THEIR ANNUAL STATEMENTS, OPEN A FILE ON IT'. THAT'S EXACTLY WHAT CHANOS DID."

lysts that "if you can't figure out what a company does after three readings of their annual statements, open a file on it". That's exactly what Chanos did.

Enron was running several schemes to inflate its revenues and disguise losses. Accounting is not an exact science; it allows for some human intervention. There is always margin for estimates and guesses that can change the full picture drastically, particularly when used strategically. Enron was using aggressive accounting practices, booking unrealised profits in current statements from contracts the company was selling on future delivery of natural gas. GAAP rules allowed companies to estimate profits on such contracts based on the present value of their estimated future profits. Of course, such practices involve a lot of assumptions and guessing that can be massaged in the company's interests. Instead of being recorded using a mark-to-market model, profits on future delivery contracts were recorded in a mark-to-model basis. As there was not even a market for those contracts, Enron was able to assume very favourable assumptions that allowed the company to always record a profit at the present time when the contracts were sold. So, selling contracts was turned into a big profitable business, allowing Enron to sell ever greater amounts of natural gas futures, and always for an expected profit. Leverage rose drastically as a consequence. But of course, if future prices proved different from the optimistic assumptions on which present values were based, the company would have to record huge losses. That is where the company had to creatively disguise financial statements.

Enron was running a complicated accounting system with more than 4,000 off-balance sheet partnerships. These partnerships, which were created as special purpose entities, served to hide the massive losses and debts the company was accumulating from its aggressive accounting guesses and estimates. No one was able to identify the problem or to fully understand the dimensions of it. Enron was selling bad debts to these created entities and then not reporting them as operating losses. Any references to them just appeared in footnotes. But the treatment given to profits was not the same. "The winners were always being put in operating profits and the losers were being put in discontinued operations. So within a few weeks, it was pretty clear something was wrong but it wasn't clear this was such an extensive fraud", Chanos remembers. The company was selling losses to itself through other entities and accepting as collateral its own stock. As losses accumulated, the company was issuing ever more stock to cover them.

The more Chanos dug into the company the more red flags he found. He knew something very wrong was going on and then accumulated a big short



Source: Datastream & Master Investor

position on Enron. In August 2001, Jeffrey Skilling, the company's CEO, suddenly left Enron citing "personal reasons" at a time when the company's stock was declining. On October 16, 2001 the company reported a huge loss of $618 million and its collapse started. Chanos was right from the beginning.

Tyco and Others

Chanos's take on aggressive accounting doesn't end with Enron. Another important case is Tyco, the Bermuda-based conglomerate that manufactures almost everything and operates in more than 100 countries. Tyco is another example of accounting manipulation to hide losses and enhance profits. Between 1999 and 2002, the conglomerate bought more than 700 companies, often asking the takeover targets to hold earnings down to allow for a steep rise post the acquisition to boost its impact. They recorded these acquisitions mostly as goodwill, always depressing the value of the real assets of acquired companies, in order to be able to pump profits through real asset sales and stretching the write-off of the goodwill for decades to minimise its impact. While not always being illegal, these tactics obfuscate financial reality and often lead to mispricing if investors aren't aware. Chanos took a big position against the company, which played very well. He entered the stock in 1999 and in 2002 the stock tanked abruptly.

The Value of Short-Selling

Chanos played a major role in uncovering one of the biggest accounting frauds in history. The collapse of Enron changed the accounting world and led to the approval of more stringent rules to make it difficult for companies to manipulate their financial statements.

“SHORTING IS NOT A CRIMINAL TRIAL. IT DOESN’T HAVE TO BE BEYOND A REASONABLE DOUBT. THERE JUST HAS TO BE A PREPONDERANCE OF EVIDENCE.”

But manipulation does not always mean fraud. The role of Chanos is not to uncover accounting irregularities but to seek out discrepancies between the economic reality in which a company operates and its reported numbers, which require estimates, guesses and accruals. Managers sometimes make over-optimistic estimates and guesses, while they may also time accruals. When that happens, the share price disconnects from its intrinsic value. In taking short positions in a company's stock, investors like Chanos act like value investors, who seek out value and help to drive the market back to its fundamentals. They're always hated and demonised, and often made accountable for panics and crashes, but all they do is arbitrage away the irrational exuberance. Due to several distortions, financial markets are not symmetrical. Undervaluation is more easily corrected than overvaluation. Forbidding short-selling does not protect private investors; it just allows for larger and longer price disconnections, which often end in bubbles and crashes. I leave the final word to Chanos: "Shorting is not a criminal trial. It doesn't have to be beyond a reasonable doubt. There just has to be a preponderance of evidence."

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BY MARIA PSARRA

SCHOOL CORNER

NEW BEGINNINGS

Please allow me to begin by wishing you all a Very Happy 2016. May the year bring health, love, happiness, and prosperity to you and your loved ones.

I like to view each new year as a fresh start, and in fact, I view 2016 as more of one than any other year in my life so far. So for this article, I chose to focus on "new beginnings". Now, this being the Master Investor magazine, we shall only focus on new beginnings in your trading and investing. But I have always felt that trading and investing are rather like "real life" in the sense that they always reflect our best and worst personal traits, our psychology, and the current stage of our lives.

> **"EVERY END OF EVERY YEAR IS A PERFECT OPPORTUNITY TO LOOK BACK, RE-ASSESS ALL INVESTMENTS AND TRADES, LEARN FROM OUR MISTAKES, AND REJOICE IN OUR SUCCESSES."**

Every end of every year is a perfect opportunity to look back, re-assess all investments and trades, learn from our mistakes, and rejoice in our successes. Furthermore, every end is also a new beginning, so we'd better enter this year well prepared and clear about our hopes and desires, and with a focused plan on how to achieve them. So let's get down to it. And to do this, do allow me to become less philosophical, and instead be more practical.

We shall start with how to take advantage of last year's lessons in order to learn and improve, and then we shall move on to how to go about planning for the year ahead.

Assessing last year's investment/trading performance

As you may know, there are a thousand and more performance indicators out there. You could use all or none of them, and still be a very successful or alternatively a very unsuccessful trader or investor regardless. Personally, I tend to use very few. So here is a list of these, which you may find useful:

- **Number of successful vs unsuccessful trades in the last year.** This will help you clearly assess your investment selection process.

- **Big winners and losers in the last year.** This will help you understand if you are using too wide or alternatively too narrow stops, and taking profits too early vs. becoming greedy and letting your profits evaporate.

- **Overall things you did well or badly trading and investment-wise during the year.** Do be honest, but at the same time, do NOT crucify yourself. It is part of human nature to make mistakes, but it is also part of human nature to leave the past behind, and move on to become wiser.

- **Financial products you used for your trading/investing,** and whether these were suitable for your risk appetite, financial situation, knowledge and experience, as well as for the prevailing market environment at the time. This will help you once again gain a clearer understanding of what is and what is not suitable for you, which you can then carry forward to your future investments.

Planning for the New Year

As one of my friends wrote and I quote, *"The 1st January 2016 is the first page of a 366 page book. Make it a good one"*. And in order to make it a good year, I add, you have to fulfil as many of your wishes as you possibly can during it. So I shall start with a simple question: What do you REALLY WANT from 2016, and what do you want from the next few years of your life? The possible answers are infinite, and you are the only one that can provide them, but here some examples to get you thinking...

Do you want capital protection vs. capital growth? A steady investment income? A new home? A new job? A family? None of the above? Just money? And are you happy to risk everything to make money? If not, just how much are you willing to risk? On a final note, do you want to make money quickly with no risk? If that's the case I strongly advise you to stop reading this article, for its author does not believe this to be possible, so you are wasting your time. What was suitable for you last year may not be suitable this year. Your life may have changed or may be about to change, or you may wish to change it yourself. I know I do. So this is something that should always be taken into serious account moving forward.

And finally, very importantly, what has your assessment of your last year in the markets thrown up in terms of what you wish to keep or leave behind? You see, I do not know your answers, but I do know mine, so for the benefits of this article, I am going to use these as an example. You can adjust these to your own.

Let us start with my risk profile and financial experience, just as most "client knowledge and experience", or to use FCA terms, "suitability and appropriateness" questionnaires do. Well, I have been trading and investing for myself and for clients for several years, and I do thoroughly understand most financial products. I have been more than reasonably successful in my trade selection over the last years, so I am confident that this is going to be all right moving forward too. Nevertheless, I am very far from perfect, which means I have made mistakes, and hopefully learnt things in 2015, which I wish to carry forward with me. On a different level, my own personal wishes and goals have changed over the year, so I need to plan accordingly.

I shall not bore you with all the details of what I learnt from my personal trading and investing last year, except to say that I realised that while I may have been best known for being a consistent short-term trader, I actually perform much better in the medium term. And as I mentioned earlier, trading and investing is always very "real life", and my own real life and many of my wishes for the future have actually changed this year. You see, on a personal level, I am at a stage of my life where I want to build something that will provide me with stable income, and maybe occasionally capital growth. I do not have my own family yet, but would like to have one someday. I really do not wish to buy a property, and I fully realise that there is no such thing as making money in the markets with no risk attached to it.

So here are some of the specific questions I asked myself, which you may find useful:

- How much do I want to risk in the markets in 2016?
- What assets suit my risk profile and financial situation for 2016 – e.g. Equities/Bonds/ETFs/Commodities/Derivatives, etc. and do I have sufficient understanding of these products?
- How much time can I devote to my own personal trading/investing?
- What do I want to get out of it? As in if I look to the end of 2016, what is it that I want to have accomplished through my investing?
- Given all of the above, what is my investment strategy for 2016?

Of course, this list is hardly exhaustive or complete, but I do believe that it will at least make you ask yourself some of the right questions, and if you are honest enough, it will also prompt you to give some really good answers. I certainly hope it does.

This concludes my article, but as always I welcome your questions and feedback.

Until next month,

Happy trading and investing everyone!

Maria is Head of Trading at ZAI Capital Markets. In her role at ZAI, Maria determines the company's trading strategy, supervises a team of experienced brokers, and advises high-net-worth individuals on suitable investment strategies. Maria employs different investment styles in order to construct personalised portfolios best suited to the risk and return preferences of ZAI's clients. Typical portfolios primarily comprise of UK and European equities and equity indices, and, to a lesser extent, commodities and fixed income exposure.

Maria appears on Tip TV on a weekly basis providing investment tips and market commentary, writes for a number of financial publications, and is often invited to present her views during conferences such as the London Master Investor Show, the London Trading Show, and the ETFs Europe conference.

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Trade Up

BY CAROLINE DREWETT

WHY MILLENNIALS SHOULD START A BUSINESS

Starting a business is a dream of many twenty-somethings at the moment. Ridding themselves of the 40-40-40 trap is appealing – the idea of working forty hours a week for someone else, for forty years, to retire on 40% of the income, has finally hit home and they are desperate to get out. But the world of business is a maze of fear, uncertainty, and red tape implemented by those calling the shots from above. The security of working for someone else might be comfortable and easy, but Millennials have never been in a better position to understand consumers and shape their own success. Forbes estimates that by 2017, Millennials in America alone will be spending $200 billion annually, which equates to $10 trillion in their lifetime. Who better to understand and, ultimately predict, sales trends than the very consumers driving the trends – the largest generation the world has ever seen?

Within the UK we are well-placed to create a generation of entrepreneurs. Only when one starts a company abroad do you realise how simple it is to get going in the UK; I started my first company aged 22 with a £10,000 loan from the bank. Riddled with student debt and fresh out of university, my mother encouraged me to start something new. I had no mortgage, no well-paying job, no flat. When you have nothing to lose, you have everything to gain. Living in Britain, we have it easy: pick a company name, pay £15, complete a few online declarations, and voila, you're a business owner. No lawyers, no accountants, not even a physical piece of paper to print.

When I started my company I was working for £6 an hour for the local council and couldn't afford to quit and go full time with my business for 18 months. I would arrive at the office early, work through my lunch break, and by 3pm, I was ready to start working on my passion – my business. My dream was always to make enough to live a sustainable life. My passion was in the betterment of society; you don't start an education company to make billions or to buy a private jet. But what I soon realised was that others who had started companies that were based solely on earning money had lost focus. Very few people have the stamina to work 100 hours a week for something they're not whole-heartedly passionate about.

When you ask yourself why you want to start a business, is the answer *to make bucket loads of cash* or is it that *society is lacking and I am the person to create something that the world needs?* If it's the former, you need to ask the question: *why should anyone hand over their hard earned cash for a product you don't even believe in?* If you provide something society needs, loves or wants, running a business will be significantly easier, both for your sales and your motivation. Some people, such as Elizabeth Holmes, owner of revolutionary blood-testing company Theranos are fortunate and savvy enough to have both – her product is predicted to save hundreds of thousands of lives a year, and she had been valued at $4.5 billion by her 30th birthday.

Having now started subsequent businesses in South America and in Asia, I have experienced and worked alongside global businesses from other Millennials, some of which were successful, some not so

successful. So what sets the two apart? I believe a great deal is determined by how each product is intended to affect society. Whether it's a publication that gives free advice to mental health sufferers, a logistics company that compares providers or an organisation that helps websites become more robust for small businesses, the successful companies' goals are usually intended to challenge monopolies and improve society for the consumer. The more famous companies of the moment such as Uber and Google are all about power to the consumer. Whether they're giving us access to endless information, or making it safer to get home at night, they believe – and, crucially, the public believes – that they are doing something *good.* The result is they are likeable, trusted, and we hand over our cash to them. Having only been going six years, Uber was last valued at $51 billion.

If your company loses momentum, and you're tired of the 100 hour week, social betterment is an easier inspiration than an extra zero on the end of your bank balance. So how do you become the next Mark Zuckerberg?

Start with a bank of ideas

Not every idea will work, whether it's because of market fluctuations, government regulations, or just that some ideas aren't right for now. Most of us aren't inventors, and most inventors are not businessmen. For obvious reasons, companies with a strong resilience to competition are less at risk of eroding market forces than innovative companies that have a monopoly on the market. But the truth is that success frequently comes from idea re-inventors – those who find a business not reaching its potential, and start a more profitable and more innovative rival company. This should be particularly appealing to Millennials with little capital behind them, but with a wealth of creativity and drive.

Reinventing the wheel is expensive, time consuming, and requires you to be passionate about something that perhaps doesn't yet exist. Offering the public a product they already know, but with enhanced service, quality or pricing is a surer way to start in the competitive business world. Once your foot is in the door, you'll be able to adjust and evolve your idea to ensure that it becomes unique and a market leader. Just because your company might not start as unique, doesn't mean it can't become unique. Apple didn't invent the telephone, yet they have managed to carve out a product that users loyally queue up for days to get their hands on.

Don't beat about the bush – get started

Whether it's after work, on weekends, or during your holiday time, there is only so far that planning can get you; at some stage, you'll need to take the leap

“THE MORE FAMOUS COMPANIES OF THE MOMENT SUCH AS UBER AND GOOGLE ARE ALL ABOUT POWER TO THE CONSUMER. WHETHER THEY’RE GIVING US ACCESS TO ENDLESS INFORMATION, OR MAKING IT SAFER TO GET HOME AT NIGHT, THEY BELIEVE – AND, CRUCIALLY, THE PUBLIC BELIEVES – THAT THEY ARE DOING SOMETHING GOOD.”

"AS MARK ZUCKERBERG HIMSELF BELIEVES, 'IN A WORLD THAT IS CHANGING REALLY QUICKLY, THE ONLY STRATEGY THAT IS GUARANTEED TO FAIL IS NOT TAKING RISKS.'"

of faith and begin. No business can be predicted – our freedom and choices are what make entrepreneurial successes and failures so interesting. Once you have your concept, the first challenge will begin with how you react to the ever-changing climates, whether economic, social or political. Adapting with perseverance is what sets the successful apart from the unsuccessful. Planning the perfect business for two years might mean the markets have entirely changed by the time you get going. See what sells, what's trending, and adjust accordingly. Crucially, put yourself out there. Embrace social media, read widely, and seek out other entrepreneurs. I love meeting new entrepreneurs and business owners as I learn from them, even the ones newer to the game than me. Become a sponge, expand and adjust your thinking to gain different perspectives from those who have been there before. See every meeting as an opportunity to learn something new, whether it's at the pub, on a plane, or at a party.

Be prepared to move out of your comfort zone

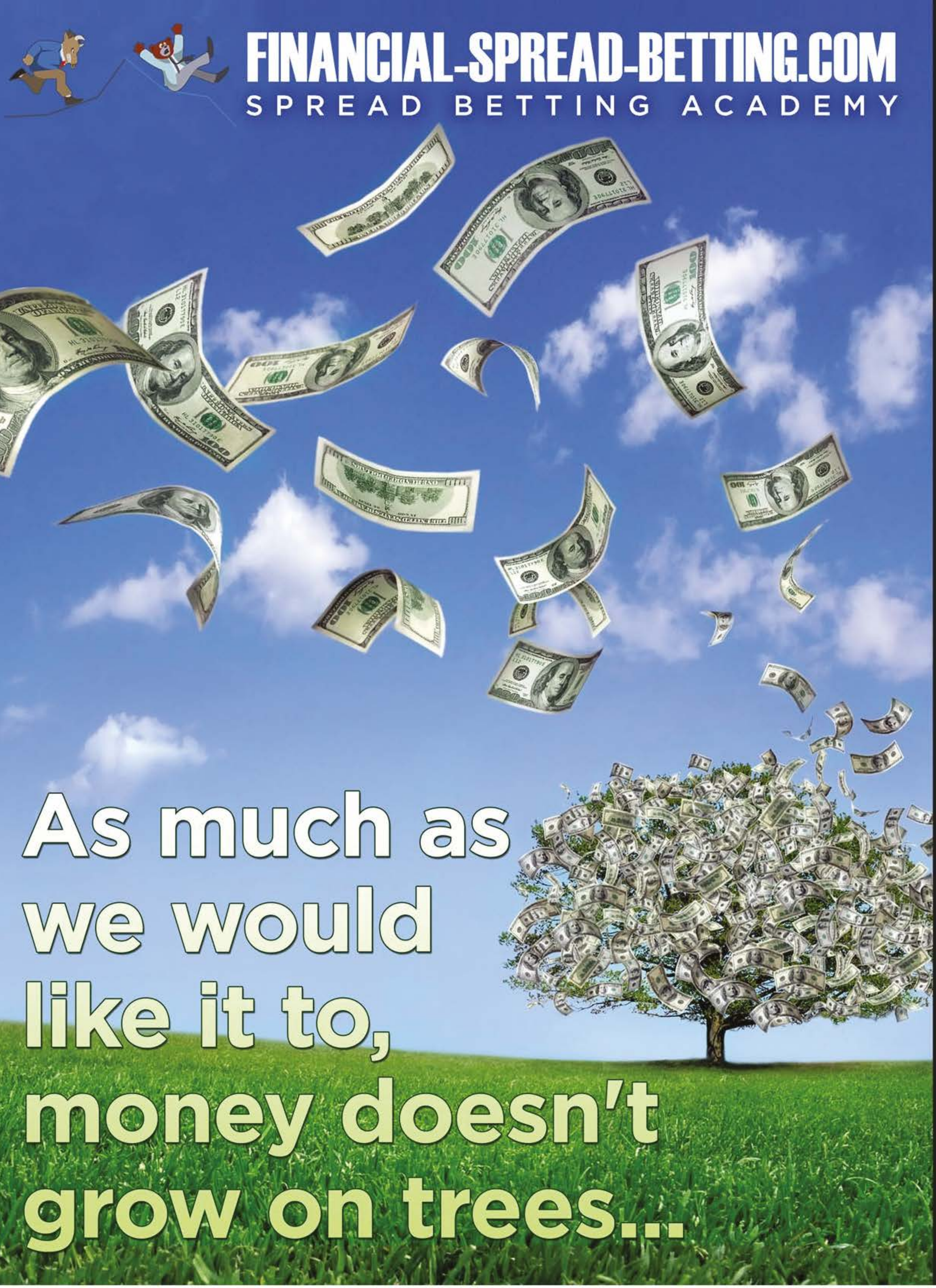
Thirdly – and this is what most people find trickiest – prepare to go from being a specialist for your current employer to a jack-of-all-trades. Unless you have significant financial backing behind you, you likely won't be able to afford a state-of-the-art office with a PR team, a HR team, strategists and web designers. If you can afford their living wage, you might be able to get an intern to help, but if not, for the first part at least, it'll just be you. The freedom of being able to make your own decisions and having variety in your day to day tasks is what being truly entrepreneurial is all about.

It means you'll be busy, but it also means that as your company grows and you can start to afford employing staff, you'll understand the individual roles of each employee. Long term, it will make you a much more personable, empathetic, and subsequently, successful employer. There's nothing worse than being forced to take orders from a boss who has no idea what you do or what your value is. At the start, you will need to work out your priorities. Is your budget best spent outsourcing all web design to a flashy designer, or would you be better spending a few weekends getting to grips with a free wix.com site and spending the money on promoting and marketing the site? Each company is different. You need to work out what's right for you depending on your personal and professional strengths.

Stay positive

There is no set rule to how each business works. Some are successful because of their eccentric and outlandish CEOs, while others like to stick with traditional and conservative methods. Just as some companies place emphasis on the product or content, others place theirs on the brand as a whole, or on one-to-one service. No company gets everything right all the time, and each company needs to find its niche in the market. However, I believe one thing to be true of every business: no one will care about your company like you do.

You can employ the brightest and most hardworking people on the planet, but the reality of effective account management always stops with the shareholders – with those earning the profit – and in the case of a small business, with you, the owner. Expect to be grinding for the long haul; this isn't the national lottery, it's hard work, it's dedication, but it's rewarding and self-fulfilling. Millennials have the advantage of technology, of education and of purchasing power. They have never been in a better position to jump in and try something new. As Mark Zuckerberg himself believes, "In a world that is changing really quickly, the only strategy that is guaranteed to fail is not taking risks."



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...but we can give you the opportunity to plant the seeds of your own success!

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First you must grasp a good understanding of basic market mechanics. Trading with trend lines for example is not rocket science, and is more akin to simple geometry - it does not take a genius to draw a line on a chart. Momentum ndicators require a few more brain cells, but any 10 year old can be taught to recognise a divergence of momentum indicator and price.

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BY EVIL KNIEVIL (AKA SIMON CAWKWELL)

THE BEST OF THE EVIL DIARIES

A big man with a bigger reputation, Evil Knievil famously made £1 million by short selling shares in Northern Rock during its collapse. He also uses his knowledge and experience to buy shares, often resulting in the same devastating effect.

At least three times a week, Evil provides his thoughts and musings on the markets. Now writing EXCLUSIVELY for Master Investor Magazine at http://www.masterinvestor.co.uk/category/evil-diaries.

He doesn't just pontificate on the financial markets in The Evil Diaries; he also comments on politics, current affairs, his favourite horses/sports bets, and the occasional film and book review thrown in for good measure. Here we take a look back on the highlights of Evil's diaries in the month of December.

3rd December

Cameron was a bit OTT calling Corbyn a terrorist-sympathiser. Of course, strictly speaking, Corbyn is just that – consider his form in relation to the IRA. But that was because he is sympathetic to Irish nationalism and its political consequences and, in any event, HMG had to and indeed did talk to the IRA. But he is not a terrorist sympathiser in relation to ISIL. He has merely misjudged the business in hand such that he invites the label.

Of course two points now arise: (i) it is unclear what the outcome of our campaign in the Middle East will prove to be; this is an unhappy result even if it is inevitable; (ii) Corbyn is right that one day we will have to talk to these lunatics but, since no one has any idea as to whom or where or when with what authority he would be wiser to keep schtum; he is however unwise.

8th December

I reckon my family owns circa 2m **Polo (POL)** which cost about £200,000. So I yesterday grasped the opportunity to meet Michael Tang, the Chairman & CEO at The Grosvenor Hotel. I told him that he is either a crook or an idiot. For some reason he did not warm to this categorisation.

However, I asked him how many shareholders there are in Polo. He did not know – this is quite ridiculous. I also asked him why he kept the Johannesburg office open and he invited me to ask Steve Dattels, whom I know and from whom Tang bought de facto control three years ago. This made and makes me angry.

There are real problems here. I would like to go into this company and sort it out. But a BVI company (i.e. Polo) cannot be boarded with less than 30% of the votes in one's pocket. This enrages me.

10th December

I am told that **Watchstone (WTG),** formerly Quindell, are in Court this afternoon with a view to getting permission to distribute the 90p a share as scheduled in the RNS of 9th November. I can't see such permission being denied. So I bought another 50,000 WTG at 97p. I do not know how Hymex and Ingenie are going. But I trust the new board to get it right. At a guess the residue of WTG is worth 30p a share.

*****

"THERE ARE REAL PROBLEMS HERE. I WOULD LIKE TO GO INTO THIS COMPANY AND SORT IT OUT. BUT A BVI COMPANY (I.E. POLO) CANNOT BE BOARDED WITH LESS THAN 30% OF THE VOTES IN ONE'S POCKET. THIS ENRAGES ME."

Mulberry (MUL) today reported its half year figures to 30th September. The figures are pathetic. MUL is capitalised at £560m and is probably worth a third of that at most. However, it is quite another proposition that the share price will go there. This is because it is being rigged. I decline to say by whom since the law of defamation does not permit me.

*****

Finally, Fergus Wilson and his wife are chucking out their £250m buy-to-let portfolio to a grouping of Indian and Chinese investors. I bet Fergus will get the better of this bargain.

15th December

I/my family own c. 250,000 **Watchstone (WTG).** Latish yesterday it emerged that a firm of solicitors, styled Your Legal Friend (hem hem), have submitted a claim against Watchstone for, essentially, the consequences of the actions of a previous board. WTG advise that the claims come to £9.4m and that they will in any event be vigorously defended and do not affect the payout schedule of 90p on 31st December. This leaves WTG stunningly cheap at 95p. As an experienced investor remarked to me, the timing of this letter from YLF is to achieve maximum effect and that it should be treated as a cappuccino – i.e. largely froth.

*****

Yesterday, as I scanned the RNS's, I was surprised to encounter a disclosure of University College Oxford's accounts. This is a charity and, therefore, I thought it very unlikely to feature in a stock exchange announcement. However, it transpires that Univ borrowed £40m in April 2015 at 3.08% p.a. for fifty years. Whoever arranged that must be awarded dining rights for life. It is not that Univ's credit rating is in doubt (I am sure it is not). It is that nobody in their right mind would lend to anybody on that basis – including HMG. And the latter can print the stuff to get out of a hole. Which no doubt it will.

"FERGUS WILSON AND HIS WIFE ARE CHUCKING OUT THEIR £250M BUY-TO-LET PORTFOLIO TO A GROUPING OF INDIAN AND CHINESE INVESTORS. I BET FERGUS WILL GET THE BETTER OF THIS BARGAIN."

Incidentally, the costs of setting up the loan, borne by Univ, were c. £500,000. I cannot begin to imagine how it is possible to spend that much. It must be the lawyers involved since only a lawyer can dream up this sort of bill.

16th December

I do not read the Guardian. It's a habit thing. So I cannot quote the recent coverage of how naughty The Mashley is. But, for the life of me, I cannot see what he is doing which is unlawful. Were I a worker summoned by Tannoy or asked to strip so that I could be searched so to control pilfering I would pack it in. But, seemingly, the workers at **Sports Direct (SPD)** do not pack it in. End of. Does this mean that one should buy SPD? Dunno. But, if its recent decline is down to the Guardian, it'll bounce back up. Now 570p.

18th December

I am chasing up Shore Capital as to what is going on by way of management charges relating to **St Peter Port Capital (SPPC).** Graham Shore says that Shore Cap owns 5.6m shares or, currently, or c. £1m worth given SPPC's share price of 18p. (This contrasts with the NAV of perhaps 40p as computed by PwC: it is the NAV that, I think – Graham Shore has yet to reply – determines the management fee.)

However, that stake's value needs to be set against the fee charged. Hence my enquiry.

Mr Shore advises that, amongst other achievements, Shore Cap has "flown" to Panama and met with representatives of the relevant ministries (unfortunately, as he discloses, with not

much progress to date). The mode of travel is odd since he presumably goes from Shore to Shore and would therefore understandably be expected to use a rowing boat.

I tried to get hold of the chairman. But he was not available. I find all this extremely tiresome.

21st December

I tried to get stuck into **Watchstone (WTG)** first thing this morning. I was half hoping for 100p in contrast to the 70p at which they were suspended last week. In the event I paid as much as 197p. I did so reckoning that these are worth 300p right now and in due course 500p and possibly more.

My reasoning is that at 175p WTG is worth c. £80m. This contrasts with (see RNS of 9th November) with retained cash of £90m, cash in escrow £55m, "contingent collections" of £40m and perhaps as much as £175m in the US unquoteds, Hymex and Ingenie. These total £360m or at least four times the current price.

"I TRIED TO GET HOLD OF THE CHAIRMAN. BUT HE WAS NOT AVAILABLE. I FIND ALL THIS EXTREMELY TIRESOME."

However, I am emphatically told that I am wrong in that the unquoteds are worth zero "since they are frauds", the £55m escrow cash will never be paid (there is no evidence that such a result will eventuate). And the contingent cash will never be paid over. etc. etc. not least that Your Legal Friend is a serious operation and will collect considerably more than the £9.4m declared by WTG.

In the light of the intemperate manner in which this assembly of counterclaims was offered, I favour my reasoning as expressed above.

Finally, believe it or not, Charles Stanley's compliance department rejected my buy orders at 166p since in their opinion WTG is a "complex instrument". WTG may be complex for them since I have long established that this department is exclusively staffed by idiots. But for other people on this earth, WTG is very easily understood. Anyone disagree?

23rd December

You could knock me over with a feather but, astonishingly, the arbitration court has ruled against **Oxus (OXS).** Well, that's £60,000 down the drain. An uncertain business.

29th December

First out of the Christmas stocking was a copy of Sir Kingsley Amis's Everyday Drinking. This was published in 2008 by his literary estate but comprises newspaper articles from another age perhaps about 1972 to 1985 and one can check this readily enough since he refers to the £1 bottle of wine or some such fantasy. Interestingly, he also refers to champagne priced at £6.50 which is not a lot less than current special offers at various supermarkets. Prices move in a mysterious way.

I can't here summarise this book. Save that I would say it has a lot of detail of a lot of drinks that would have knocked even me over within the first hour of a session – Sir Kingsley clearly took his subject seriously. The book is called Everyday Drinking and, as a result, the reader might suppose that he is considering ordinary booze at a modest price. Far from it: the title is derived from the fact that Sir Kingsley must have been flat out boozing every day to make sure he covered the ground. This is quite a different idea. Although I should add that he died relatively young since he obviously drank too much.

However – and I pass this on to readers since it is a vitally important snippet – he does stress that the Dry Martini when well done cannot be over-praised. The definition of "well done" for these purposes is partly a matter of taste and I have known purists who have brought into the mixing area a bottle of vermouth without actually taking the cork out. Certainly, I am reminded that if you are ever lost in a jungle you need only set out a table upon which you are overtly mixing a Dry Martini and, for sure, a voice will emerge offstage declaiming that That Is Not How To Make A Dry Martini – whereupon one traipses back to civilisation.

Whatever. Sir Kingsley mentions that that supremely successful capitalist and stock operator John D Rockefeller rated a Dry Martini his favourite drink and lived until he was 98. So one should not hold back on health grounds.

Finally, I had thought that one could get a copy of Everyday Drinking for virtually nix on Amazon. But, au contraire, you'll have to cough up a bit more. Still well worth it.

30th December

I yesterday bought **Pantheon (PANR)** at 148p since the bull case is that their prospect in East Texas is worth 200m barrels of oil or equivalent net to Pantheon. I well remember Andy Brough of Schroders telling me some years ago that with oil shares one can never tell just how much oil is really there – despite (perhaps because of) the explorer in question being insufferably bullish. However, the flow rates for Pantheon will shortly be published and, apparently, the management's best estimate is that the oil is there and will cost less than $1 to lift. The pressure is so great that pumping will not be required.

Inevitably there will be a fund-raise (of perhaps $20m) around current levels. But Pantheon is capitalised at £285m and is well able to absorb the placing. This should be taken up by institutions, none of whom are yet involved. I do not know who will do the placing: Investec? Cantor?

DECEMBER 2015

BEST OF THE BLOG

The Saudis want everyone to go bust

It would seem that the Saudis want everyone to go bust in their attempt to tear down the shale oil revolution, only to push oil prices back up again in future. But do they still have control of this market? Judging by the persistent weakness observed in the market, it seems that everything is falling apart, including Saudi Arabia.

Oil prices just hit a low not seen since the peak of the financial crisis (in February of 2009). If the trend remains in place, the market will soon settle at 2004-2005 prices. On one hand, this is exactly what the Saudis want, in order to regain their market share and push other producers out of the market; on the other hand, given that the worst of the recession is behind us and that a price near $50-$60 would already be below the marginal costs faced in many oil exploring areas, one could question whether such low prices are just the result of OPEC's output decisions or whether they hide other developments. Saudi Arabia's task has been easier than first thought due to a mix of international developments. Unlike what happened in 2009, when oil prices were boosted by a declining US dollar driven by the FED's massive asset purchases, this time there's no QE and the interest rate is on the verge of being hiked. Anticipation of this event alone has been driving the dollar higher, which has had a negative impact on com-

“UNLIKE WHAT HAPPENED IN 2009, WHEN OIL PRICES WERE BOOSTED BY A DECLINING US DOLLAR DRIVEN BY THE FED’S MASSIVE ASSET PURCHASES, THIS TIME THERE’S NO QE AND THE INTEREST RATE IS ON THE VERGE OF BEING HIKED.”

modities prices in general, and of course on oil in particular.

While a change in US interest rates should have a direct negative impact on oil prices, the final effect is usually positive. The reason for this is the fact that a rate hike usually comes at times when the economy is improving. A rate hike usually comes with higher aggregate demand, which should boost the appetite for energy products, as suppliers attempt to increase production to fill the higher demand for their products. But this time, not even an improving US economy has been able to pare oil losses. Many say that the excess oil production has been so large and for so long, that stocks are piling up everywhere and more than offsetting the positive effect stemming from aggregate demand. But that may be just half the story.

By Filipe R. Costa

Click here to read the full article

"USING THE IDEOLOGY OF IBN ABDUL-WAHHABI, IBN SAUD HELPED TO ESTABLISH THE HOUSE OF SAUD AS THE PRE-EMINENT DYNASTY IN THE ARABIAN PENINSULA."

War on Terror II: The Janus-Faced Kingdom

In 1744 in the Arabian city-state of Al-Diriyyah, a prominent Muslim cleric by the name of Muhammad ibn Abdul-Wahhabi came to Muhammad ibn Saud, the emir, asking for protection. This was granted and the two decided to ally themselves. Ibn Saud, from whom the current rulers of Saudi Arabia are descended, endorsed Ibn Abdel Wahhabi's ideas about cleansing Islam from various heresies which had gained currency and to restore the religion of the Prophet to its purest, and most austere, form.

Their alliance was formalised by the wedding of Muhammad bin Abdul-Wahhabi's daughter to Abdul Aziz, son and successor of Ibn Saud. Since that time, the two families have remained intimately linked. Today, The Al ash-Sheikh, Saudi Arabia's leading religious family, are the descendants of the al-Wahhabi, and have historically led state-sanctioned religious congresses and dominated Saudi Arabia's clerical institutions.

Using the ideology of Ibn Abdul-Wahhabi, Ibn Saud helped to establish the House of Saud as the pre-eminent dynasty in the Arabian Peninsula. The use of religion as a keystone of political legitimacy was new: previously martial valour and wealth prevailed. Over time, the House of Saud attracted allegiance from most of the neighbouring clans.

By October 1916, when one Captain TE Lawrence *(Lawrence of Arabia)* landed in the Arabian Peninsula with instructions from the British high command to foment rebellion against the Turkish (Ottoman) Empire, Feisal ibn Saud emerged as the natural leader of the Arabs. Backed by British guns and money, Faisal became King of Iraq in 1921.

Assisted by Lawrence, the Sharif of Mecca, Hussein bin Ali, led a pan-Arab revolt against the Ottoman Empire. Although the Arab Revolt of 1916 to 1918 failed in its objective, the Allied victory in World War I resulted in the end of Ottoman control in Arabia.

By Victor Hill

Click here to read the full article

Can Shell maintain its dividend?

Royal Dutch Shell's remarkable build up of cash, and the strength of cash flow in relation to dividend cost, suggests that Royal Dutch dividend bulls have a rational argument to support their bullishness.

Sometime in the summer of 2014, the share price of the Royal Dutch Shell Group rose a bit above 2,400p – like the lark ascending – briefly gliding in the clear air of new share price territory. Then, without indication or warning – no 'double top' or anything of that sort – began its long descent to a share price of 1,463p last seen!

There, it appears to be on an annual dividend yield just under 7.7% and a market 'short selling' rating that is registered as 'low'.

As we all know, a dividend yield at that level, suggests that the market believes that the dividend payout will be cut. The Chief Executive of Royal Dutch Shell persists in being bullish about the dividend and notes that he has considerable cost cutting to do that will assist him in that objective and buttress the dividend payout.

We know what has happened externally to the share price! But what has been happening to the company's inside financial fundamentals, bathed in the lurid, yellow glow of the stage footlights, dramatically highlighting the collapse of the price of oil and gas? Are these internal indicators as awful as the outside share price that has fallen around 40% from the 2014 summer share price high point? And what does the market, in consensus of estimates, hazard as its guess of earnings and dividend prospects now?

For example, what has happened to the company's holdings of balance sheet cash and 'near cash' (as near liquid assets were also known in my youth)?

By Robert Sutherland Smith

Click here
to read the
full article

Winners and losers: The best and worst funds of 2015

Trustnet Direct, the retail investment platform from FE, has recently published a list of the best and worst performing UK unit trusts and OEICs in the first 11 months of 2015. There are more than 4,000 of these funds to choose from and the divergent returns shows what a significant difference your investment decisions can make to your portfolio.

"TWO OF THE TOP FIVE FUNDS OF 2015 INVEST IN THE JAPANESE STOCK MARKET, WHICH HAS BENEFITED FROM A MASSIVE PROGRAMME OF QUANTITATIVE EASING."

Two of the top five funds of 2015 invest in the Japanese stock market, which has benefited from a massive programme of Quantitative Easing. In both cases the managers added significant value as the main Nikkei 225 index only made a total return of 15% over the period. They did this via their stock selection decisions and the ability to hedge the currency.

Another top performer was **MFM Techinvest Special Situations,** a UK small cap fund that was up 33% over the 11-month period. It has an unusual and concentrated portfolio with the 10 largest holdings accounting for 34% of the overall weighting and has just £7.1m in assets under management.

The other two most successful funds are also both highly unusual. **Natixis H2O MultiReturns** is an absolute return fund that invests in bonds, equities and currencies with the aim of outperforming GBP LIBOR by 4% per annum over rolling 3-year timeframes. It has made its money by shorting US bonds to benefit from higher interest rates, while also going long the dollar for the same reason.

Premier ConBrio Sanford Deland UK Buffettology is a UK fund with a concentrated portfolio where the top 10 holdings account for 53% of the assets. The managers look for businesses with predictable and consistent earnings, enduring franchises with pricing power, strong free cash flow, strong balance sheets and a high return on capital employed. It has just £21.2m in assets under management.

The five funds at the other end of the spectrum have all been badly affected by the slump in commodity prices caused by the slowdown in China and strong dollar. A couple of them invest in Brazil, a country that relies to a large extent on oil and other raw materials and has been embroiled in a number of high profile scandals. Another holds small oil producers, while the other two provide exposure to mining companies.

By Nick Sudbury

Click here
to read the
full article

BY RICHARD GILL

READ TO SUCCEED – A BOOK REVIEW

THE ART OF EXECUTION

HOW THE WORLD'S GREATEST INVESTORS GET IT WRONG AND STILL MAKE MILLIONS

BY LEE FREEMAN-SHOR

Fund management is a funny industry. Numerous studies over time have shown that professional investors in charge of actively managed funds consistently fail to beat their benchmark. In other words, they don't do what they are paid to do. One of the most recent studies in this area, carried out by S&P Dow Jones Indices, found that nine out of ten actively managed European equity funds have underperformed in the past decade.

There aren't many other industries where such failure to deliver would be tolerated. A doctor who only correctly diagnosed one in ten patients wouldn't be employed for long. And a football manager whose team won 10% of its games would definitely be sacked – Jose Mourinho was recently given the boot after winning 40% of matches this season. Yet, despite the poor showing from active managers, trillions of pounds a year continue to be managed by and pumped into their funds. The Art of Execution, written by fund manager Lee Freeman-Shor, begins with this theme.

Best ideas, worst performance?

As a manager at Old Mutual, Freeman-Shor ran the "Best Ideas" fund. The rationale was that it should be easy to make money by asking the best investors to invest in their best ideas. Freeman-Shor gave 45 such investors between $20 million and $150 million of the fund's money with the strict instruction that they only invest in their ten best stock ideas.

> **"NINE OUT OF TEN ACTIVELY MANAGED EUROPEAN EQUITY FUNDS HAVE UNDERPERFORMED IN THE PAST."**

The result? Most individual investments actually lost money. The stats showed that only 49% of what were supposed to be the "very best" investment ideas actually turned a profit. And some investors were only successful 30% of the time – a success rate worse than betting on red at a roulette table.

Yet, here comes the twist. While most *individual* investment ideas lost money, *overall* almost no managers were in the red. In fact, most made a lot of money. So the question is: how could these managers still be making money if most of their ideas turn out to be wrong? The answer: The art of execution.

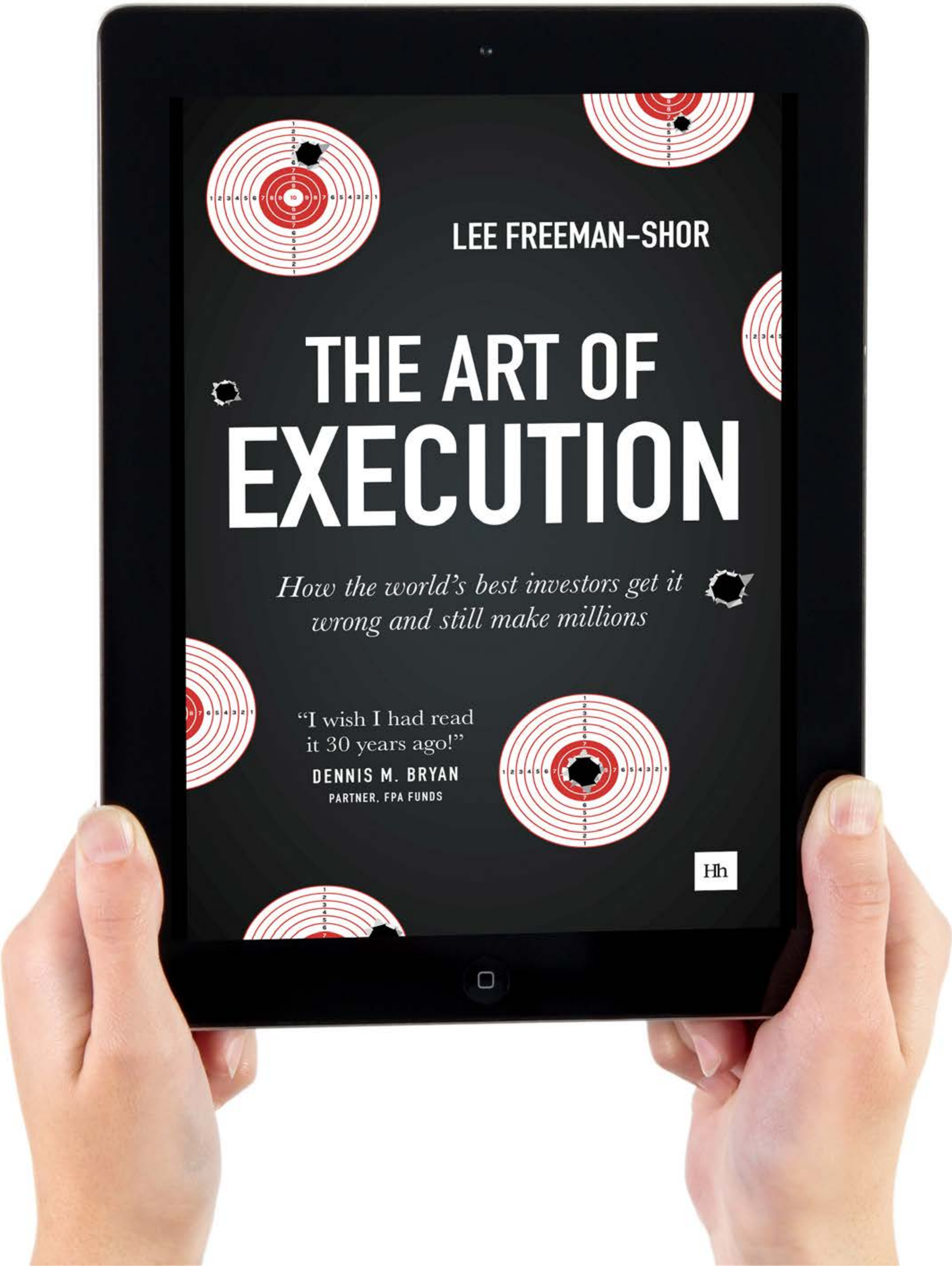
Execution, execution, execution

The term "execution" referred to in the book does not relate to a grizzly death. In this context we are talking about exactly how investment ideas are put into practice and managed. The main thing we are talking about here is money management. As legendary investor George Soros once said, *"It's not whether you're right or wrong that's important, but how much money you make when you're right and how much you lose when you're wrong".*

The main body of the book runs on this theme, being divided into two sections, one focussing on what to do with your money when your investments are doing badly and the other on what to do when they are going well. The analysis is based upon a review of 1,866 investments, involving over 30,874 trades.

Rabbits, Assassins and Hunters

In Part 1, focussed on how to act when you are losing money, we are introduced to three different "tribes" of


LEE FREEMAN-SHOR
THE ART OF
EXECUTION
How the world's best investors get it wrong and still make millions
"I wish I had read it 30 years ago!"
DENNIS M. BRYAN
PARTNER, FPA FUNDS
Hh

investors. Each tribe consists of individuals who acted in a similar manner.

The **Rabbits** are the least successful of the investors encountered by author – unfortunately all remain anonymous, which is no fun as many are said to have been big names in the City and Wall Street. This tribe had the habit of digging holes for themselves which they never get out of, doing nothing as their investments plunged in value.

Our bunny friends in fact had a lot of human flaws, especially behavioural finance related biases and failings. Most readers will probably admit to making these investing mistakes from time to time – for example, buying glamour stocks, becoming emotionally attached to an investment, blaming others for their losses, being afraid to realise a loss, and many others. Overall, they were too afraid to take action and suffered from it as their bad investments continued to plunge in value. You could say that they got caught in the headlights.

> **"THE ASSASSINS WERE VERY GOOD AT KILLING THEIR LOSING POSITIONS IN ORDER TO PRESERVE THEIR CAPITAL."**

Fortunately there are some simple rules that Rabbit like investors can put in place to keep themselves out of trouble. Most important of these is the one exhibited by a better performing tribe – the **Assassins.**

Following Warren Buffett's main rule of investing (never lose money) **the Assassins were very good at killing their losing positions in order to preserve their capital.** They had hard rules which told them what to do if a stock fell below a certain level, usually between 20%-33%, then sold out (using stop losses) without any emotion. Recognising the other key rule, "time is money" the Assassins also sold out of stocks if they were down by any amount of money and the investment showed no sign of recovery after a certain period of time.

In contrast to the above two tribes, but also being successful, are the **Hunters.** They didn't stand by and do nothing as their investments fell, nor sell out as things got bad. In fact they bought more shares as the price went down and profited as it went back up – benefiting from the process known as "averaging down". You may think that this strategy is in contrast to the advice given to the Rabbits. But the difference with the Hunters is that they were mainly in value stocks which recovered over time. They also spread their investments out over time and didn't go all in at the outset like the Rabbits did – thus benefiting from a well planned and well executed strategy. You'll learn more in the book about exactly how they did it.

Raiders and Connoisseurs

Part 2 covers what investors should do when their investments are in profit. Of course being in a winning position is a lot better than being in a losing one. But how you act is just as important.

The first of the two tribes we meet in this situation are the **Raiders** – those who took a small profit on their investments as soon as they saw fit. While they ensured they made at least some return on their investment they could have made a lot more by running their winners. One investor thought he was clever by banking a 15% gain in just a month but rued the decision as it went on to more than double in value. Again, like the Rabbits, the Raiders suffered from psychological biases such as poor self-control, fear of making losses and short-termism. Overall, Freeman-Shor's analysis showed that holding on would have resulted in much bigger gains. After all, **selling small winners means you can never have big winners.**

Then again we have the **Connoisseurs,** the most successful investor type encountered by the author. This is interesting given that their hit rate was the worst amongst all the tribes – six out of ten ideas lost money. But when they won, they won big. How did they do it? One of their techniques was to buy quality companies – those which they thought had a low chance of delivering negative surprises – with a view of holding for ten years or more. Another was to look for stocks with large upside potential, so that when they won, they won big. To increase their odds of hitting the jackpot they also built up big positions. Perhaps most importantly of all they held on to their winners.

> **"SELLING SMALL WINNERS MEANS YOU CAN NEVER HAVE BIG WINNERS."**

To sum up, the final brief chapter provides a useful checklist of the five best habits of winning investors, alongside a list of the five worst habits of the not so successful managers.

Conclusion

The Art of Execution is unique in the investment literature in that it doesn't teach you how to find investment ideas or how to value stocks. That is interesting given that the investment industry spends a lot of time on idea generation. Instead the book advises and guides the reader as to what they should do *after* they have made an investment, depending on certain circumstances. The principles are often driven by investment theory and supported by interesting and detailed examples from the author's experience.

Some may argue that Freeman-Shor cherry picks data to back-up his arguments and also ignores some concepts of portfolio theory – i.e. losing positions may not have been sold as other stocks in the portfolio may have been doing well. But the overall message is clear – the best investors make money because they get rid of their losers more quickly and let their winning ideas run. Overall, The Art of Execution is a great complement to the retail investor's library.

FAST FORWARD

The Technologies & Companies Shaping our Future

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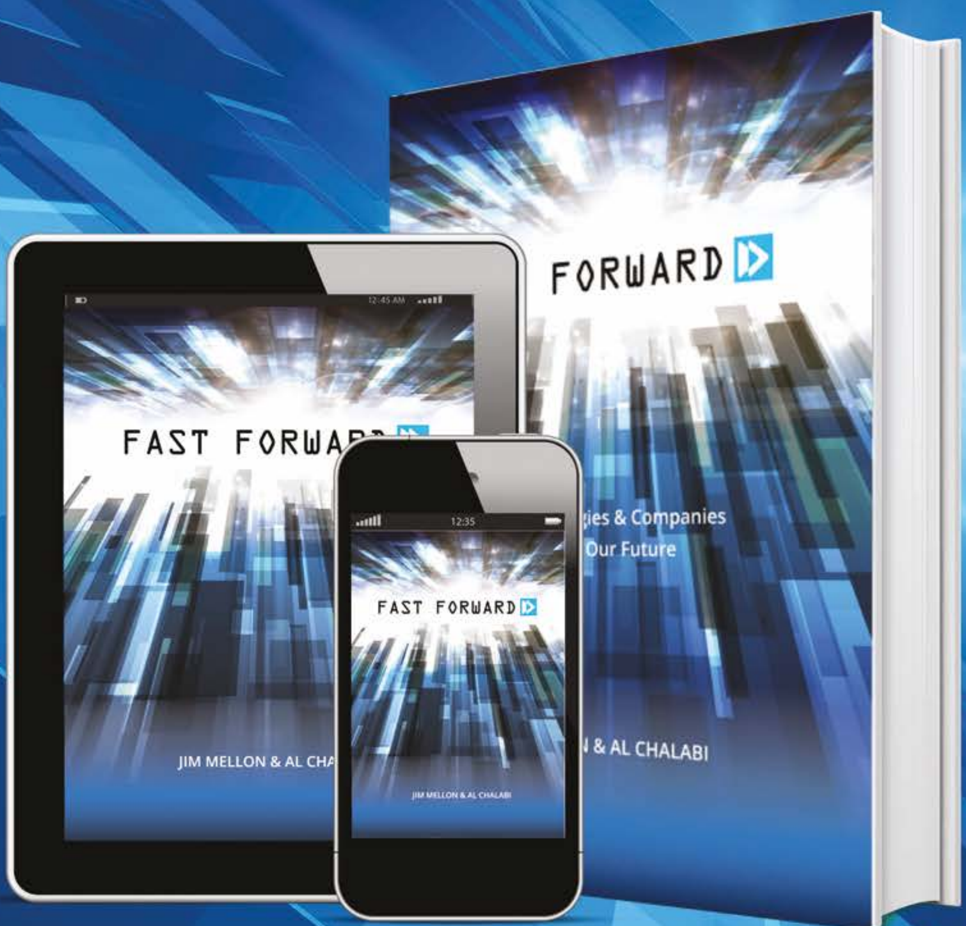

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BY ADRIAN KEMPTON-CUMBER

THE FINAL WORD

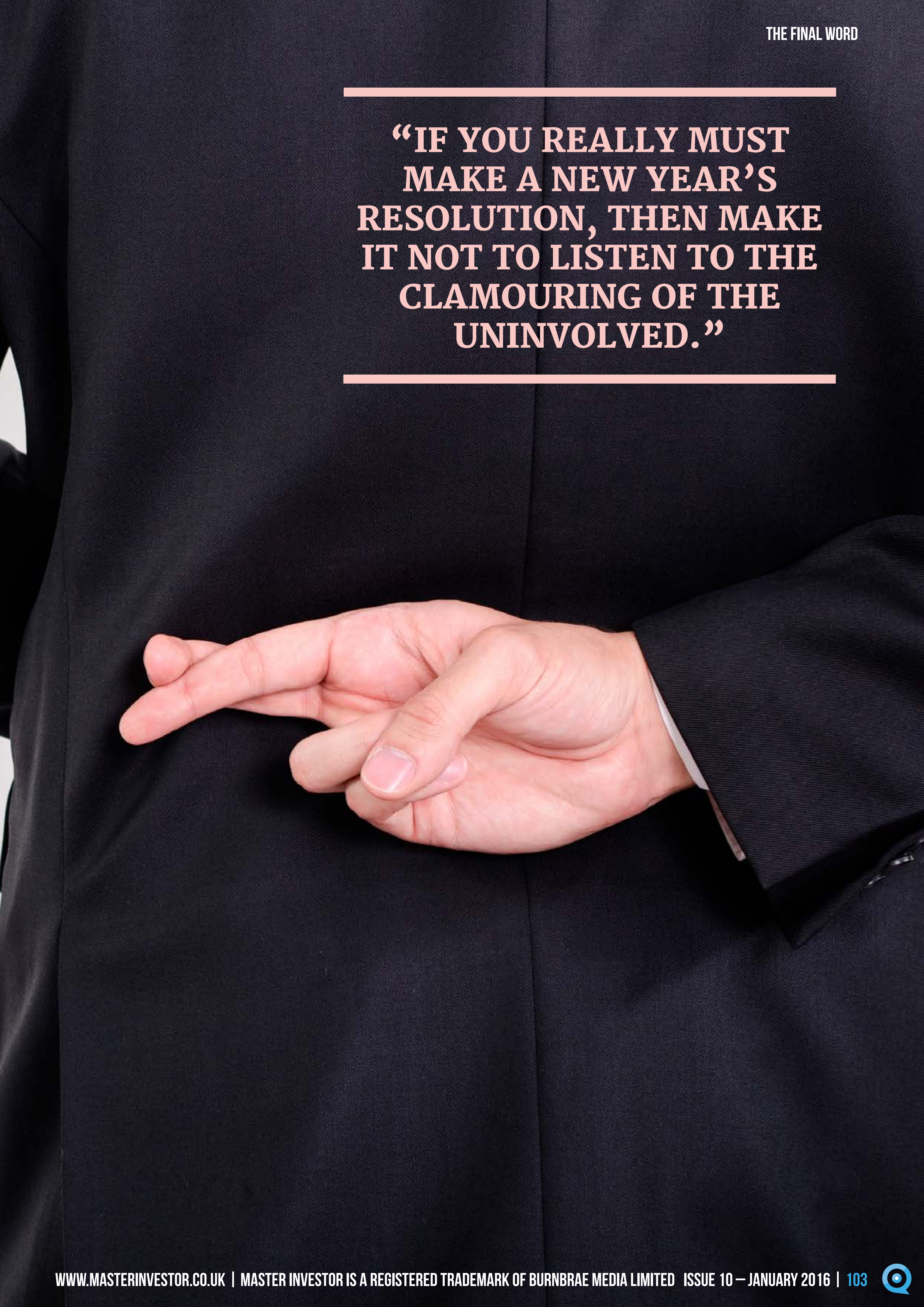
ETHICAL TRADING

A word I hear bandied about a lot these days is 'ethical'. It's become the uberzeitgeist of the holier-than-thou unrealistic expectations department, where putting appearances before profit is what led to the VW emissions fraud. A few years ago I did an exercise based on a trading idea I'd had. It crossed my mind that if there were such a thing as an 'ethical' company then surely it would be less profitable than the average, poncing about, as one imagines they must, with all sorts of unnecessary exercises at great expense. At the other end of the scale, surely the least ethical would be more profitable on average.

I set about collating information on the most and least ethical companies. It turned out there were companies which published lists of them, making my job that much easier. The lists are global so I quickly realised the only subset in decent enough numbers for a statistically relevant dataset was US companies. This would mean I'd have no concerns over currency differences or regulatory inconsistencies. All companies would be subject to the same conditions over the same period.

My idea was to go short ethical and go long unethical. I created my own indices of the most and least ethical companies and I then compared them to the main US indices. What was astonishing then was that it made little or no difference – both indices pretty much tracked the market.

I've repeated the exercise for the latest published ethical companies list from an outfit called Ethisphere, who don't seem to have an 'unethical' list. (Maybe they thought it was unethical?) They issue these lists each March, and again I've isolated the US companies. There are about 70 of them in both the 2014 and the 2015 lists, with a few in and out, but mostly the same companies. The current list, out on 19th March 2015, is not yet a year old (10 months at time of writing). The previous list is from 20th March 2014. A table below shows the results based solely on stock prices on those dates for the 'ethical' companies and also the Dow Jones.



"IF YOU REALLY MUST MAKE A NEW YEAR'S RESOLUTION, THEN MAKE IT NOT TO LISTEN TO THE CLAMOURING OF THE UNINVOLVED."

	2014-15	2015-16	2014-16
US 'ethical' companies	8.00%	-13.48%	-6.56%
Dow Jones Industrials	10.71%	-8.98%	0.77%

It wasn't such a washout this time, but the ethical companies are now underperforming as I'd originally imagined. What may surprise you is some of the companies that make the list. It illustrates nicely the utter futility of 'morals' and 'ethics' *per se*.

Starbucks is a regular 'honoree', as they call them. I'm sure most Brits wouldn't consider Starbucks to be an ethical company. Some companies don't get into my index because they are either not listed on the US exchanges, or they are part of a larger concern which has been overall excluded from the list. Representing the latter, the cruise companies Holland America and Seabourne are both in the list itself. How ethical it is to even run cruises, much as cruising is certainly one of my favourite ways to holiday, is a matter of debate. Some may be surprised to know that Koch Industries made the list in 2007.

And that's the point isn't it really? What is ethical? And the answer is ethical is a moving goalpost. Ethics, and morals for that matter, vary from person to person and from day to day and from place to place. That is the unfortunate fact for politicians who wish they were constant, and religious leaders who claim they are absolute. It is the reason that so-called civilised societies find cohesion in marginalising certain demographics – for example, bankers, drug dealers, terrorists, the 1%. In the past it included such groups as homosexuals, any number of foreign nationalities, fascists, communists, witches, and so on. Hating this marginalised group allows society to feel they are as one, and ignore the fact that most of them don't share the same ethics on very important issues.

An ethical profit-driven company would seem to be something of an oxymoron. I suspect that it's all rather like 'greenwash'. Greenwash relates to the superficial or misleading efforts made by companies in the guise of caring about the environment. There must be an ethical equivalent. How about 'Fair Trade Wash'? Or 'sweet ethic-al', as in "they're doing sweet ethic-al about xyz"?

Ethics would appear to be the luxury of the smug uninvolved individual. Ethical committees seem to hold back scientific advances in a tribute to the Luddites. It doesn't seem to be a particularly helpful concept at all.

The very idea of an ethical investment is a joke. After all, for one person to gain, another must ultimately lose, which hardly fits the bill. It's interesting we associate sport with fairness, when it could be argued to be entirely unfair that one side or player must lose for another to win. Sportsmanship is actually rather Machiavellian. "Good luck!" say all the players, who then proceed to do everything in their power to make sure that 'luck' doesn't materialise.

When they taught us sports at school they said it was to nurture 'team spirit'. Why then, I thought, don't they teach team spirit using an orchestra, where the better everyone does, the better everyone does? That seems more like team spirit to me.

Ultimately, profit motivated companies are not meant to be ethical. Investing itself, upon which all commercial concerns rely, isn't ethical in the first place. You have to choose investments that allow you to live with yourself. Don't abdicate responsibility to a third party to decide Starbucks are ethical on your behalf, so you have deniability after the event, and then moan about them investing your money in Starbucks like some sort of pathetic ingrate.

Back in 2013 The Comic Relief charity got into hot water because of people doing exactly that. The charity pronounced that all the money donated would go to the cause and not be spent on admin. Obviously then, the money had to be invested for a period of time, in order to do the same magic that allows banks to offer free banking. People got all bent out of shape, especially when it turned out their fund management team had invested in tobacco companies, while the charity itself had an active anti-smoking stance. Actually that's hilarious. It's poetic. They also invested in arms and alcohol related stocks. Actually three sectors I've been keen on this last year. Looks like they knew what they were doing.

When you are choosing what to invest or trade in then, forget ethics, just think about what you're happy with yourself,

"AN ETHICAL PROFIT-DRIVEN COMPANY WOULD SEEM TO BE SOMETHING OF AN OXYMORON."

and do the due diligence accordingly. Sleeping soundly at night is the objective, not ticking some boxes made up by some pseudo-green, whingeing, Russell Brand-loving urban-cyclist with one child who's "not allowed to eat meat", and thinks that giving £3 a month to some charity advert off the tube makes them a philanthropist.

Most people will come out with all sorts of received opinions about how things should be, and how you should behave, according to them. But remember, broadly speaking, their narrative is not supported by action. In fact their second-hand ideology doesn't even make a whole. Don't be sucked in. If you really must make a New Year's Resolution, then make it not to listen to the clamouring of the uninvolved. The problem with people is that when they're freed from tyranny they simply invent some of their own.

So: short ethical, long the market.

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MARKETS IN FOCUS

DEC 2015

GLOBAL EQUITIES

Index	Last Month %	2015 %	Proximity to 52w High*
S&P/ASX 200	2.5	-2.1	
Hang Seng	-0.4	-7.2	
NASDAQ 100	-1.5	8.4	
Dow Jones	-1.7	-2.2	
S&P 500	-1.8	-0.7	
FTSE 100	-1.8	-4.9	
Nikkei 225	-3.6	9.1	
Bovespa	-3.9	-13.3	
DAX Xetra	-5.6	9.6	
Euronext 100	-5.8	8.0	
CAC 40	-6.5	8.5	
IBEX 35	-8.1	-7.2	
Russian Trading System	-11.3	-3.3	

COMMODITIES

Commodity	Last Month %	2015 %	Proximity to 52w High*
Platinum	7.3	-26.1	
Natural Gas	5.9	-19.4	
Sugar (No. 11)	4.0	6.0	
Copper	4.0	-25.9	
Iron Ore	3.9	-40.7	
Palladium	3.3	-29.4	
Coffee	2.4	-23.7	
Gold	-0.3	-10.4	
Silver	-1.7	-11.9	
Soybean	-2.0	-15.6	
Cocoa	-3.3	8.6	
Crude oil (Light Sweet)	-11.0	-31.0	
Crude oil (Brent)	-16.3	-35.4	

FOREX

Pair/Cross	Last Month %	2015 %	Proximity to 52w High*
EUR/GBP	4.6	-5.5	
USD/CAD	4.0	19.5	
EUR/USD	3.0	-10.0	
AUD/USD	1.0	-10.5	
EUR/JPY	0.7	-9.4	
EUR/CHF	-0.5	-10.0	
GBP/USD	-1.5	-4.8	
USD/JPY	-2.3	0.6	
GBP/AUD	-2.5	6.4	
USD/CHF	-3.4	0.0	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Jan 14	Feb 04
ECB	0.05%	Jan 21	Mar 10
FED	0.50%	Jan 27	Mar 16
BOJ	0.10%	Jan 29	Mar 15
SNB	-0.75%	Mar 17	Jun 16
BOC	0.50%	Jan 20	Mar 09
RBA	2.00%	Feb 02	Mar 01
RBNZ	2.50%	Jan 28	Mar 10
BOS	-0.35%	Feb 10	Apr 20
BON	0.75%	Mar 17	May 12

FTSE 350 TOP

Sector	Last Month %	2015 %	Proximity to 52w High*
Bwin.Party Dig. Ent.	25.3	10.0	
Micro Focus Int.	24.3	47.7	
Brewin Dolphin Hold	18.8	4.1	
AA Ltd	16.3	-10.9	
Circassia Pharmac.	16.0	14.5	

FTSE 350 BOTTOM

Sector	Last Month %	2015 %	Proximity to 52w High*
Vedanta Resources	-27.0	-52.1	
Anglo American	-26.7	-75.1	
Aveva Group	-26.2	23.1	
Entertainment One Ltd	-22.3	-40.1	
Int. Personal Finance	-22.0	-35.7	

FTSE 350 SECTORS TOP

Sector	Last Month %	2015 %	Proximity to 52w High*
Electricity	6.7	-10.1	
Health Care Equip	5.7	7.6	
Travel & Leisure	4.4	12.4	
Households Goods	3.3	28.8	
Software & Comp Serv	2.7	32.3	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	2015 %	Proximity to 52w High*
Forestry & Paper	-13.6	27.0	
Industrial Metals	-12.2	-52.6	
Mining	-8.0	-48.6	
Oil & Gas Producers	-6.9	-20.6	
Tech Hardware & Equip	-6.4	7.1