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# WELCOME



Dear Reader,

April is my team's favourite month, because it gives us a chance to meet the most important stakeholder of our company – you, the reader!

Every year, in spring, we organise what has by now become the UK's largest event for private investors. On April 23rd, approximately 8,000 of our readers will descend onto the Business Design Centre in London's Islington district.

For our readers, this is primarily a chance to learn how to improve their investment performance. For us, it's a chance to get first-hand feedback about our work and how we can best serve you during the other 364 days of the year.

**If you can join us on April 23rd, then please stop by at the booth of the Master Investor Magazine.** James Faulkner, our Editorial Director, will be hosting the stand. With him will be a selection of our most popular authors, all ready and eager to hear your questions, feedback and concerns. We have firm commitments from Victor Hill, Richard Gill, Robert Sutherland-Smith and Adrian Kemp-ton-Cumber. Their stand will be on the left-hand side of the venue right where you come in!

Besides meeting our editorial team, you'll have the chance to listen to a record-breaking 46 different presentations – more than double the 22 we hosted last year. On the main stage, you'll have six exciting speakers, of whom one is a regular star guest (Jim Mellon), whereas the other five haven't spoken at Master Investor before – with one speaker flying in from the US especially for the occasion.

There'll be more than 80 different companies with booths, the majority of which are listed companies that you can easily invest into by calling your broker. The remaining companies represent a carefully curated cross-section of alternative investments, investment services, investor media, and other relevant areas. We literally cover all angles! If you haven't signed up for your ticket yet, you can still do so [HERE](#).

Keep track of developments throughout the day of the show by following us on Twitter: [@masterinvestor](#) #MasterInvestorShow.

We are looking forward to seeing you there.

Best regards,

Swen Lorenz  
Editor, Master Investor Magazine



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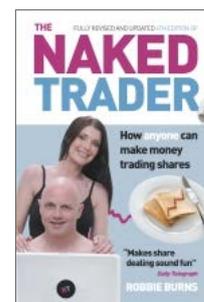
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BY JIM MELLON

# MELLON ON THE MARKETS

**I was going to write this piece in Brussels, but decided against going – and so I write from Hamburg. The incompetence of the Belgian police makes it difficult to feel safe in the city of waffles and Eurocrats, so I will defer visiting for a bit.**

When I made my decision not to go, it struck me that lots of others will be feeling the same; wary of Brussels, Paris, maybe even German cities. Surely this just adds more gravitational pressure to the downward trajectory of European "growth"?

The ECB's latest ruse to counteract the appalling economic malaise – one of its own creation – is to PAY banks to lend, to increase the amount of bond buying, and to widen buying of bonds to some corporate issuers as well.

Will the next step be to deliver so called "helicopter" money to the European economy? This basically means that the Central Bank would finance national treasuries by delivering newly created money to National Central Banks, without adding corresponding assets to its own balance sheet. This would be a crazy move – and one that would be highly resisted by the Bundesbank – and if badly done, or overused, would certainly lead to high inflation in due course.

But, of course, these are desperate times for the Euro Zone. Sure, Ham-

burg appears prosperous – although it was evident that a lot of migrants are hanging around the railway station with little to do.

But Hamburg isn't Athens, or Rome, or Lisbon, where times are as tough as they have ever been. And it isn't Paris, which on successive visits looks shabbier and shabbier compared to London.

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**“WILL THE NEXT STEP BE TO DELIVER SO CALLED ‘HELICOPTER’ MONEY TO THE EUROPEAN ECONOMY?”**

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The ECB is trying to counteract the zero productivity growth of its enslaved territories, the persistent and pernicious unemployment, and the excess savings which represent an

unwillingness to invest by pursuing what are, in my opinion, the wrong policies.

A modicum of QE was appropriate at the depth of the Financial Crisis; but today QE has more limited effects, and as above, helicopter money could just turn the whole of the Euro Zone into a type of Zimbabwe or Weimar Republic.

In what is now a *stagnation* crisis, the most important thing is to fix the banks – and that probably means recapitalising them with state or Euro funds. Euro Zone banks, in many cases, have high non-performing loans, inadequate capital, and even when bribed or cajoled into lending, can't find enough borrowers of quality to lend to.

The sectors that are best performing from a return point of view are generally unproductive, like real estate, or share prices buoyed by buybacks. This is because money is going to wherever there is a positive yield, without sufficient discrimination. Zombie companies are being kept afloat, while across the whole continent good companies are unwilling



*XXL Photo / Shutterstock.com*





to invest in new capital equipment because the returns on that equipment are just not compelling when external and domestic demand is so weak.

In those circumstances, the ECB should be focussing on delivering substantial capital to the banks and encouraging the immediate recognition of non-performing assets. At the same time it should *raise* interest rates, certainly above the zero bound, because without a proper cost of money, and *especially* with a negative cost, the wrong economic decisions are made. In those circumstances, even a Japan type slump lasting over more than twenty years would appear to me to be a good outcome.

But of course, the response of the arch Federalists at the ECB and the EU generally is to use a self-generated crisis to advocate ever closer union. But the European Union isn't Japan or the US; it has no common language, highly divergent levels of income, and stridently different national priorities. Herding fish into a common purpose just won't happen.

So in the meantime, the Euro Zone plods along, inching ever closer to its next and major crisis. I would imagine that the Euro itself will remain range bound, because Europe isn't the only place on earth that wants to lower its currency; it isn't the only place that has imposed negative rates to try to stimulate demand and inflation; and it isn't the only place that is trying to export its deflation.

More on all that at the Master Investor Show on April 23rd.

But in the meantime, what do we do? Well, as I keep on saying, shorting negative yield bonds (Bunds, Swiss and JGBs) is the best trade I have ever seen. If that's not possible for some investors, look at the other side of the trade. Gold and silver are moving up – and this is just the beginning.

If you impose negative interest rates on cash (i.e. tax it) you do two things: one, people look at hoarding money at home; and two, they look to genuine stores of value (gold is no longer the Barbarous Relic of John Maynard Keynes!).

And because ultimately the central banks will get what they want – inflation! (and probably not in a good way) – gold and silver will rise to reflect this.

I am always a bit wary of gold, because I prefer to invest in things that are not static, but on this occasion I am very bullish indeed.

I think you buy gold and silver outright, or look for a good play. **Fresnillo (LON:FRES)** in silver and a big gold

**“I AM ALWAYS A BIT WARY OF GOLD, BECAUSE I PREFER TO INVEST IN THINGS THAT ARE NOT STATIC, BUT ON THIS OCCASION I AM VERY BULLISH INDEED.”**

play like **Franco Nevada (TSX:FNV)** or **Barrick (TSX:ABX)**. There are smaller ones out there too, and I will talk about them at Master Investor.

Among markets, I am still most bullish on Japan; the yen will most likely be range bound, but the total aggression of the Bank of Japan in flattening the whole yield curve in negative territory will drive people to a yield based stock market strategy. I will have specific recommendations at the Show.

I also like some beaten up biotech stuff, including **Medivation (NASDAQ:MDVN)** and **Gilead (NASDAQ:GILD)**.

I hope to see you at the Show. We are closing at 10,000 delegates and every stand is sold. I imagine it is by far the biggest investment show in Europe. It's a great place to get ideas.

**Happy Hunting!**

**Jim Mellon**



[Click here to follow Jim's trades on Twitter](#)



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BY SWEN LORENZ

## AN INTERVIEW WITH

# PATRICK BIRLEY

## CEO OF ISDX

**Swen Lorenz:** Patrick, you run the ISDX, which when spelled out stands for ICAP Securities and Derivatives Exchange. In a nutshell, what does ISDX do?

**Patrick Birley:** We are a fully regulated UK based stock exchange offering an alternative venue for companies seeking access to public markets. Our history is that we evolved from the old OFEX and then Plus Markets which came about to ensure that companies were not faced with a monopoly provider of exchange services.

**SL:** Britain already has two well-known markets for equities, the London Stock Exchange and the Alternative Investment Market (AIM). The LSE owns AIM and they form a strong unit, with AIM basically providing a stepping stone for smaller companies who are not yet big enough to join the main board of the LSE. The ISDX has now come in as an "alternative to AIM", as you describe it yourself. Explain to us why ICAP, the City firm that owns the ISDX, chose to challenge the well-established LSE/AIM model?

**PB:** ICAP bought the former Plus Markets primarily because it held a RIE (Recognised Investment Exchange) licence that has the potential to be used in multiple asset classes and the Group may choose to leverage this ability at some future date. However, in the meantime, we are focused on developing our equity market offering and we have made good pro-

gress in the last year or so. It is worth pointing out that ISDX has a Growth Market (similar to AIM) and a Main Board (similar to the LSE) so we don't see ourselves as a stepping stone but rather as a partner that will remain loyal to issuers and remain able to serve their needs as they grow.

**SL:** How has the ISDX developed since ICAP embarked on the project?

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**“WE EVOLVED FROM THE OLD OFEX AND THEN PLUS MARKETS WHICH CAME ABOUT TO ENSURE THAT COMPANIES WERE NOT FACED WITH A MONOPOLY PROVIDER OF EXCHANGE SERVICES.”**

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**PB:** Initially we needed to make some adjustments to our rules and this saw a reduction in the number of shares quoted on our market. Subsequently we have re-written the rule books to simplify the admissions process and started engaging

much more extensively with the community in order to build trust. There have been a few 'false-dawns' in the previous guises of our market so this time around we have been keen to do the work first, and talk about it afterwards. Relationships with our community (mainly issuers, investors, advisers, brokers and market makers) have started to improve significantly and there is a strong sense that we are building something long term and worthwhile.

**SL:** The companies that have so far chosen to list on the ISDX are sometimes also listed on other markets. That in itself isn't unusual and happens with many equities around the world. However, if you're dealing with small companies and trading in their equities gets fragmented between different platforms, isn't that actually a disadvantage? How do you protect investors against oversized spreads and lack of liquidity? Isn't the very existence of the ISDX leading to a further fragmentation of the market?

**PB:** The market makers in ISDX stocks are generally the same as they are on AIM stocks. ISDX distributes data on their prices and trades to most data-vendors and the more advanced ones show a combined picture ensuring that there is a joined-up picture available. Many large-cap stocks trade on multiple venues (the end client is often unsure where their trades are concluded) so trading on two venues shouldn't create any serious issues. It might take some extra effort in





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**“WE DON’T SEE OURSELVES AS A STEPPING STONE BUT RATHER AS A PARTNER THAT WILL REMAIN LOYAL TO ISSUERS AND REMAIN ABLE TO SERVE THEIR NEEDS AS THEY GROW.”**

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the short term but we believe that there is real merit in having competition for trading.

**SL:** How can investors trade shares on the ISDX?

**PB:** Most brokers will offer to trade ISDX stocks but historically it has required a phone call to confirm the price. This has recently changed and most brokers should now be able to offer electronic execution through the RSP system in the same way as AIM trades. The system only went live at the end of March so some brokers may be slightly slower on the up-take. But give your broker a call and they should be able to help.

**SL:** Have there been a number of outstanding IPOs on your market yet? Which ones have proven particularly popular with your community?

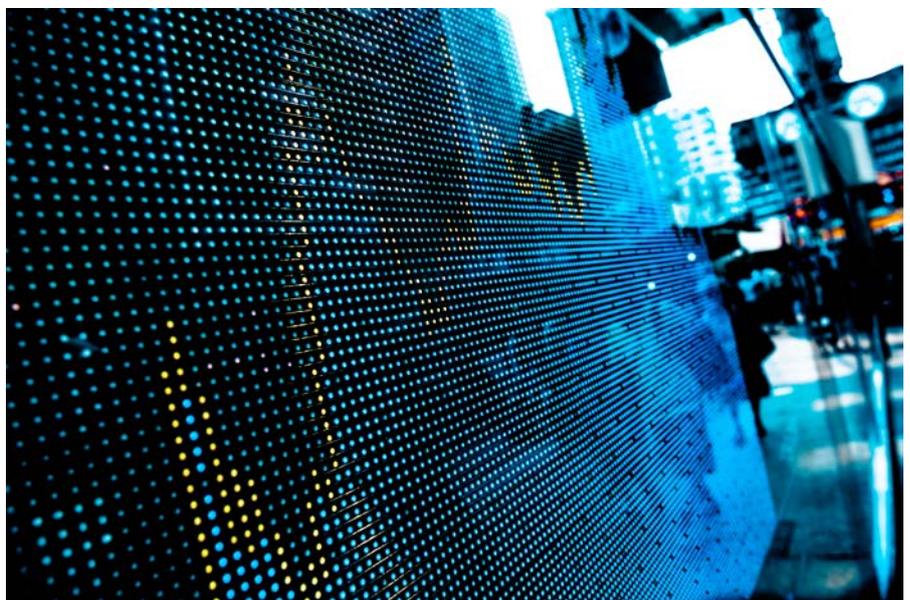
**PB:** We went from only two new clients in 2014 to 21 in 2015, of which 18 arrived in the last six months. It is always difficult to pick out any particular one but I suppose I am particularly delighted to have welcomed the first firm focused on Cuban investment (Lenigas Cuba) and the first quoted Blockchain company (Coinsilium).

**SL:** Another segment of the ISDX is the Social Stock Exchange (SSX). We already featured an interview with Tomas Carruthers, the CEO of the

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**“WE WENT FROM ONLY TWO NEW CLIENTS IN 2014 TO 21 IN 2015, OF WHICH 18 ARRIVED IN THE LAST SIX MONTHS.”**

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**SSX, in our last issue. Why did you choose to partner with them?**

**PB:** I met Tomas shortly after joining ISDX and was engaged by the social theme. I have been encouraged by a number of buy-side investors who are becoming increasingly thoughtful about long-term returns that combine financial and social and/or environmental outcomes so was keen to find ways to work with SSX.

*I believe that this has been a win-win arrangement so hopefully it is good for everyone!*

**SL:** I understand that during 2015, you and your colleagues quietly broadened the operation of the ISDX. You had two new listings in 2014, then 21 in 2015. Of the 2015 cohort, 18 were listed during the second half of the year. It seems that

# ICAP Securities & Derivatives Exchange

the ISDX has been gathering steam! Can you update us about what has been happening during 2016 so far? Presumably you'll be much more visible among the investment community from now on?

**PB:** *That's right – we've been keen to get things moving and then talk about them, which probably seems very old-fashioned! The last piece of the jigsaw was getting automated trading for private clients and with that starting to roll out, we feel it is time to raise our profile and you will hopefully hear more from us over the coming months. I should emphasise that we will continue to evolve our market and want to combine a traditional, customer orientated approach with some innovative twists so hopefully there will be plenty to talk about.*

**SL:** You will soon be presenting your entire story and your value proposition to our audience at the Master Investor Show. The ISDX is one of the show's biggest supporters and you will be speaking on our main stage. Any sneak preview on what the audience can expect to hear about from you?

**PB:** *We're looking forward to the show and particularly to meeting a wide range of investors. We are there to listen as well as talk! In terms of my session on the stage, I will simply be setting out our stall and letting investors know how ISDX operates and why we want companies to join with us as we grow.*

**SL:** There is also one ISDX-listed company in particular, Milamber plc, that you are bringing along to the Master Investor Show. They are a tiny firm, but they seem to have ambitious plans and exciting portfolio companies. Can you tell us what our delegates should be interested in when speaking to the Milamber executives on the exhibitor floor?

**PB:** *We recently held an event with Milamber at the ICAP offices in Broadgate and it was a great success with talking robots and all sorts of technical wizardry! Yes, they are small but they have some fantastic companies that they are work-*



## ABOUT PATRICK

Patrick Birley brings to ISDX over 25 years' worth of industry experience. During these 25 years, Patrick has held senior positions at a number of exchanges and financial institutions, including NYSE Euronext, the London Stock Exchange, LCH.Clearnet, the European Climate Exchange and the South African Futures Exchange (Safex).

Patrick's vision for ISDX is to create an exchange where companies can join a public market easily, cost-effectively, efficiently and, most importantly, with pride.

*ing with and everybody should make an effort to come and meet Milamber at the show.*

**SL:** Many smaller companies don't get much research coverage, if any. Another one of our exhibitors at the show is All Street, an independent research provider who are aiming to empower investors. Have they been covering ISDX-listed shares?

**PB:** *Getting high quality research in the small-cap space has been challenging but All Street are a great example of what can be provided at a very reasonable price.*

*Emma and her team have great energy and offer a straightforward service which should help companies get exposure amongst the investor community.*

**SL:** It sounds like 2016 will be an exciting year for the ISDX. We will probably be checking in with you for an update before the end of the year. Thank you for the interview, and we are looking forward to seeing you and your team at the Master Investor Show.

**PB:** *Thanks Swen and all best wishes for a successful show!*





BY ALAN STEEL

# WHEN I'M SIXTY-FOUR

## ALAN STEEL'S GUIDE TO RETIREMENT

**"Will you still need me, will you still feed me, when I'm sixty-four?"**

### The Generation Game

When you were at school were you in the worst class the teachers had ever come across? Funnily enough so was I. Imagine that. You and I both just happened to be in the worst classes our teachers had encountered. But do you know something? When comparing notes with those older and younger than me I discovered we were all being told the same. It was an early lesson that every generation is similar despite what we're told.

It was a trigger that led me much later to be fascinated by demographics. And the more you study the subject the more you realise that throughout history generations behave the same. We tend to think much the same at the various stages in our lives, and behave the same economically. We're tempted to invest the same way. No wonder. Our brains were wired over many thousands of years in dangerous Pleistocene savannah lands where sabre tooth tigers roamed. And to eat you

had to shoot lunch which sped past at a great rate of knots. That's why male brains are wired to focus, while female brains were wired so their spatial skills could keep their eyes on Daisy, Rebecca and Justin, while tidying up the cave and cooking what hubbie shot with his bow and arrow as it ran by.

Life wasn't very kind to contrarians back then. If you spotted a shadow in bushes which just possibly could belong to a sabre toothed tiger it wasn't a bad idea to run like hell before considering at a safe distance whether you were wrong or not. Experience told you it was a safer bet than saying, "hang on chaps maybe it's just a funny shape". That's how *you* ended up as lunch. So genes passed down from generation to generation were from the nervous and cautious majorities – hence our herd instincts as investors today.

It's not a winning combination... behaving during the various stages of our lives as previous generations do *and* being wired to feel comfortable only



within the herd. And that's why we're Born to Run, as Bruce Springsteen reminds us. As a consequence we buy and sell stock market investments at the wrong times. Carl Richards in the US puts it better than anyone else with his simple drawing showing two hills with a valley in between. On the first hill it says GREED/BUY, in the valley it says FEAR/SELL, and on the second hill it says REPEAT UNTIL BROKE. Quite.

There's no doubt that in my lifetime we've lived through the wealthiest period in history for most of us. Those like me who were born just after World War Two have had countless wealth building opportunities previous generations never had. Despite this, statistics show the average private pension

fund at retirement today lies somewhere between £28,000 and £50,000. Shocking!

Following George Osborne's latest Budget, which attracted before the event headlines predicting the end of pensions after too many years of political interference and broken promises, his latest wheeze, the so called Lifetime

ISA, has drawn widespread praise. Apparently, for the over 18s/under 40s, being able to invest from April 2017 up to £4,000 a year into a tax-free growth fund where HM Government will add a 25% bonus each year until you hit 50 will definitely encourage the next generation to start saving. Fat chance. You will only get people to change their ways when they experience disquiet from within, and when they truly understand the issues. Right now I'd say we're a long way from that.

## Where to Start

In 1975, when I was 28, having failed to become an actuary when they found I had a personality, and after a couple of years as an IFA, I started this company.





I had no pension rights. But it was by then possible for self employed/controlling directors to aim for the same maximum pension benefits available to PLC directors and employees. Basic rate tax was 35%. So every contribution to your pension pot was increased by 54%. All the growth rolled up tax free. And when the fund was ready to pay out a fair chunk was tax free too. Plus a guaranteed income for life was available at interest rates way into double figures. That's what you call a No Brainer. But most twenty-odd-year-olds were too busy spending and living for the day. I bet it's the same today. Demographics again. Plenty time after all. Mmm.

So despite the constant developments in investment products over the years, the lowering of costs, the never ending tinkering with pension laws and taxes, and the ever changing economic conditions, I'd say planning for retirement hasn't actually changed that much. People still wait far too long to start and then sit in the middle of the cautious herd. Like the frog that sits contentedly in slowly warming water they only notice their error when it's far too late. So what do you do?

First of all you need to have a goal – the earlier the better. Next you need to understand the difference between investments and deposits. Then it makes sense to get as many tax breaks as possible on your side. And despite what Osborne said on Budget day

## “STATISTICS SHOW THE AVERAGE PRIVATE PENSION FUND AT RETIREMENT TODAY LIES SOMEWHERE BETWEEN £28,000 AND £50,000. SHOCKING!”

about having to understand maths, all you actually need is the Rule of 72. Basic arithmetic sexed up slightly.

Einstein called it Compound Interest when he named it as mankind's best ever discovery. It's simpler as the Rule of 72 though. How simple is it? Take the return after tax on your savings. Divide that into 72. The answer is how long it will take to double your money. 1% p.a. in a cash ISA? 72 years! Best of luck with that. The average return net of all costs in the Invesco Perpetual Income Fund since 1979? Slightly over 14% p.a. Long-term investors in that fund doubled their money every five years. Have that invested inside a private pension pot over the last few years... and bingo! You've just added a further 30% or more free of charge. Money for nothing, as Mark Knopfler would say.

Starting with a goal is absolutely crucial. It adds perspective. Express your own goal in today's money. When do you want to be financially independent? Age 55? 60? How many years away

is that? If it was today, how much income *after tax* would you want to have to spend? And would you be happy if that income never increased, or would you like more to spend each year? You get the gist.

Let's take an example. David is 30 and wants to aim for financial independence (not necessarily full retirement) at 55. He'd be happy with £2,000 a month net in today's money. He thinks building in ongoing wage inflation at 3% is prudent. Studying interest rates and income returns back over the last 120 years suggests he'll need a fund of at least £1.25 million to even stand a chance. And it depends how much tax it's exposed to. Minimising your exposure to tax on savings takes time and discipline. Now do you see the problem? And the less time you have to plan and invest well, the harder it is. It's not a straight line to retirement, it's an uphill struggle.

The good news is, no matter what changes they've made to the UK Tax

## “PENSIONS ARE UNDERESTIMATED BY TOO MANY. THEY ARE AFTER ALL SIMPLY TAX EFFECTIVE INVESTMENTS WITH FUNNY RULES.”

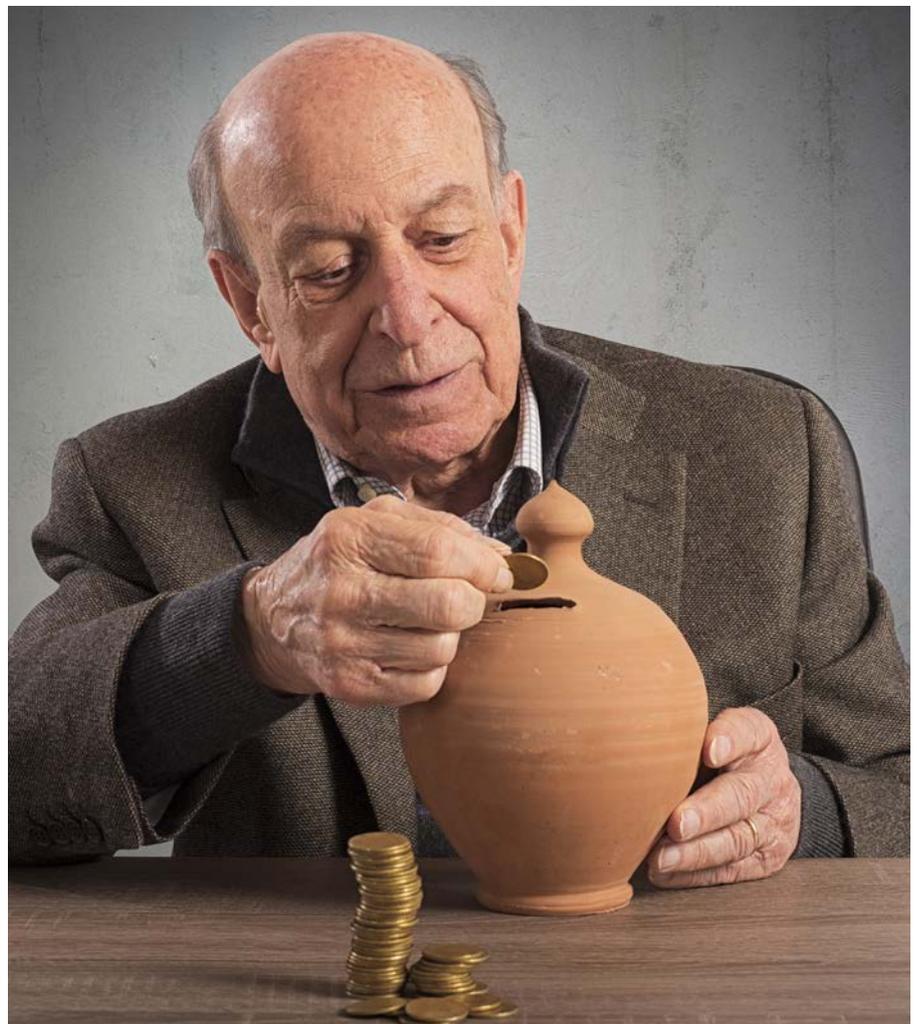
System over my lifetime, it's still designed to tax Income when you're living and Capital when you die. So if you save using all available capital exemptions, or allowances, and into real asset investments such as investment or unit trusts, especially those protected against tax such as ISAs, you stand a good chance of success.

But pensions are underestimated by too many. They are after all simply tax effective investments with funny rules. Take the example of the Invesco Perpetual Income fund launched 37 years ago. Sitting quietly inside a pension plan for a basic rate taxpayer from then until now, for a net once only £1000 premium you'd have a pension fund today of over £160,000. That's three to five and a half times the average pension pot today.

### Strategy

When I sit down with new clients who want to review their investment strategy I find it helpful to help them set goals so they can then evaluate how effective their current situation stacks up, warts and all. Invest in the most tax effective areas first, then work your way down makes so much sense. Whatever others say, pensions are still the best starting place for higher rate taxpayers. If the ones you have are disappointing, it's what you invested in inside them that's the problem. Poor funds will not help you reach your goals. Change them but watch out for the costs. Outside pensions and ISAs watch out for taxes too. There's little point losing out when readjusting to better funds. Other plans like VCTs or EIS schemes are useful too. But just like building a structure to last, it's best to get the foundations right first.

And when I talk of Pensions you may understand them as SIPPs. A common mistake! The vast bulk of individual pension plans should simply be Personal Pensions able to invest in funds



like Investment/Unit trusts. Self Invested (SIPP) plans carry extra charges and are only suitable for a few more sophisticated investors in my view. Sadly SIPPS are still able to hide extra charges made by unscrupulous advisers. Be careful.

I have found over the years the bulk of investors aiming for a quality of income and life in retirement achieve it by starting as early as possible, setting real goals, then investing in a mix of Pension plans, ISAs, and if further funds are available, in flexible funds or individual shares taking advantage of Capital Gains annual exemptions. Married couples these days have opportunities to build and protect wealth using their individual allowances.

But what's a sensible investment strategy in terms of the underlying assets? I'd suggest too many older investors are already over-exposed to property and recent taxes suggests this illiquid investment should be ignored now in favour of an area that has worked perfectly for the last 50 years and more – Equity income Trusts. When I ask newly retired folks "would you like an investment that delivers an income that rises above inflation each year, on average, and that over rolling three to five year periods tends to increase in value above inflation?" they respond favourably. In fact, they tend to be surprised. Astonishing as it may sound, considering the millions of words written in personal finance columns over the last 40 years, there are still people coming



into our offices who've never heard of Neil Woodford – and that includes one young fund manager seeking our strategic help (but her secret's safe with us).

So what about the twenty-odd-year-olds? If they have money spare after having fun, or paying off university debt, a simple ISA type monthly savings plan makes sense. Pound Cost Averaging (who thinks these names up?) is an ally if you're investing monthly, as you should be, into risk equities such as small company trusts with managers like Harry Nimmo or Gervais Williams, to name but two.

But even by that age those with generous parents or grandparents could have been building up pension pots very tax effectively, never mind the compound interest benefits. For ages now it's been possible from birth for youngsters to have £3,600 a year gross, with only £2,880 outlay thanks to tax relief, invested in a rolling tax-free growth plan and kept away from their spendthrift ways until age 55, when hopefully they'll be sensible. That's a 25% uplift by the way. And you thought such a bonus only starts in April 2017.

### As Tears (or Years) Go By

Back in the mid 1990s when I believed demographics was the secret behind the best investment strategy, a Sunday Times journalist phoned up and said that while he appreciated my beliefs regarding the positive benefits the Baby Boom demand was delivering to stock market investments, he wanted to concentrate on what thirty-odd-year-olds should be doing regarding retirement

planning. Once we'd established he'd once been thirty-odd himself, and reminded him at that age you tend to be a walking ATM with little left over, it highlighted to him the need to start even earlier. So don't underestimate the impact of starting in your twenties, even if that means just putting a little in the right funds once a month. Once you start it makes it easier to increase your monthly outlay when you hit your thirties and as the superior returns start rolling in.

I should admit at this stage that demographics alone do not explain stock market movements. Think of the severe crashes we saw in 2000-02 and 2008/9. Nothing really to do with demographics. Maybe to do with repeating cycles. Let's face it: cycles are natural. Night follows day, the tide goes out then in, and there are four seasons. Unless you're Scottish, of course, in which case there are only two – winter and next winter.

And then there's sentiment, interest rates, inflation, debt and so on. And it all gets hammered home to you in your forties. All the dreams of early retirement in luxury quietly dissipate. So how do you build an investment strategy at that age bearing in mind a need to concentrate on tax-effective structures first, to aim at building your family's standard of living whether you make it to retirement or not, while protecting against the odd stock market crash?

What about "safety first" strategies? No doubt you'll have heard of "Lifestyling" and "GARS". Over many years of dispensing advice, I've found that



**“ABSOLUTE RETURN FUNDS SHOULD BE RENAMED ABSOLUTE RUBBISH RETURNS IN MY VIEW. SO-CALLED LIFESTYLING LOOKS MORE LIKE A GIMMICK TO ME.”**

safety first type plans become popular only after the losses and uncertainty of crashes. It's worth remembering Laws of Averages before becoming too despondent. While the media love painting our screens and newspapers with black and sombre colours, the fact remains that stock markets are in periods of profit at least five times longer than they spend in downturns. So optimism is better for your wealth than pessimism.

How do you build your wealth? Sticking your money in safety first strategies? Go check the numbers over the last 10 to 20 years. And bear in mind that bad news sells much better than good news. Absolute Return funds should be renamed Absolute Rubbish returns in my view. So-called Lifestyling looks more like a gimmick to me. It sounds good in theory to have a fund that slowly turns to caution as you near retirement. In theory, perhaps. Remember what Ronald Reagan said about economists. He said an economist is someone who sees something




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**“SUCCESSFUL RETIREMENT PLANNING IS BEST IF YOU CAN BEGIN THE PROCESS IN YOUR TWENTIES OR THIRTIES. OK, START IN YOUR FORTIES BUT APPRECIATE THE UPHILL STRUGGLE.”**

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happening in practice and says "but it doesn't work in theory". And what if your retirement was a couple of years ago when it paid to be exposed to equities, not caution?

Over all these years I've found that once you've set your goals, tucked the Rule of 72 into your memory bank, and grasped the sense of investing in tax-enhanced and protected flexible funds, at whatever stage you're at – twenties, thirties, forties or fifties – your strategy should be for growth. To protect against the odd fall, it's not a bad idea to build a core of Equity Income trusts, with an additional emphasis on growth managers with a good reputation. Names like Gervais Williams, Nick Train, Terry Smith etc. I wouldn't bother with "cheap" UK Index Trackers or Passives unless you want to track the top twenty shares in the FTSE down. Again, go check the numbers.

### Barcelona

The closer you get to retirement or slip into it the more you'll want a regular income, with as little tax as possible, and protection against stormy days in the markets. That's where my football team analogy comes in handy. And

that team of managers and their tactics should have been building for years to put the best tax effective structure in place. Building a plan that minimises costs when switching from attack, say, to defence. In retirement in particular it makes sense to build your team of managers from the back, just like Brian Clough did all these years ago. Start with the best goalkeeper and work up through the spine.

Sticking to the football analogy, why settle for Barnsley if you can have Barcelona for much the same price? And as far as risk's concerned, have you noticed that while Barcelona has three of the best scorers in the business, they also have a goalkeeper, a back four, and a midfield – and that these defenders and protectors aren't numpties (Scots word for t\*\*\*\*)?

Successful retirement planning is best if you can begin the process in your twenties or thirties. OK, start in your forties but appreciate the uphill struggle. But even if you didn't plan and find it hard going to decide what's next, bear in mind that if you're married one of you could have another 30 years or more to plan for – which brings me back to how our brains are wired and why it represents serious problems for investors, particularly as we head into increasingly long retirements.

Remember our Pleistocene (or reptilian) brains. At the core of our modern brains is the ancient hypothalamus, still in charge of emotions, fighting, fleeing and flocking – as well as the other "f", associated with sex. So it's

this ancient brain that's in charge of reacting to all the bad news thrown our way these days by news channels. Breaking Spirits rather than Breaking News. How else do you explain why we consistently buy and sell equities at the wrong times as a herd?

In the US the Dalbar research people have measured for 30 years now the average returns of investors over short and long periods. It makes grim reading. Consistently private investors underperform the benchmarks by as much as 4% to 6% a year. And now we have Pensions Freedom in the UK. Despite eight out of ten retirees saying they prefer an income in retirement guaranteed to live as long as they do, the same percentage don't want an annuity, which is incidentally the *only* way to achieve it.

Instead folks are cashing in or opting for Drawdown. I have four things to say about this: 1) Already HMRC have pocketed 30% more tax than they expected in their wildest dreams. 2) There's been a 300% rise in retirees defrauded out of their pension savings by crooks. 3) Already inexperienced and panicky private pension owners, if they've gone for perceived safety and/or Index Trackers, are down heavily since "freedom" was introduced on 6th April last year, five days too late for fools. 4) Nowadays Personal Pension pots can be free from the dreaded Inheritance Tax, and can be shared by families, possibly free from Income Tax. It's surely worthwhile taking good independent experienced tax planning advice. The alternative is unthinkable.

### About Alan

Alan Steel rose to prominence in the financial sector after being the first person to put pen to paper to accuse Equitable Life of rampant mis-selling. A true champion of the ordinary saver/investor, Alan founded Alan Steel Asset Management in 1975, and now has £900 million under management. Visit the company website at [www.alansteel.com](http://www.alansteel.com).





BY FILIPE R. COSTA

## THE MACRO INVESTOR

# THE TROUBLE WITH PENSION FUNDS

### A New Era

Putting money aside during your working life to achieve a savings target and then enjoy a peaceful retirement has never been as difficult as it is today. A mix of stubbornly low investment returns and higher longevity is turning pension schemes upside down and challenging the way we see and manage our life savings. International standards advise that to maintain the same standard of living as that enjoyed in employment, an individual should save enough to achieve a pension near 70% of his or her salary. For that to be possible, it is estimated that at least 12% of an individual's salary should be saved every month. But current reality shows that the average pensioner converting a defined contribution scheme into an annuity is hardly hitting the 50% of salary level, even when having saved at the recommended rate. With annuity rates declining year after year, the current savings approach is failing to deliver results. The fortunes of all those lucky enough to be in defined benefit

**schemes are also changing, as companies are scaling back their contributions to minimal levels that will be insufficient to provide a pleasant retirement for future generations.**

The future is challenging for all of us, and in particular for the next generation. On the one hand, we are all 'victims' of the advances in knowledge that are prolonging our lives and forcing us to spread the savings pot over an increasing number of retirement years. In order to retire at the same age as past generations did, we will need to save much more or, alternatively, we must delay retirement for a number of years. At the same time, in a world where interest rates have been decreasing rather quickly and continually, and have been (and continue to be) kept at very low levels for a prolonged period of time, one must either save more and/or change investment strategy. When longevity and low returns are combined the result is frightful: we may be unable to accumulate a reasonable stock of wealth by retirement age, and thus we may end up delaying retirement when

faced with the alternative of living below par lifestyles.

### A Plethora of Problems

There are two major pension schemes under which workers may be enrolled: defined contribution and defined benefits. Each has its own virtues and weaknesses but both have been severely damaged in a world where discount rates and investment returns are unduly low and life expectancy is rising.

In a defined contribution scheme the employer and/or the employee contribute a pre-specified percentage of the employee's salary every month to the pension pot. That money is then managed during the working life to accumulate some uncertain level of funds at the retirement date. While the amount set aside every month is pre-defined, it varies with salary, as it is usually defined as a percentage instead of being a fixed amount. At the same time, the money put aside is invested, which means there is no guarantee of achieving an exact savings level at retirement date. The employee's



A close-up photograph of a hand placing a silver coin on top of a tall stack of similar coins. To the left, there is a shorter stack of copper-colored coins. In the foreground, several coins are scattered on a light-colored surface. The background is a soft, out-of-focus green.

**“THERE ARE TWO MAJOR PENSION SCHEMES UNDER WHICH WORKERS MAY BE ENROLLED: DEFINED CONTRIBUTION AND DEFINED BENEFITS. EACH HAS ITS OWN VIRTUES AND WEAKNESSES BUT BOTH HAVE BEEN SEVERELY DAMAGED IN A WORLD WHERE DISCOUNT RATES AND INVESTMENT RETURNS ARE UNDULY LOW AND LIFE EXPECTANCY IS RISING.”**

| Life Expectancy Between 1960 and 2013 |             |             |             |             |             |             |             |             |             |                    |
|---------------------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|--------------------|
| Country Name                          | 1960        | 1970        | 1980        | 1990        | 2000        | 2010        | 2011        | 2012        | 2013        | 1960-2013 Increase |
| Australia                             | 70.8        | 71.0        | 74.3        | 77.0        | 79.2        | 81.7        | 81.9        | 82.0        | 82.2        | 11.4               |
| Canada                                | 71.1        | 72.7        | 75.1        | 77.4        | 79.2        | 80.9        | 81.1        | 81.2        | 81.4        | 10.3               |
| Switzerland                           | 71.3        | 73.0        | 75.5        | 77.2        | 79.7        | 82.2        | 82.7        | 82.7        | 82.7        | 11.4               |
| China                                 | 43.5        | 62.9        | 67.0        | 69.5        | 72.1        | 74.9        | 75.0        | 75.2        | 75.4        | 31.9               |
| Germany                               | 69.3        | 70.6        | 72.7        | 75.2        | 77.9        | 80.0        | 80.7        | 80.9        | 81.0        | 11.7               |
| Denmark                               | 72.2        | 73.3        | 74.1        | 74.8        | 76.6        | 79.1        | 79.8        | 80.1        | 80.3        | 8.1                |
| Euro area                             | 69.3        | 71.2        | 73.5        | 75.9        | 78.3        | 80.7        | 81.3        | 81.3        | 81.4        | 12.1               |
| European Union                        | 69.3        | 71.0        | 72.9        | 74.9        | 77.2        | 79.7        | 80.3        | 80.3        | 80.4        | 11.1               |
| France                                | 69.9        | 71.7        | 74.1        | 76.6        | 79.1        | 81.7        | 82.1        | 82.0        | 82.0        | 12.1               |
| <b>United Kingdom</b>                 | <b>71.1</b> | <b>72.0</b> | <b>73.7</b> | <b>75.9</b> | <b>77.7</b> | <b>80.4</b> | <b>81.0</b> | <b>80.9</b> | <b>81.0</b> | <b>9.8</b>         |
| High income                           | 68.0        | 70.1        | 72.2        | 74.4        | 76.0        | 78.4        | 78.7        | 78.9        | 79.1        | 11.1               |
| Japan                                 | 67.7        | 72.0        | 76.1        | 78.8        | 81.1        | 82.8        | 82.6        | 83.1        | 83.3        | 15.7               |
| Low income                            | 39.2        | 43.4        | 46.8        | 49.7        | 52.2        | 59.0        | 59.7        | 60.3        | 60.8        | 21.6               |
| Sweden                                | 73.0        | 74.6        | 75.7        | 77.5        | 79.6        | 81.5        | 81.8        | 81.7        | 81.7        | 8.7                |
| United States                         | 69.8        | 70.8        | 73.7        | 75.2        | 76.6        | 78.5        | 78.6        | 78.7        | 78.8        | 9.1                |

Data Source: World Development Indicators  
 Last Updated Date: 17/02/2016

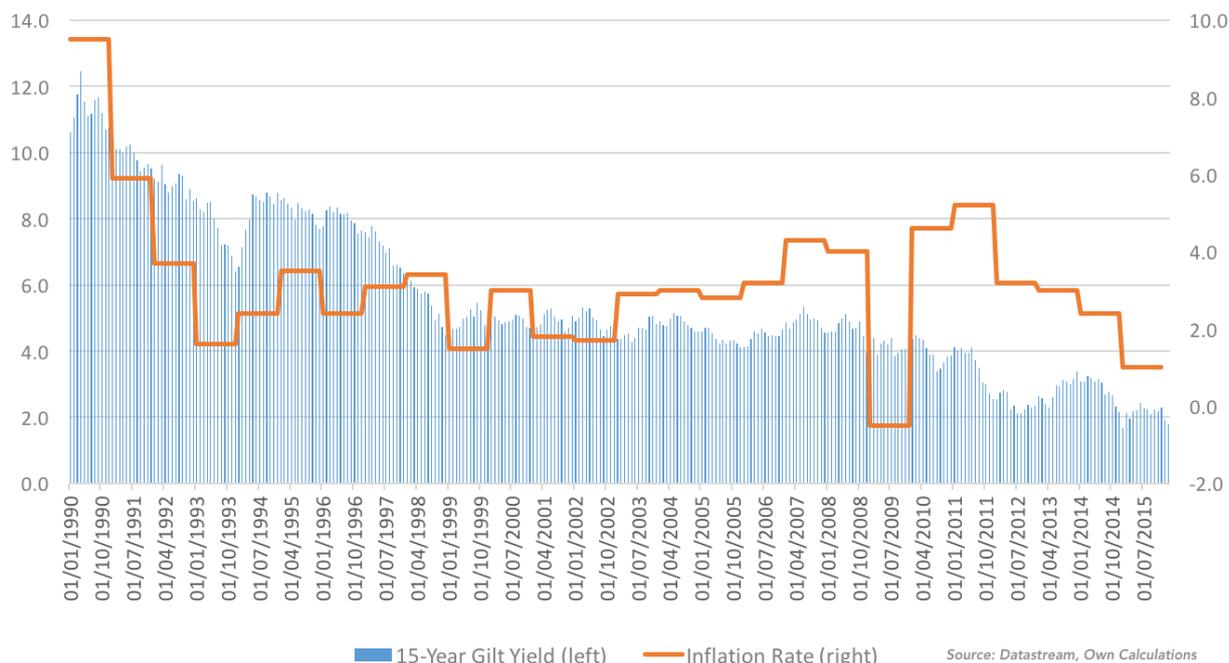
retirement benefit will then be determined by the size of the accumulation at the retirement date, which is not known with certainty and thus constitutes a risk for the employee. But that is not the only risk. At the time of retirement, the retiree usually converts the pension pot into an annuity in order to dissipate the risk of living a longer life than expected (and then running short of money before death). At that single moment, the success of getting a good deal is heavily dependent on interest rates. With current 15-year gilt yields

(usually taken as a benchmark for annuities) at record low levels near 1.8%, the about-to-retire employee will end up with the worst annuity deal ever, certainly far less than he was expecting when he enrolled into the pension scheme. This risk is, in fact, highly significant. Annuity rates have fallen dramatically since the mortgage crisis was imported from the US around 2008. In the UK, a 65-year-old individual on a single life policy could get around £7,908 annually per £100,000 of accumulated savings in 2008; today he can

only get £5,633 with the same pot. Had the cost of living decreased this might have mitigated some of the decline in rates, but that is certainly not the case in a country where consumer prices are now 16% higher than they were at the end of 2008. Under these conditions, an individual incurs a significant risk of failing to maintain a decent standard of living during retirement.

A simple example helps us to understand how an annuity is impacted by a mix of declining interest rates and

UK 15-Year Gilt Yields and Inflation (annual pct.)



Source: Datastream, Own Calculations

**“WHEN INTEREST RATES DECLINE, PENSION LIABILITIES INCREASE SUBSTANTIALLY AND PENSION FUNDS MOVE INTO DEFICITS, FORCING CORPORATIONS TO DIVERT MONEY AWAY FROM INVESTMENT AND INTO FILLING THOSE DEFICITS.”**



vestment and into filling those deficits. This weighs negatively on credit ratings and helps to explain why corporations are currently abandoning these kinds of pension schemes, at the expense of future workers' benefits.

A simple example helps us to understand how deeply a company may be hit by declining interest rates. Let's suppose the discount rate is 2.0% and a company expects to hit the £500,000 level on an individual pension fund. For that to be possible, with 30 years still to go, £1,020 must be put aside each month. But if the discount rate declines to 0.5%, the new amount will be £1,288. Seen from a different angle, the decline in the discount rate has created a funding gap of £154,479 that must be filled at some point, either by a reversion in discount rates or by an increase in monthly contributions to the fund. Lower rates increase the present value of liabilities and thus also increase the burden of pensions in defined benefit schemes. The new entrants to the jobs market will no longer have access to defined benefit schemes, as companies have learned the lesson taught by central banks. In a stress test conducted in 17 European countries in January (including the UK), it was found that if confronted with a significant financial shock that triggered a further fall in interest rates and a rise in inflation, the accumulated funding shortfall in pension schemes would amount to €773 billion (£610 billion). The UK's share of that figure is €125 billion (£ 98.7 billion), which puts it in one of the weakest positions overall.

Regardless of the type of pension scheme, it is clear that a prolonged period of low interest rates has a huge impact on pensions and would ultimately impair the living standards of pensioners.

### **Traditional Thinking Destroyed the Spirit of Saving**

For investment in the form of accumulation of capital to be possible some savings must exist. Savings may come in the form of private savings or government savings (unlikely). When that isn't enough, one needs to finance investment through external savings and thus allow the external deficit to in-

creasing longevity. Let's suppose an individual saves a portion of his monthly salary towards a pot in order to try to accumulate £500,000 at the age of 65 – the age at which he expects to retire. Upon retirement, and provided that everything goes as planned, he needs to convert the £500,000 savings pot into an annuity. If, by then, the discount rate used to set the annuity is 2.0% and a man is expected to live 80 years on average, he might get a monthly pension of £3,218. But what about if the discount rate was just 0.5% and life expectancy around 85 years instead? Under those circumstances, he could not get more than £2,190, which is 32% less than initially expected. This is exactly what has been happening to all those unfortunates that have retired during the last few years, which explains why annuities have become so unpopular. On one hand, a pension fund is expected to de-risk as the retirement date approaches to avoid untimely losses near the point when the savings pot is going to be converted into an annuity; but on the other hand, pensioners have their fortunes tied to

the specific conditions prevailing at the date they convert their savings pot into an annuity.

In a defined benefit scheme, the compensation during retirement is pre-defined, generally expressed in terms of the employee's salary and length of service. An example would be a benefit of 2.5% of average salary during the last five years of employment for each year of service. If the employee worked for, let's say, 30 years then he would be entitled to a defined benefit of 75% of his average salary during the last five years. The precise amount is dependent on the average salary (which may not be known with certainty), as with the defined contribution scheme, but under a defined benefit scheme the retiree is not exposed to the risks stemming from investment returns and increased longevity. This is because that particular burden is left to the company, which bears all the risks. When interest rates decline, pension liabilities increase substantially and pension funds move into deficits, forcing corporations to divert money away from in-



crease. That is often the only way some emerging economies are able to ignite an industrialisation process, but it may lead to a sticky end if debt is allowed to rise too rapidly. No matter how we put it, in order to invest more, we need to save more; that is, we need to forego some present consumption in favour of some higher future consumption. This time preference is what dictates the natural, unmanaged, interest rate level, as observed by the Austrian school. In a mature society this rate is lower as such a society has achieved a high level of development. In a depressed economy the rate is high because the marginal utility of consumption is high, while in a booming economy that rate tends to decrease. The interest rate is like a price of future consumption in terms of present consumption. The higher the marginal utility of present consumption, the higher the interest rate. But the Keynesian view that inspires central bank action goes in the opposite direction. In practice, this means that when the economy is in recession central banks cut interest rates to very low levels, which sucks money into capital activities when it should be directed towards consumption. This creates extra capacity in the economy, perpetuating past excesses, without sufficient savings for it. In the future, the wealth created is not sufficient to bid up all the products that were produced with the extra capacity, and a recession occurs. According to the Austrian view, central banks should instead allow rates to increase in order to attract higher savings to back up future investment and wealth. It comes as no surprise that given arti-

ficially low levels of interest rates, any attempt to save money is frustrated. That includes pension funds.

**“IT COMES AS NO SURPRISE THAT GIVEN ARTIFICIALLY LOW LEVELS OF INTEREST RATES, ANY ATTEMPT TO SAVE MONEY IS FRUSTRATED. THAT INCLUDES PENSION FUNDS.”**

### Central Banks Are Hurting Us

For the last seven years the major central banks have kept interest rates at their lowest ever levels. In the UK, the BoE has kept its key rate at 0.5% while engaging in the purchase of assets to disseminate the effects of the low short-term rate across the yield curve. In Europe, the ECB announced an asset purchase programme worth more than €1 trillion, which included €60 billion in monthly asset purchases to be completed by March 2017. This came on top of negative deposit rates. As a consequence of these programmes, sovereign bond yields experienced steep declines. It all started with shorter maturities and safer debt but eventually the effects spread towards longer maturities and riskier

peripheral debt. The increment in the demand for bonds generated by central banks presses bond prices higher, which increases the portfolio value of a pension fund initially. However, pension funds don't really hold debt for the sake of profiting from price rises, but rather to generate cash flows, which means they will end up with depressed returns at the time they need to purchase additional bonds. So, instead of being euphoric about price rises, pension funds should be worried about the yield they will get when it comes to their next bond purchases. Over time decreasing yields have a negative impact on pension funds' performance.

But the ECB was not happy with its trillion-euro programme and decided to expand it to a new pace of €80 billion per month. The central bank also cut its deposit rate to -0.40% and is now including investment-grade corporate bonds in its monthly purchases. For all those pension funds jumping from the low-yielding sovereign debt to the highest-graded corporate debt this decision came as an additional blow, as the yields on these corporate bonds are now following the same route followed by sovereign debt before the first asset purchase announcement last year. A 4% yield in 2011 has been turned into a 1% yield today.

The yields on shorter maturity sovereign debt across Europe are now mostly negative, meaning that investors need to pay for the privilege of lending money to governments. Even for longer maturities, the yield is currently very low and is rapidly approach-

### European corporate bond yields are tumbling, due to interest rate cuts and quantitative easing



Source: BofA Merrill Lynch

ing zero. Almost all yields are below expected inflation levels. A 10-year German bond returns just 0.21%. For those willing to jump into higher yields, 10-year bond yields on Italian, Spanish, Portuguese and Greek government debt offer 1.25%, 1.51%, 2.76% and 8.82% respectively. But the increment comes with extra risk. The British reality isn't any better. A gilt can be purchased in return for an annual income of just 1.46%. It may seem good enough given that the country has never defaulted on its debt obligations, but in light of the fact that the inflation rate has rarely fallen below the 2% level, investing in these bonds comes with a potential loss in purchasing power. Unless there is a massive deflation problem on the horizon, no matter which bond one chooses, it would always be a choice between taking extra risks or simply minimising the loss of purchasing power over time. These rates are well below the natural rate involved in the time preference explained by the Austrian school of economics and thus are forcing savers into much riskier investments than they desire. Instead of purchasing high-grade German bonds, individuals will now need to purchase lower-grade Greek bonds; instead of bonds, individuals need to purchase equities; and instead of highly liquid assets, individuals will need to consider highly volatile and illiquid alternative investments.

While the risk-on theme may be available to some, it isn't for pension funds. Most pension funds are now being trapped between a rock and a hard place by central banks and governments. They need to increase exposure to riskier assets, but they are severely limited by regulatory regimes that don't allow them to increase the share of riskier assets above a certain level or, if they do, they often require pension funds to put money aside. Pension funds are exposed to a very unfavourable set of conditions that doesn't allow them to effectively manage our retirement funds.

## Final Comments

Central banks will continue to keep interest rates at very low levels for an extended period of time, which will continue to depress the rate of return we can get on safer assets. Because consumer inflation has been above

## “INVESTING IN PRIVATE EQUITY, WINES, FINE ARTS, PROPERTY, AND EVEN LITIGATION FINANCE AND PEER-TO-PEER LENDING, MAY HELP TO ENHANCE RETURNS AND ACHIEVE A HIGHER SAVINGS POT FOR RETIREMENT.”

those rates of return, we may end up being paid a negative real rate of return. Limited by regulations, pension funds aren't able to overcome these challenges and can hardly beat inflation. Even if they do, pensioners are highly exposed to a single moment in life – the moment they convert their savings pot into an annuity – that may change their living standards during retirement, for the sake of guaranteeing a future income. Under a scenario of extreme central bank intervention and rigid regulation, those wishing to maintain living standards during retirement will need to find alternative, potentially more illiquid, investments. These assets pay a premium return over bonds and equities due to their illiquidity, but for those on a 30- or 40-year savings plan near-term liquidity may not be too much of an issue. After all, they don't need the money until their 60s and even at that age they don't need it all at once. Investing in private equity, wines, fine arts, property, and even litigation finance and peer-to-peer lending, may help to enhance returns and achieve a higher savings pot for retirement. Under a longer time interval, the risks involved in these investments are greatly reduced in a well-diversified portfolio and there are a few ways of getting exposure without needing to purchase the entire asset at once. For example, an investor can get an exposure to litigation finance through **Juridica Asset Management (JIL)** or to wines through the **Wine Investment Fund**. I believe many specialised investments turning illiquid assets into readily purchasable assets will spread.

While the main aim of quantitative easing has been to push investors out of bonds and in the direction of riskier asset classes, most pension funds have just left their investment strategy unchanged (as reported by the Pensions and Lifetime Savings Association). Pension funds just don't enjoy the legal flexibility to react to the status quo

and will simply fall short of investment goals.

Defined contribution schemes usually turn your portfolio into a highly liquid one, mainly consisting of high grade bonds, as retirement nears. This means a dormant performance for the last 10 years or so, according to current standards. The main reason is to allow for a smoother conversion of the funds into an annuity. But if you opt out of conventional pension funds, you no longer need to convert anything. You can turn assets into cash as needed while still enjoying a premium return on the remaining illiquid assets.



Under the current low rate environment, the only way to stand a chance of growing or maintaining your purchasing power in 30 to 40 years' time is by changing your investment attitude and embracing less liquid assets. The alternative of investing in pension funds often means accepting a negative yield world, which makes the task of preserving purchasing power a tough one (unless you believe we will experience massive deflation). After all, with all this central bank intervention, if there is risk, it comes from investing in high-grade debt. Invest in that and you're almost certain to lose purchasing power over time. Central banks have just turned sovereign debt into the riskiest long-term investment ever and are on the warpath to do the same to high-grade corporate debt.





BY JOHN KINGHAM

## THE DIVIDEND HUNTER

# DIVIDEND INVESTING FOR RETIREMENT

**When I first started out as an investor I was not in the least bit interested in dividends. My plan was to invest for growth by investing primarily in the accumulation units of a FTSE All-Share tracker, and then at some distant point in the future switch over to an income strategy, which would most likely be an annuity of some sort.**

Since those early days I have had a long and bumpy route from passive investor to active stock picker, and today my opinion on dividends could not be more different. Dividends are now the cornerstone of my retirement investing strategy and I intend to use the same basic strategy for both capital accumulation today (through dividend reinvestment) and income in retirement (through dividend withdrawal).

I want my portfolio to be flexible and capable of providing both capital accumulation and dividend income and so it has three major goals, each of which is defined in relation to the FTSE All-Share: 1) have a higher dividend yield; 2) produce higher capital and dividend growth; and 3) be less volatile.

To achieve those goals I only invest in dividend-paying stocks that appear to offer the best combination of defensiveness and value-for-money. Defensiveness refers to aspects of a company like its growth rate, growth quality and profitability, whilst value-for-money refers to factors such as a

stock's earnings and dividend yields.

As a gentle introduction to how I approach the task of dividend hunting, in the rest of this article I'll outline five key points which are at the heart of my strategy and then briefly review a couple of popular dividend-paying stocks.

### **Key point #1: Build a diverse portfolio**

The first point to remember as a dividend investor is that dividends are not guaranteed. In a well-run company dividends are paid out of cash which is either not needed for current operations, or cannot be reinvested within the business (perhaps by building a new widget factory) at an attractive rate of return. However, if a company runs into hard times and finds that it isn't generating enough spare cash to cover the dividend then the right thing to do may well be to cut or suspend the dividend.

Given this uncertainty around dividend payments, the sensible thing

for income-seeking investors to do is to spread their portfolios across a diverse range of income-generating stocks. For me that means holding around 30 stocks, with most of them making up somewhere between 2% and 5% of the portfolio, and none making up more than 6%.

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**“I ONLY INVEST IN DIVIDEND-PAYING STOCKS THAT APPEAR TO OFFER THE BEST COMBINATION OF DEFENSIVENESS AND VALUE-FOR-MONEY.”**

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With that degree of diversification I can sleep well at night even if one company completely suspends its dividend. Although that's unlikely, even if it did happen the impact to the total dividend thrown off by the portfolio would be negligible.



## “THE PROBLEM WITH BUYING COMPANIES AT LOW VALUATIONS AND WITH HIGH YIELDS IS THAT THERE IS USUALLY A GOOD REASON WHY THE YIELD IS HIGH.”

Beyond holding shares in many companies and making sure that no one position is excessively large, it's also a sensible idea to try to diversify in terms of industry and geography. For me this means holding no more than three companies from any particular industry and making sure that, on average, at least 50% of the revenues generated by my investments come from outside the UK.

### Key point #2: Buy high quality companies

A broadly diversified portfolio of weak or badly run companies is unlikely to generate a steady stream of growing dividends, so my second key point is to focus on high quality companies, or perhaps above average companies at the very least.

Defining "high quality" in the context of companies is a complex and subjective matter, but for me it comes down to these four cornerstones of quality: 1) an unbroken record of dividend payments stretching back at least ten years; 2) an above average growth rate (measured across revenues, earnings and dividends); 3) above average consistency or quality of growth; 4) above average profitability – i.e. the rate of return generated by the company's fixed and working capital.

There are many other factors of course, but if a company doesn't have a long track record of reliable dividend payments and a good combination of growth, consistency and profitability, then I think it would be difficult to describe that company as high quality, especially from the point of view of a dividend investor.

### Key point #3: Buy when prices are low and when yields are high

Although the quality of each company is important, just as important is the

price paid for a company's shares. Sometimes I will avoid a high quality company because its share price is too high and its dividend yield too low. At other times I will invest in a company which is not quite in the high quality bracket but only when its share price is very low and its dividend yield very high.

The problem with buying companies at low valuations and with high yields is that there is usually a good reason why the yield is high – and it's usually an unpleasant reason. If everything looked rosy then investors would buy the stock and pump up the share price, which would in turn lower the yield. So for the yield to be relatively high there is usually some sort of problem that the company is facing, and to be a high yield investor you have to be willing to invest in companies that have obvious (but hopefully short-term) problems that other investors would rather avoid.

### Key point #4: Hold for years rather than days, weeks or months

Most income investors already have a relatively long-term outlook, so the problem of excessively frequent buying and selling is less of an issue than it is with many other types of investor.



But it is still a point worth making. In most cases when a stock is bought the intention should be to hold it forever, unless something particularly good or bad happens (which I'll cover in the next key point).

Barring exceptionally good or bad outcomes, I would say that most of your investing time should be spent doing nothing other than simply watching your dividends roll in month after month.

### Key point #5: Regularly take profits on winners and replace losers

Buy and hold investing is a popular approach for income investors, where





the intention is to simply buy a company's shares and hold them forever; but I prefer to be slightly more active than that.

Rather than buying a dividend-paying stock and then never touching it again, or only making another investment decision if the original company is taken over or goes bust, I think a regular plan of portfolio maintenance is a better idea. A good analogy is gardening, where fast growing plants should be trimmed back and weeds removed if a garden is to be maintained in tip-top condition.

In the investing world this means taking profits on holdings that have done exceptionally well and occasionally removing investments that have done badly and are unlikely to recover. I like to do my portfolio gardening on a regular basis, but I don't want to be hyper-active so I limit myself to an average of about one investment decision each month.

Those five key points make up a framework upon which many separate activities and investment rules of thumb hang. One of those activities is the analysis of potential investments, which is actually quite an involved process on its own and one I don't have the space to cover today. Instead I'll finish this article off with a couple of short re-

views of two very different companies, which will hopefully highlight the ever present trade-off between quality and price.

### Unilever: A quality company, but is it a quality investment?

Unilever is the name behind many famous brands such as Magnum ice cream and Dove soap. It is a classic defensive dividend stock as it operates in the non-cyclical (i.e. defensive) consumer goods sector. It sells small ticket, repeat purchase items that its customers will buy even in the middle of a bad recession.

The company has a long history of dividend payments and profits, fairly consistent growth and above average profitability. In short, Unilever is definitely the sort of company I would be happy to invest in, at the right price.

And just what is the right price? Here's one way to think about it:

Unilever has grown its revenues, earnings and dividends by an average of around 3% a year over the past few years. As I write, its share price is 3,141p and its dividend yield is 2.8%. If we assume that Unilever can continue to grow its dividend by 3%, and that the dividend yield remains the same, then investors will receive a return of 2.8% from the dividend and 3% per year from growth, giving a total expected return of 5.8% per year.

In comparison, the long-term average return from the FTSE 100 has been

around 7% per year. With the FTSE 100 at 6,106 and its dividend yield at 4.1%, the index would only have to grow its dividend by 2.9% each year for investors to continue to receive that historically average 7% long-term return. Looking at the FTSE 100's track record it appears that a 2.9% dividend growth rate would not be out of the ordinary.

So why would an investor buy Unilever with an expected rate of return of 5.8% when they can buy the FTSE 100 (which is less risky than Unilever), which has an expected rate of return of 7%?

**“I’M NOT SAYING THAT UNILEVER’S SHARES ARE ABOUT TO DECLINE BY 30%, BUT IT’S A DISTINCT POSSIBILITY UNLESS THE COMPANY CAN KICK-START ITS GROWTH RATE.”**

The answer is that Unilever's investors are probably expecting the company to grow by more than 3% per year. Perhaps Unilever can grow faster than that, but by paying a high price and accepting a low dividend yield, those investors are taking on a lot of risk. If that high growth rate fails to materialise then the market could re-price Unilever as a low-growth stock, with an appropriately higher dividend yield, and



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that would mean a significant decline in its share price.

For example, if Unilever continued to deliver a 3% growth rate then its dividend yield would need to be around 4% in order for its future shareholder returns to at least match the market. A 4% yield for Unilever would occur at a share price of 2,200p, and that's some 30% below its current price.

I'm not saying that Unilever's shares are about to decline by 30%, but it's a distinct possibility unless the company can kick-start its growth rate.

### BP: A high risk, high yield investment

Unlike Unilever, BP is definitely not a defensive dividend stock. For a long

time investors thought it was, and perhaps they were right; but those days are over. In recent years the company, its dividend and its shareholders have been through the meat grinder; first because of the Gulf of Mexico disaster in 2010 and now because of a collapse in oil prices.

Unlike Unilever, which sells ice cream and soap and other things that people will buy no matter what, BP sells oil and related products which can have massively volatile prices. That volatility can in turn massively affect the company's profits and cash flows from one year to the next.

As things stand today BP's dividend is completely unsustainable with oil prices at their current low levels. For now the company has decided to stick

with its dividend and maintain the payout, but that situation will not last without a significant rebound in oil prices, although nobody really knows if or when that will occur.

This high degree of uncertainty is reflected in BP's share price and dividend yield, which are currently 353p and 7.6% respectively. In most cases a dividend yield above 5% should be viewed with suspicion, and that is definitely the case here.

So do BP's unsustainable dividend and volatile characteristics mean it's a no-go area for dividend investors? I don't think they do. Although the risks around BP's dividend are substantial, I think they are mostly already in the price. If BP's dividend is cut in half then the yield will still be 3.8%, which is respectable. Of course it could be cut further than that or even suspended entirely, but it might also be maintained at its current level for years and that would almost certainly lead to a significant rise in the share price.

This is all very speculative, but personally I don't see anything wrong in having a small number of these more speculative positions in a dividend portfolio. That's why, despite the relatively high risk, I currently have about 2% of my portfolio invested in BP.

#### About John

John Kingham is the managing editor of UK Value Investor, the investment newsletter for defensive value investors which he began publishing in 2011. With a professional background in insurance software analysis, John's approach to high yield, low risk investing is based on the Benjamin Graham tradition of being systematic and fact-based, rather than speculative.

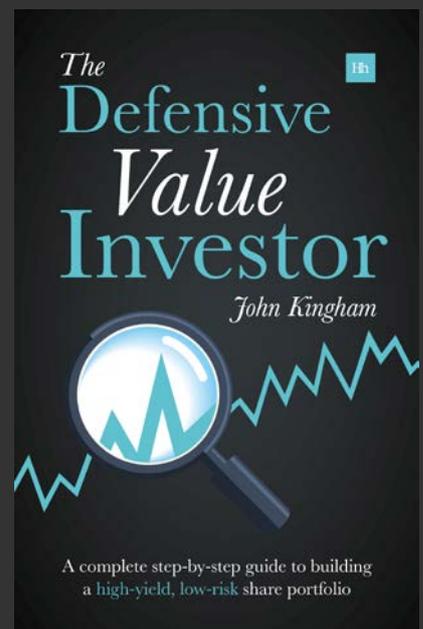
John is also the author of *The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio*.

His website can be found at: [www.ukvalueinvestor.com](http://www.ukvalueinvestor.com).

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BY CAROLINE DREWETT

## MILLENNIALS & MONEY

# PENSIONS VERSUS LIFETIME ISAs (LISAs)

**As the 2016 Budget was unveiled, causing dramatic scenes and statements from across the country due to disability cuts, one of the positive and potentially life-changing schemes for Millennials was somewhat overshadowed. Available to people between the ages of 18 and 40, the Lifetime ISA (LISA) is an appealing option for first time buyers, or those who traditionally struggle to save on their own. It particularly caught my eye as a business owner, and as someone who has never been employed by one single employer. It is a move away from the typical pension scheme, and instead of being tied to your employer and relying on their contributions it is, for once, the government that helps you. This is even more significant given the increasing number of self-employed Millennials and Britons who are moving away from traditional 9-5 jobs and becoming their own boss.**

At first glance, I thought the LISA might be too good to be true; the government contributes 25% as a bonus for anyone who pays into the scheme, which you can utilise on a house worth up to £450,000 anywhere in the UK – not just in London (unlike the Help-To-Buy ISA, which has a £250,000 UK-wide cap). Individuals can pay in up to £4,000 a year, which allows for a £1,000 government addition, so if you maximise the scheme over the years from 18 to 50, you'll be getting £32,000 tax-free from the government, just for saving. With pensions scandal upon pensions scandal hitting the headlines of late, is it time to steer clear of pensions and move towards new initiatives like Osborne's LISA?

The greed of people like Sir Philip Green, who is currently facing calls to be stripped of his knighthood in response to the BHS pensions crisis, is a case in point. With a pension deficit valued at £225m, the Financial Times has rightly declared that more responsibility needs to lie with pensions companies, and that Green's offering of £80m (of which only £40m is cash and the rest is a secured loan) while he continues to add to his £3 billion fortune from his other ventures, all from the comfort of tax-haven Monaco, is unacceptable.

Recently, even global pension schemes in Asia, which are traditionally more flexible and generous than those in Europe, have come under

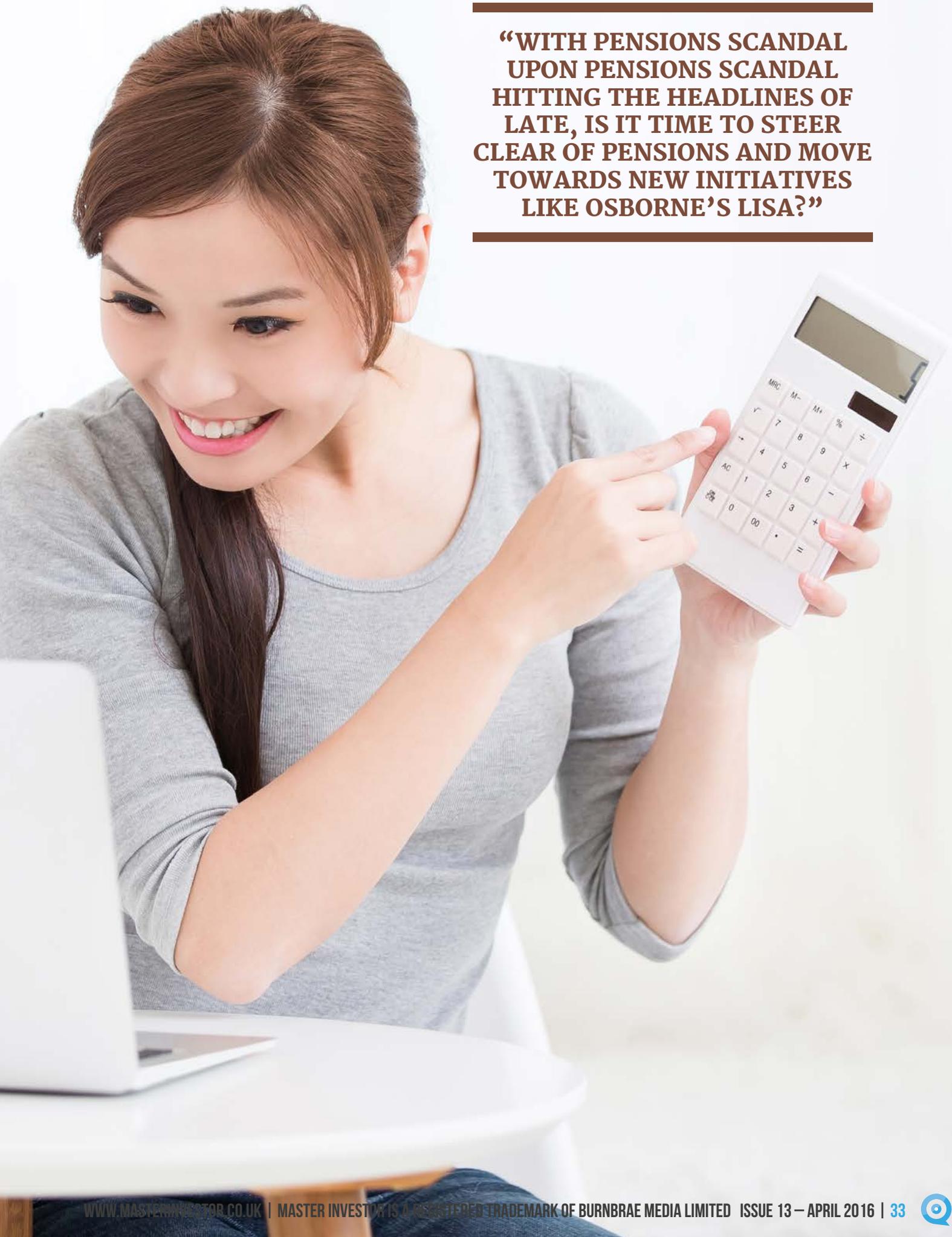
fire. The Singaporean Central Provident Fund (CPF) made headlines when they informed their pension scheme holders that pensioners could withdraw funds from age 64 onwards, but that "with the current RA (retirement account) interest rate, [the] RA balance is expected to last 64 years." For an individual to be forced to maintain a balance in their fund until age 128 when the oldest living Singaporean was 115, and with an average country-wide life expectancy of 82, this is surely a government scam.

With these rigid and unappealing pensions, is it any wonder that so many Millennials are ignoring them entirely and splashing out when

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**“WITH PENSIONS SCANDAL UPON PENSIONS SCANDAL HITTING THE HEADLINES OF LATE, IS IT TIME TO STEER CLEAR OF PENSIONS AND MOVE TOWARDS NEW INITIATIVES LIKE OSBORNE’S LISA?”**

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## “THE ANNUAL SAVINGS LIMIT FOR THE LISA IS ONLY £4,000 A YEAR, BUT GIVEN THAT IT’S COMPLETELY TAX FREE AND EASY TO PAY INTO, IT’S A GOOD STARTING POINT FOR THE SAVINGS NOVICE.”

they should be thinking about how to secure their retirement? Schemes like the LISA might just be the answer for those who want flexibility, are aiming to buy their own home, yet don't fancy gambling their pension pot on their own life expectancy breaking all world records.

So how would a LISA out-perform a regular pension? Firstly, whilst pensions are traditionally considered the most reliable form of retirement security, they tend to be inflexible. Money is almost always locked in pensions until retirement age, except in extreme circumstances, and as the retirement age gets continually extended, your money is trapped for longer, regardless of your financial circumstances. Comparatively, LISAs have two withdrawal options: for first time buyers purchasing their first home, or when the individual reaches 60. On top of that, there is a 5% early withdrawal penalty; if you get into financial difficulty at any stage in life the money is always available there and then, completely tax-free.

Secondly, LISAs are beneficial to those who are self-employed. One of the greatest strengths of pensions is that employers must contribute to them, thus increasing a fund by the salary-in-



cremented pension contribution value. Given that roughly 25% of Millennials are now self-employed, myself included, this perk is wasted on anyone working for themselves without the extra contributions of an employer topping up their fund. To compensate, Osborne is offering a 25% tax-free bonus on all money paid into a LISA. Essentially, the government is paying what employers have traditionally taken care of, thus encouraging Britons to save with huge incentives. The annual savings limit for the LISA is only £4,000 a year, but given that it's completely tax free and easy to pay into, it's a good starting point for the savings novice.

Naturally, with any new scheme, there has been some criticism, not least that the time frame of these schemes affects the timing of government tax revenue. Pensions are taxed at the time of withdrawal, rather than at the source. For Millennials starting a pension fund now, their tax revenue will be incurred by the time Osborne is well and truly retired, sitting in his country pile watching the grandkids run around, far away from any financial crises. Comparatively, encouraging people to invest in LISAs now instead of pensions means that money is taxed immediately, with withdrawal during retirement being tax free. Of course, this means that Osborne gains tax revenue during this government, which contributes to his figures rather than the tax revenue figures of a government in 40 years' time when people withdraw their pensions.

Once again, here we have a clear option for Millennials wanting to break free from the constraints of the baby-boomer generation. If researched carefully, and utilised wisely, there are now exciting fiscal schemes out there. Let's not be pigeon-holed into thinking that we must conform to the outdated vision of a life at work paying endlessly into a bottomless pit based on government-endorsed pension schemes. Let's be innovative with our investments and even more so with our savings.



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BY NICK SUDBURY

## FUNDS IN FOCUS

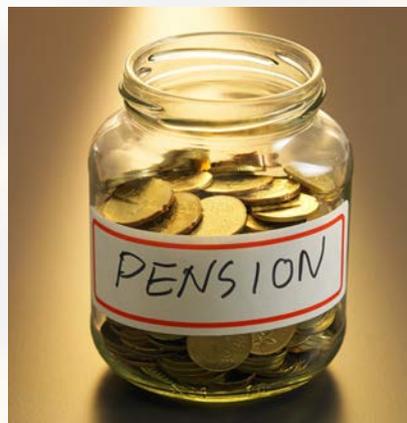
# THE BEST INVESTMENT COMPANIES FOR INCOME DRAWDOWN

**The new pension freedoms that were introduced in April 2015 have been widely welcomed with one of the most popular features being income drawdown. According to data from the Association of British Insurers, 43,800 people invested a total of £2.85bn in these plans in the first six months after the change in the rules came into effect. This is equivalent to an average fund value of almost £65,000.**

Those who opt for income drawdown can leave their pension fund invested and take out whatever income they want as and when they need it. Unlike an annuity they keep full control of their assets and can pass on the residual value to their beneficiaries, but they need to be comfortable with the ongoing risk to their capital.

A recent report by pension specialist Retirement Advantage calculated that drawdown investors could have experienced an 8% average loss in the value of their pension fund. They worked out that a drawdown plan of £100,000 invested in a mixed portfolio of assets on April 7th 2015 would have fallen to £86,522 by the end of January after taking out income equivalent to the prevailing annuity rate of £5,571.

Drawdown would only be suitable for those who are comfortable with this sort of risk to their capital. In most cases it would be people with other reliable sources of retirement income such as a company pension, or those who have used part of their fund to buy an annuity that would fall into this category.



The problem is that it is harder to make up for any losses when you need to continue to take an income from the same investments, although there are several safeguards that you can put in place to minimise the potential risk. The most obvious of these is that you need to make sure that you have a sufficiently diversified portfolio. Normally this would include different asset classes such as shares, bonds and cash so as to limit the impact of market falls and to provide more consistent returns.

Another important consideration is not to take out too high a level of income that it depletes the remaining value of your fund. The safest way to do this is to limit the withdrawals to the natural yield of your portfolio, which means that you will only take



**“UK DOMICILED INVESTMENT COMPANIES HAVE MORE FLEXIBILITY AS THEY CAN TRANSFER UP TO 15% OF THEIR ANNUAL INCOME TO THEIR REVENUE RESERVES. THEY CAN THEN USE THE MONEY TO SMOOTH THE DIVIDENDS SO THAT INVESTORS ARE ABLE TO ENJOY A STEADILY INCREASING LEVEL OF INCOME.”**

out the income and not the capital. This would leave the underlying investments intact thereby improving the chances of long-term capital growth and a gradually increasing stream of interest and dividends.

### Smooth operators

Most of those who opt for drawdown will want to invest their portfolio in a number of different funds, as these provide a professionally managed exposure to the markets and a much greater level of diversification than would otherwise be possible.

The problem with open-ended funds is that they have to distribute all of the income they receive during their financial year. This means that the annual dividends will tend to fluctuate and could be higher one year than the next, which could be quite a challenge for retirees who are dependent on the distributions to maintain their standard of living.

UK domiciled investment companies have more flexibility as they can transfer up to 15% of their annual income to their revenue reserves. They can then use the money to smooth the dividends so that investors are able to enjoy a steadily increasing level of income. Investment companies domiciled offshore can transfer as much as they want as they are not subject to the 15% upper limit.

The Association of Investment Companies (AIC) has identified 19 funds that have successfully increased their dividends each year for at least 20 years. A further 18 have done so for between 10 and 20 years.

It's easier for investment companies to do this because the managers can set aside some of the income in the reserves, which they can draw on whenever their underlying holdings



unexpectedly cut their dividends. Open-ended funds have no such protection.

Many people think that 2016 will be a difficult year for dividends, with some of the biggest companies on the London Stock Exchange having to reduce their distributions to reflect the fall in their earnings as a result of the slowdown in the global economy. The likes of Tesco, Glencore, Antofagasta, Standard Chartered and Rolls Royce have already cut their pay-outs and others are expected to follow suit.

If all goes according to plan, an investment company should be able to generate an increasing stream of income that outpaces inflation, while also growing their capital over time. They are helped by the fact that they can gear their returns (borrow to invest) and in many cases have lower ongoing costs than their open-ended equivalents.

Research by the AIC using data from Morningstar reveals that a £100,000 investment made on 31st December 1995 in the average UK Equity Income investment company would

have grown to £215,874 by the end of 2015. This represents an increase of 116% over 20 years. The annual income would have risen from £3,826 to £8,993, which was way ahead of inflation, with total dividends over the period amounting to £124,548.

### A shortlist of suitable candidates

There are more than 400 investment companies listed on the London Stock Exchange, although not all of them would be suitable for drawdown investors. The best way to narrow it down is to identify those that have the necessary characteristics and you can then pick and choose which ones you want to include as your core portfolio holdings.

The most important quality for drawdown is the reliability of the income, so a good starting point would be the 19 investment companies that have successfully increased their dividends each year for the last 20 years or more. One or two of these are quite small, so it is worth cutting it down to those with a market value of at least £100m as an added safeguard.

Retirees also need a decent starting level of income, but some of these funds pay less than 2%. It would be better to limit it to those that pay at least 2.5%, which is more than you can get from most savings accounts. This may sound low but two of the funds – Witan and JPMorgan Claverhouse – have recently increased their annual dividends by 10.4% and 7.5% respectively.

**“A GOOD STARTING POINT WOULD BE THE 19 INVESTMENT COMPANIES THAT HAVE SUCCESSFULLY INCREASED THEIR DIVIDENDS EACH YEAR FOR THE LAST 20 YEARS OR MORE.”**

Another key point is to look at the level of dividend cover that measures the number of years that the reserves could be used to maintain the current dividend. Some funds are more prudently managed than others, but a figure of at least 0.75 should ensure that there is no sudden cut in your income.

Once you have taken all of this into account you get a shortlist of 11 investment companies that could make decent core portfolio holdings. They are listed in the table and all have fund managers that have been in place at least four years. The one exception is the Scottish Investment Trust, where Alasdair McKinnon took over in July 2014.

## The key points to look for

The first thing to note from the table is that the majority of the investment companies operate in the UK Equity Income sector, with just four global funds out of the 11. This is not as much of a problem as you might think, as most UK-based investors will want the lion's share of their portfolio exposed to their home market. They can then use the international funds to add the required level of diversification.

You can see the benefit of this from the performance data. Over the 12 months to the end of February the two funds with the best returns were Scottish American and the Scottish Investment Trust, both of which have a global mandate. On average the 11 funds lost almost 7% over the last year, but over three and five years they have produced total returns of 14% and 40% respectively.

The dividend yields of the 11 investment companies range from the 2.5% on offer from Witan to the 5.99% paid by Merchants and between them they average 4%. It is also worth noting that other than the Scottish Investment Trust they all pay quarterly. There are several different combinations that will ensure that you receive a dividend each month and by choosing the right allocation you should be able to get a relatively consistent monthly income.

Another welcome feature is that all but one of the funds have ongoing charges of 1% or less, which will have a major beneficial impact on the long-term returns. The exception is Witan, where

the annual cost is 1.02%. It is different to the others because it invests most of its portfolio in other funds, which is a more expensive process but delivers additional diversification.

Investment companies, unlike their open-ended counterparts, can trade at a premium or discount to the underlying net asset value (NAV) of their holdings. If you buy the shares at a discount that subsequently narrows it will improve your returns, although there is always a risk that the discount could widen. At the end of February 10 of the 11 funds were trading at less than their NAV, giving the potential for additional outperformance.



The investment companies listed in the table would all potentially make decent long-term core portfolio holdings for those in income drawdown. Investors would need to decide for themselves how many they invest in and how much they allocate to each based on the size of their portfolio, their risk tolerance and income objectives. They may also want to hold additional funds on a tactical basis to increase the diversification or bolster the potential capital growth.

**Investment companies that have increased their dividends every year for the last 20 years with a value of at least £100m, a yield of at least 2.5% and dividend cover of at least 0.75 years**

| Investment Company        | AIC sector           | Market cap (£m) | Value of £100 invested over 1 year | Value of £100 invested over 3 years | Value of £100 invested over 5 years | Dividend Yield (%) | Dividend Cover (Years) | Dividend frequency  | Discount/Premium (-/+) | Ongoing charges (%) |
|---------------------------|----------------------|-----------------|------------------------------------|-------------------------------------|-------------------------------------|--------------------|------------------------|---------------------|------------------------|---------------------|
| Brunner                   | Global               | 218,5           | 92,99                              | 114,17                              | 137,82                              | 3,11               | 2,06                   | Mar, Jun, Sept, Dec | -16,92                 | 0,75                |
| City of London            | UK Equity Income     | 1178,6          | 93,26                              | 120,5                               | 154,61                              | 4,25               | 0,78                   | Feb, May, Aug, Nov  | -1,93                  | 0,42                |
| F&C Capital & Income      | UK Equity Income     | 241,29          | 94,01                              | 114,1                               | 132,39                              | 4,12               | 1,04                   | Mar, Jun, Sept, Dec | -1,57                  | 0,66                |
| JPMorgan Claverhouse      | UK Equity Income     | 305,91          | 93,06                              | 122,8                               | 143,7                               | 3,89               | 1,29                   | Mar, Jun, Sept, Dec | -7,48                  | 0,85                |
| Merchants                 | UK Equity Income     | 456,66          | 88,56                              | 110,89                              | 130,11                              | 5,99               | 0,93                   | Feb, May, Aug, Nov  | -6,3                   | 0,62                |
| Murray Income             | UK Equity Income     | 444,59          | 86,67                              | 99,84                               | 127,42                              | 4,93               | 1,3                    | Jan, Apr, Jul, Oct  | -8,33                  | 0,74                |
| Schroder Income Growth    | UK Equity Income     | 166,05          | 90,73                              | 114,76                              | 150,14                              | 4,27               | 1,02                   | Jan, Apr, Jul, Oct  | -8,76                  | 1                   |
| Scottish American         | Global Equity Income | 334,23          | 109,56                             | 117,24                              | 131,6                               | 4,23               | 1,18                   | Mar, Jun, Sept, Dec | 2,33                   | 0,9                 |
| Scottish Investment Trust | Global               | 616,62          | 95,82                              | 112,88                              | 133,44                              | 2,72               | 3,09                   | Feb, Jul            | -11,58                 | 0,66                |
| Temple Bar                | UK Equity Income     | 681,43          | 87,37                              | 99,58                               | 135,66                              | 4,02               | 1,11                   | Mar, Jun, Sept, Dec | -8,9                   | 0,48                |
| Witan                     | Global               | 1442,1          | 94,6                               | 132,13                              | 163,21                              | 2,5                | 1,51                   | Mar, Jun, Sept, Dec | -4,38                  | 1,02                |
| <b>Average</b>            |                      | <b>553,27</b>   | <b>93,33</b>                       | <b>114,44</b>                       | <b>140,01</b>                       | <b>4,00</b>        | <b>1,39</b>            |                     |                        | <b>0,74</b>         |

Source: The AIC, all data as at 29 February 2016. The ongoing charges include performance fees where relevant





BY VICTOR HILL

## OPPORTUNITIES IN FOCUS

# TECHNOLOGY TRUMPS POLITICS IN THE AGE OF REALITY TV

**Political elites are crumbling before our eyes across the West because we are now living in a real-time Reality TV show. The West is becoming post-political. Let's invest accordingly.**

*The medium is the message* Marshall McLuhan, the Canadian intellectual, told us back in 1963 – the same year that, according to the great Philip Larkin, sex began in England. People have argued about what he meant. That was well before the age of the internet, smartphones and Reality TV.

But if it was not quite evident then, it is now. I don't want to worry you, but the model has changed in a fundamental way.

What you used to watch furtively on late-night TV is now the fabric of our waking lives. Those Reality TV shows – *Big Brother*, *Gogglebox*, *The Apprentice*, *Benefits Street* – have, like independent life forms, stepped out of your flat screen and entered your living room. (My personal favourites are of the *Obsessive-Compulsive Cleaners Meet the Slobs* variety.) They inhabit the world beside us. We are

living in a hybrid reality, like *The Only Way Is Essex* (TOWIE), which has changed the way people behave. Go to Essex – the young women *really do wear dark glasses over orange tans*.

The world of Reality TV is post-political. Mavericks, populists, game show hosts, cheerleaders, celebrity chefs (Jamie, but no doubt soon, Paul), opinionated BAFTA-winning *luvvies* and supermodels are where the power is. Only they can shift opinion, grab a headline or provoke righteous outrage on *Twitter*. Old lumbering political machines across the West with which I grew up, love them or loathe them, are in terminal decline.

So what? Why should you give a damn? Very simply, what I am going to explain here is *why, in the era of post-reality*, no conventional power structures in the Western world are likely to survive unscathed. That has

consequences for financial markets and asset values.

The US Republican Party is in crisis. Not because it is sure to lose the presidential election, but because it might actually win it. Last Christmas, I was predicting that the old guard of the GOP would stop Donald Trump as he was barely house-trained. (And he was studiously alienating the Black and Hispanic votes – not to mention women.) But I was wrong – he is now almost sure to get the Republican nomination, bar a last minute backlash by the establishment – in which case he might run anyway as an independent.

And during the campaign, The Donald will delve into the Pandora's Box of the Clintons' past like a Jack Russell down a rabbit hole. (Did you know that labour wages declined when Hilary was a director of Wal-Mart?) Do check it all out for yourself



**“OLD LUMBERING POLITICAL  
MACHINES ACROSS THE  
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on *YouTube* – though you can skip the weirder claims about occultism and daemonic possession – they're boring. But if The Donald works that material right, he could well make it to the White House.

Anne Applebaum, the veteran American journalist, recently speculated in the *Washington Post*<sup>1</sup> that a Trump presidency might entail the end of the West. She says: *we are two or three bad elections away from the end of NATO, the end of the European Union and maybe the end of the liberal world order as we know it.* The Donald, compounded with the distinct possibility of a disorderly Brexit, has liberal America wringing its hands.

*It would be a global disaster if Mr Trump were to become president* wrote Martin Wolf in the *Financial Times*<sup>2</sup>. How did America get here? I believe that there are four main forces in play.

The first is the pronounced despondency of the American middle class, or more accurately (though it sounds snobbish), what the English call the *lower-middle-class*: the skilled workers, truck drivers, micro business owners and junior managers. What Lenin called *the aristocracy of labour*. These people's disposable incomes have been under pressure for years and particularly since the Credit Crunch, while the well-off have recovered and the plutocrats have re-rocketed to unimaginable wealth. These are the people most likely to be in debt, to face competition from immigrant workers and who no longer enjoy any prospect of lifetime employment.

The second is that America has fallen out of love with its political institutions, even its hallowed *Constitution*. It is not just despondent – it is angry. Until re-



cently, virtually all Americans regarded the document drawn up by the Founding Fathers back in 1787 as the textual embodiment of American exceptionalism. These days, many Americans, not just cult followers and survivalist extremists, regard *Big Government* as the problem. A partiality for states' rights is one thing; a belief that those who oppose gun control are the enemies of liberty is something else. To a degree, the Republican Party has fostered this anti-constitutionalist sentiment by allowing the *Tea Party* to flourish. A tendency that the elders thought would undermine the Democrats has turned around and bitten them on the bottom. The Donald himself seems entirely unimpressed by the Constitution – he doesn't even seem keen on the rule of law; it is *liberal America* which now proudly drapes itself in the pages of the Constitution.

If America has lost faith in institutions, its politicians have fallen into near contempt. Mainstream politicians are regarded as smug, predictable, ignorant and corrupt. This is why Trump – who has questioned why Wall Street and the

pharmaceutical industry need to make such generous donations to Congressmen's campaigns – is regarded by so many as a breath of fresh air.

The third is that – it was going to happen sooner or later – America has allowed itself to be gripped by a mood of irreversible national decline. I wrote about this in the January edition of this magazine (*2016: The Year of Living Dangerously*). This is partly because President Obama's hands-free approach to foreign policy has failed to project American power effectively. He studiously stayed out of Libya in early 2011 and now blames the Europeans for messing up. America used to be assertive; now it's just passive-aggressive to its long-standing allies.

The fourth reason is that Donald Trump – who builds those flash hotels and golf courses – is, first and foremost, a Reality TV star. This is the key to understanding why he is about to seize the nomination of the Grand Old Party (GOP) of the USA as their candidate for 45th President of the United States.

What concrete solutions are advanced to counter America's malaise? Senator Cruz wants America to return to the Gold Standard. Mr Trump just wants to make America great again, to build, Hadrian-style, a wall along the Mexican border, to deport eleven million people and to ban Muslims from entering America.

Meanwhile in Europe there is a corresponding seismic shift away from traditionally dominant political elites. The

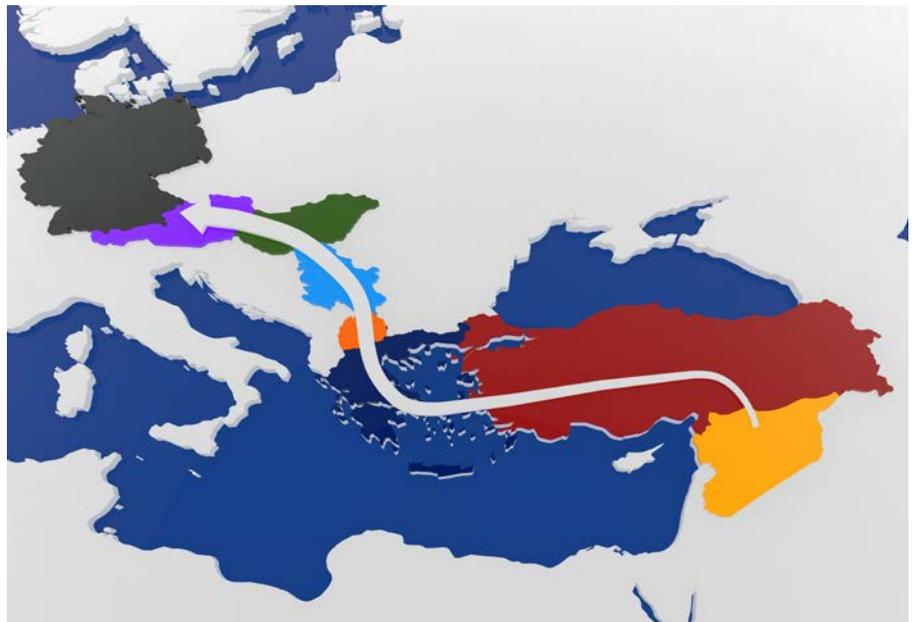
**“AMERICA HAS FALLEN OUT OF LOVE WITH ITS POLITICAL INSTITUTIONS, EVEN ITS HALLOWED CONSTITUTION. IT IS NOT JUST DESPONDENT – IT IS ANGRY.”**

## “THE NEW POLITICAL POPULISM IS NATIONALISTIC IN TONE – FROM UKIP IN BRITAIN TO MR ORBAN’S FIDESZ IN HUNGARY – BUT IT OFTEN HAS SOCIALIST-LEANING ECONOMIC POLICIES AS WELL.”

British Tory Party, one of the most enduring political entities of the modern world, is also in deep trouble, because factions of the coalition of interests it represents are veering in different directions. (The Labour Party is already *de facto kaput*.) The odds of a Brexit are narrowing: I believe that it is too close to call but that the momentum for OUT will build as spring turns to summer. Brexit will leave the Tory Party, as Norman Lamont famously said, *in office but not in power*. The man who would be king is, of course, Boris – a post-political, post-reality politician who has succeeded brilliantly in building a personal political brand with appeal far beyond the traditional confines of the Tory heartland.



In France, the Presidential election of May 2017 is wide open and I believe that the chances of Marine Le Pen of the Front National actually making it to the Élysée Palace are much underestimated by the bookies. (Suppose there is another gruesome terrorist attack?) President Hollande, with abysmal ratings, has dragged the *Parti Socialiste* down with him. Yet the contenders on the right are either spent martinets (Sarkozy) or odious relics of another age (Juppé).



In Germany, Frau Merkel's popularity is in free fall while *Alternative für Deutschland* (AfD), an explicitly Euro-sceptic and anti-immigrant party, is gaining ground. Elections on 13 March in three German *Länder* produced a significant swing away from Merkel's CDU in favour of AfD. In Sachsen-Anhalt AfD polled a quarter of the vote. This bodes ill for Merkel and the CDU in the Bundestag elections scheduled for September 2017.

The governments of Eastern Europe are moving inexorably to the right, especially since the intensification of the refugee crisis, which many central Europeans regard as the product of EU, and largely German, mismanagement.

Viktor Orban, the Prime Minister of Hungary, has even said that his country might be better off leaving the EU and teaming up with either Mr Putin's Russia or – very interestingly – Mr Erdogan's increasingly intolerant Turkey. The new Polish government is well to the right of its predecessor and has made clear that it will not accept "quotas" of new (Muslim) migrants foisted on a conservative Catholic country. Switzerland has withdrawn its application to join the EU; and Serbia, once a

keen aspirant for EU membership, is now having second thoughts.

Up in Finland, the anti-immigrant True Finn party is actually in the coalition government. Their leader, Timo Soini has been Foreign Minister and Deputy Prime Minister since May 2015. He stated recently that he will try to push for a referendum on "Fixit" at the earliest opportunity<sup>iii</sup>.

It's not quite right to characterise all



this, as the traditional left usually does, as a lurch to the right. The new political populism is nationalistic in tone – from UKIP in Britain to Mr Orban's *Fidesz* in Hungary – but it often has socialist-leaning economic policies as well. Take, for example the *Front National's* pledge to nationalise the banks in France and to end "speculation" on financial markets. Of course, if we combine those two things – nationalism and socialism – we conjure visions of the Nazis, which in my view, would be to fall into the same trap as much of the liberal commentariat. Nigel Farage and Viktor Orban – or for that matter, Donald Trump – are not budding Hitlers; they do not want to put people into concentration camps. But they do represent a new style of anti-politics which feeds on the downside of globalisation.

The political-philosophical system that we call democracy is itself in transition. Electorates have been getting more fickle for years; but in the age of Reality TV, sustained loyalty to a single political party is becoming rarer. Just look at how membership of political parties in the UK has declined. The number of paid-up members of the Conservative Party has gone from over three million in the mid-1950s to less than 150,000 under Mr Cameron.

Add to that the phenomenon of lower voter turnout in elections, and the fact that politicians, by and large, have become objects of derision. Most people – especially those who survive on welfare – seem to believe that centre-right parties govern solely in the interests of the rich. At the same time as *socialism* has lost economic credibility.



If there is one global theme which unites the *new right* across the Western world it is hostility towards mass immigration. I believe that opposition to mass immigration which will fundamentally change the nature of society is reasonable; and that the attempts by the metropolitan elite to suppress all discussion of the matter by brand-

**“IF YOU CAN’T BEAT THEM, JOIN THEM. OF COURSE WE HAVE TO LEARN TO LOVE SOCIAL MEDIA – AND TO LEARN HOW TO INVEST IN IT.”**

ing it "racist" was anathema – and had seriously deleterious consequences. It was Blunkett, Straw and Blair<sup>iv</sup> and co who created the ghastly *English Defence League*.

Dani Rodrik of Harvard University has talked about the *political trilemma* of the global economy: the mutual incompatibility of democracy, national sovereignty and economic integration<sup>v</sup>. So, it turns out that we simply cannot have it all: we have to choose. For better or worse, we are choosing to compromise democracy.

It is very tempting to take the line that politicians don't really matter anyway. Economic and social policy is moulded by impersonal forces, so why bother to vote? Except that politicians do make decisions all the time which impact your life from how much tax you pay, how much is spent on what, where to locate an airport, to whether to use military force abroad. If you think politics doesn't matter, just look at Brazil, where the advance of one the world's major economies has been stymied by venal and mendacious politics; or Venezuela, where a major oil producer which once enjoyed middle-income status was plunged into poverty by a bunch of hysterical Corbynistas. (Mr Corbyn's friend and advisor, Ken Livingstone, was a protégé and admirer of the late President Chavez.)

We have to acknowledge that the old representative-based model of democracy, to which people like me are so attached, is in transition in the internet age. How should we respond? How do we protect ourselves from the fallout of Reality TV politics?



If you can't beat them, join them. Of course we have to learn to love social media – and to learn how to invest in it.

So here is my prediction. *When it finally dawns on us that we are in a post-reality, post-political age, conventional (non-digital) businesses will look vulnerable as against those who control the information flow.*

For the foreseeable future, our lives will be shaped by companies that control the internet and social media. The two giants that control here are Alphabet Inc. stroke **Google (NASDAQ:GOOGL)** and **Facebook (NASDAQ:FB)** which are powered, ultimately, by **Microsoft (NASDAQ:MSFT)** and **Apple (NASDAQ:AAPL)**. And **Amazon (NASDAQ:AMZN)** sells huge volumes of products that people identify online. Then there is **Netflix (NASDAQ:NFLX)**, which creates and disseminates original entertainment. Almost all other players are peripheral. Of course, the world might change again, in a way we could not possibly imagine. (If we could imagine it, someone would have already done it.) Until it does, these corporations are likely to be permanent fixtures.

**Google** is not just the most central information nexus in the world, the intermediary at almost every synapse of the global brain; it is also fast becoming the runaway leader in Ar-



tificial Intelligence (AI). If you haven't yet heard of Demis Hassabis – Google him now! He is the co-founder of *Deep Mind Technologies* – which was bought by Google in January 2014. He is also the human brain behind the machine which recently has been beating masters at the game of Go<sup>vi</sup>. He is a genius who will change our lives for good or ill – and he is one of several geniuses within Google's orbit. Google may well turn out to be the most momentous corporation in the history of capitalism. (Yes, I admit, it's scary...)

In the information age, the internet predominates. **Facebook's** Mark Zuckerberg – sartorially challenged in the global street-smart garb of T-shirt and jeans – out-trumps Trump in the infor-

mation flow. Zuckerberg can speed-dial India's Mahindra Modi or China's Xi Jinping as quick as The Donald can press the Domino's Pizza button.

I am not quite so bullish on **Twitter (NYSE:TSTR)**. Stephen Fry recently flounced out of the Twittersphere with a harrumphing valediction – the digital equivalent of a slammed door. Gobby guru Russell Brand still has millions who consume his inane meditations broadcast across cyberspace, though he has never really recovered, so it seems, from his later regretted endorsement of Ed Milliband in last year's general election.

Of all the pre-eminent social media firms, why is Twitter in trouble? I think it's because all of the other giants provide masses of quality information which is overwhelmingly useful; all that Twitter provides is unauthenticated, subjective opinion. You *learn things* on *YouTube* (owned by Google) that you simply would not be able to read in newspapers – partly because of libel laws, and partly because there is a consensus in the published media to stick to mainstream material. I've never learnt anything from Twitter. Opinion is not information.

**Microsoft**, not long ago considered almost a spent force, has enjoyed a comeback under Indian-born CEO Satya Nadella. It has moved to exploit its unique position as the global provider of the software platforms through which we access the internet. I know that Microsoft is spying on me. Since I upgraded to Windows 10 they keep asking me if I like the screen saver, and then I get more and more of what

I like. (Pictures of mountains, if you really must know.) But if they can do that, they probably know exactly what MS Office applications I use and even the amount of time I have taken to write this. Just as we leave our DNA everywhere in the physical world, we are leaving traces of our deep psyche all over cyberspace, every day.

**Apple** probably became the most cash generative corporation in the history of capitalism during Steve Jobs' second reign as CEO because this corporate mega-star was able to engender an unrivalled level of brand loyalty. That's why they can manufacture a smartphone in China for maybe US\$30 and sell it for US\$500 in a downtown American shopping mall. They are as much about corporate strategy as technology. And yet, for now, Apple's business model doesn't depend on mining and refining its customers' data in the way that Facebook, Google and Amazon do. But that probably will change. Anyone can make smartphones – it's about how you can affect the information flow.

**Amazon** is often regarded as the uber-internet brand but it has actually achieved its global dominance as much by aggressive acquisition as by organic growth.

And let's not overlook **Netflix**. Lord Hall, the Director-General of the BBC recently said that the BBC, with an annual drama budget of £220 million simply cannot compete with Netflix which has announced plans to spend US\$5 billion this year alone on new commissions<sup>vii</sup>. Increasingly, the BBC is co-producing its sumptuous drama

**“GOOGLE MAY WELL TURN OUT TO BE THE MOST MOMENTOUS CORPORATION IN THE HISTORY OF CAPITALISM. (YES, I ADMIT, IT'S SCARY...)”**



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productions. For example, of the £20 million cost of the recently broadcast *The Night Manager*, the BBC put up only £6 million – and shared both risks and rewards with other production companies (not Netflix). (You know that when R4's Thought for the Day reflects and *The Guardian* pontificates about a TV series that we have got the most politically correct thriller of all time. Of course they have always conflated capitalism with arms-dealing.) But the BBC was outbid by Netflix for *The Crown* – an epic 20-episode series about the life of HM The Queen, to be shown later this year. Reportedly, Netflix paid £100 million for this project.

But you don't have to be Google to make your mark in the age of the internet and Reality TV. There's a girl of about seventeen who regularly uploads video blogs of herself sitting in her suburban bedroom doing her make-up. She's called Zoella. And every week she gets over six million views. Her "channel" attracts premium advertising rates. So she's probably making more than you are. Maybe Zoella will express her views on the EU referendum soon. Maybe she will still be famous when the Tory Party has been forgotten. Or maybe she will fade after her fifteen minutes of fame.



Internet dating – almost regardless of class, creed, income or even age – is globally, already the main way that young relationship-seekers find partners. Even in traditionally conservative societies like India.

The FBI's assault on Apple over the decryption of the smart phone that belonged to the San Bernardino terrorists is hugely significant. Maybe this case will come to be called *USA v. Internet*. I had supposed that FBI-CIA were sincere in their desire to know what information the terrorists possessed in the cause of "security". Until I heard a computer scientist named Ian Brown, Professor of Information Security and Privacy at the Oxford Internet Institute, explain that they could already extract

this data from the wretched device with ease<sup>viii</sup>. What they really want is a "back door" into the internet, of a kind that President Putin probably already possesses. The traitor, Snowden, even did a little *YouTube* piece recently to back this line of argument. (From exile in Russia – funny he has nothing to say about what goes on *there*.)

Tim Cook, Apple's CEO, in a recent interview with *TIME* magazine<sup>ix</sup>, explained that if Apple were to commission a group of its engineers to give the US authorities the "GovtOS" (Government Operating System) that they want, Apple and its peers would lose the possibility to encrypt data altogether. So, if the FBI or MI6, or whoever, wanted to turn on your smartphone camera to take a sneaky peek at what you are up to, nothing could stop them. And the IRS (America's version of HMRC) would not be far behind. (Apparently, HMRC already has a team scouring our Facebook profiles for evidence that we have under-declared our earnings.) In the event, the court case scheduled for 22 March was postponed at the request of the US DoJ. And on 29 March the FBI admitted that it had found a way to unlock the phone. Round one to Apple.

When the British lowered the Union Jack in Africa we left most of our former colonies with parliaments presided over by a Mr Speaker, wearing an 18th century gown and wig. Silly, you might think. So do the Chinese, who



## “THE MEDIUM – THE INTERNET – HAS BECOME MUCH MORE IMPORTANT THAN THE POLITICAL MESSAGE.”

have now effectively taken over much of Africa: they think democracy is bunk. They teach children in primary school that democracy is a money-fuelled struggle for power between corrupt competing elites who win power by buying votes from gullible electorates with promises they cannot possibly keep. (Mind you, that was exactly the view of Joseph Schumpeter<sup>x</sup>.)

The System is now bigger than the politicians. The System is framed by technology. Karl Marx said in the 1870s, that modern governments were merely the *management committees of the bourgeoisie*. He was wrong then; but he's right now.

The *medium* – the internet – has become much more important than the political *message*. Even politicians like The Donald, hereon in, will only be able to alter political and economic variables at the margin. Representative democracy, in its 19th and early 20th century incarnation, is dead. Long live social media!

**Action:** In my opinion, investors should divide their portfolios into *politically-sensitive* and *information-sensitive* segments. Politically-sensitive stocks are things like utilities, the fortunes of which are driven to a high degree by governmental regulation; while infor-



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mation-sensitive stocks depend solely on technology or, more crudely, dominance of the internet. In my view, investors should now have at least half their *information-sensitive* segment invested in entities which already control the internet (Google, Facebook, Microsoft, Apple, Amazon, Netflix etc.), and the other half in the challengers and upstarts to existing business models – the brasher and more innovative the better.

One way to get comprehensive exposure to the information segment is via

a good technology fund. The **Henderson Global Technology Fund** is one: a Luxembourg-listed SICAV with a track record going back to October 1996. They have nearly 10% of the fund in Alphabet-Google and about one third of the fund is spread amongst Google, Microsoft, Facebook and Apple. Other major holdings include Visa, Samsung, Cisco, Tencent and MasterCard. In total, it had 65 holdings at the end of January with over US\$2 billion under management.

- i Is this the End of the West as we know it? Washington Post, 04/03/2016: [https://www.washingtonpost.com/opinions/donald-trump-and-the-end-of-nato/2016/03/04/e8c4b9ca-e146-11e5-8d98-4b3d9215ade1\\_story.html](https://www.washingtonpost.com/opinions/donald-trump-and-the-end-of-nato/2016/03/04/e8c4b9ca-e146-11e5-8d98-4b3d9215ade1_story.html)
- ii Donald Trump embodies how great republics meet their end, Martin Wolf, Financial Times, 01/03/2016, available at: <http://www.ft.com/cms/s/2/743d91b8-df8d-11e5-b67f-a61732c1d025.htm?siteedition=uk#axzz42KAwBwUD>
- iii Interview with Stephen Sackur, Hardtalk, BBC World 23 March 2016.
- iv See *Broken Vows: Tony Blair and the Tragedy of Power* by Tom Bower, 2016.
- v See discussion in *The End of Alchemy*, page 348.
- vi See: <http://www.wired.com/2016/01/in-a-huge-breakthrough-googles-ai-beats-a-top-player-at-the-game-of-go/>
- vii The Sunday Telegraph, 20 March 2016, article by Patrick Foster.
- viii Interview on BBC R4 PM Programme, 10/03/2016, available at: <http://www.bbc.co.uk/programmes/p03m5sj8>
- ix TIME, 28 March 2016, interview by Lev Grossman, page 24.
- x Joseph Schumpeter (1883-1950) was an Austrian-born American economist and political scientist whose *Capitalism, Socialism and Democracy* was first published in 1942.





BY ADRIAN KEMPTON-CUMBER

## CHART NAVIGATOR

# USING FUNDAMENTALS TO FIND FAILURES

As regular readers will know, I like to approach trade ideas from as many different angles as I can. This month I'm having a look at fundamentals, like company borrowing, dividend payments and so forth. As interest rates have already started rising in the US, it's reasonable to expect them to rise here in the not too distant future. After years of low rates, many companies have regarded low interest rates as the new norm, and my bet is they've exposed themselves to unrealistic amounts of borrowing. In some cases they've done this simply to prop up failure in normal business, or to maintain dividends. These – especially the latter – are terrible reasons for borrowing simply because interest rates are low. With rates so low, even if we saw a rise of just 1 or 2 percentage points then the amount of extra interest payable might increase the cost of servicing such a debt by as much as 100%. It's a big deal.

It's worth remembering though that many of these companies also have pension black holes – another potentially explosive threat to their balance sheets. So I'm going to look at companies that may be setting themselves up for a fall by doing some logical guesswork based on their own published numbers.

It's important to use a reliable source for the data we use. ShareScope is an

excellent package that many of you probably already use. It's the leading share analysis tool in the UK. As well as a host of technical indicators, which

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**“AFTER YEARS OF LOW RATES, MANY COMPANIES HAVE REGARDED LOW INTEREST RATES AS THE NEW NORMAL, AND MY BET IS THEY’VE EXPOSED THEMSELVES TO UNREALISTIC AMOUNTS OF BORROWING.”**

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I use regularly, it also has a wealth of fundamental data which is useful for just this kind of analysis. You can find literally hundreds of metrics by changing parameters going back up to 11 years, and forecasts into the future for some as well. The point here is the methodology. You might choose to apply slightly different parameters than I will, but that's the whole point. As private investors we find opportunity,

and hopefully profit, in not doing what everybody else does. Don't be afraid to be different.

We are probably going to find it easier to identify companies that are likely to fail here rather than ones that are likely to do well. We could use another approach to find the success stories of tomorrow.



WM Morrison (LON:MRW) is a company I wrote about in the Blog recently. I suggested they are likely candidates for a hostile takeover in the supermarket wars that are playing out in our towns and cities. During a period of significantly increased borrowing, they've also increased their annual dividend. We're range bound between roughly 150p and 200p on the chart, and a fall below the range could signify a measured move down to pennies, hence my suggestion of hostile takeover at some point. Borrowing remains high and you can see that it has been increasing while the shares have lost half their value from around 2013.



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**“AS PRIVATE INVESTORS WE FIND OPPORTUNITY, AND HOPEFULLY PROFIT, IN NOT DOING WHAT EVERYBODY ELSE DOES. DON’T BE AFRAID TO BE DIFFERENT.”**

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I wrote a piece in this column last September about using Corporation Tax as an indicator. It's probably one of the few figures on the published accounts that gives us a litmus test on company health. It follows the same pattern of falling off a cliff in the last few years. I've considered it unlikely that companies will pay decent amounts of CT for any reason other than they have to. So this data further supports the failure in Morrisons, and that the stock really is at a pivotal point. It is failing again at the top of that range. That could be the chance for a nice early entry for shorting and taking advantage of the lower support to manage the trade and take profits or simply be ahead of the curve should it fail there.

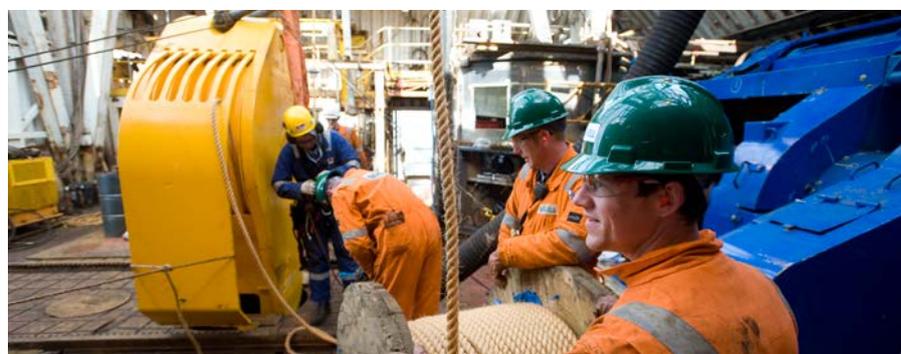
I also wrote about **Wood Group (LON:WG.)** on the Blog in a piece entitled "[Wood Group - Who Even Owns This Stock?](#)" Things looked pretty miserable for the stock then and nothing has changed really from a technical point of view.

Interestingly here we see borrowing increasing alongside increasing CT payments and increasing dividends. Does that mean we might not be so sure about a failure at the 500p support level then? I'm a big fan of TA though. It's a great way to do what I would call 'content free' analysis. In other words I don't necessarily need to know anything about a company to analyse its share price, and if certain patterns or conditions present themselves I can buy or sell accordingly. So I'm always





going to put TA ahead of fundamentals. But from a standpoint of logic, how can year-on-year increases in borrowing, CT payments and dividends persist? Perhaps this is a case where my CT approach is giving us the heads up. That is the one metric that's fallen this year, and it's probably the most relevant and honest of all the figures. Based on that I'd still say we're not looking at a recovery any time soon. Roll on the bad times. The price is falling out of the cloud on the monthly chart and heading towards that support level, and once past there it would most likely fall, rise a little to fail at the 500p Support level, which would then become Resistance, and continue on down. There are plenty of lower highs where early entry has been possible and falling out of the cloud could be considered an entry point to go short too, depending on your risk profile.



So it does look as though we're seeing support for the Technical Analysis in the fundamentals. The snag with fundamentals, I always find, is they're so time consuming. That said a quick bit of data mining with a package like ShareScope and you can take the waiting out of shorting. Won't market analysts be aware of all this stuff in the accounts though? Well, yes they will, but typically analysts who favour fun-

damentals thumb their noses at TA, and long may they do so. A friend of mine gets quite perturbed by the off-hand attitude to TA, as if it's some sort of voodoo when in fact it's quite the opposite. I always say to him that I am very pleased more people don't use it, because if everyone did there would be no opportunities to make more than pence by doing so!

| MORRISONS      |       |       |       |       |       |       |       |       |       |       |     |      |
|----------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-----|------|
| Year           | -10   | -9    | -8    | -7    | -6    | -5    | -4    | -3    | -2    | -1    | 0   | +1   |
| Borrowing (£b) | 1.319 | 1.021 | 0.851 | 1.050 | 1.240 | 1.052 | 1.697 | 2.432 | 3.033 | 2.519 |     |      |
| Dividend       | 3.07  | 4.00  | 4.80  | 5.80  | 8.20  | 9.60  | 11.80 | 10.70 | 13.00 | 13.65 | 1.5 | 5.73 |
| CT (£m)        | -62.6 | 121.0 | 58.0  | 195.0 | 260.0 | 242.0 | 257.0 | 232.0 | 62.0  | -31.0 |     |      |

| WOOD GROUP     |       |       |       |       |       |       |       |       |       |       |       |       |
|----------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|
| Year           | -10   | -9    | -8    | -7    | -6    | -5    | -4    | -3    | -2    | -1    | 0     | +1    |
| Borrowing (£b) | 230.0 | 202.8 | 196.7 | 291.4 | 183.4 | 124.7 | 148.3 | 201.0 | 285.2 | 327.5 | 354.3 |       |
| Dividend       | 2.02  | 3.33  | 4.50  | 7.27  | 8.28  | 8.82  | 10.58 | 8.61  | 13.70 | 17.18 | 20.07 | 23.31 |
| CT (£m)        | 23.89 | 31.78 | 45.32 | 88.26 | 62.22 | 33.02 | 31.08 | 65.03 | 49.85 | 72.54 | 41.85 |       |





BY ROBBIE BURNS

# ROBBIE BURNS' TRADING DIARY

**Over the last couple of years there have been some excellent new issues on the market that have rocketed up. For example, telematics outfit Quartix (QTX) has doubled, Fever-Tree Drinks (FEVR) have fizzed up and quadrupled, polymer washing beads maker Xeros (XSG) has spun up three times. And I'm all out of terrible puns right here, right now. But because of the Brexit fears, there'll probably be a dearth of new issues till the back end of the year. But before the likely shutdown, there are some last-minute ones that look interesting.**

New issues are always a bit tough to value – it means you often have to take a bit of a chance with a valuation. I tend to get out fast if the share price starts to sink and load up if it increases. I thought all you Master Investors were probably too tied up trading the FTSE and your favourite oil companies to check some over so I thought I'd have a look.

Sometimes new issues seem to be floated at silly prices just so those already invested can sell up. Some seem more serious and so generally I'd prefer if they were on the main market than AIM. But... there have been a lot of great ones recently so I don't exclude anything (unless they are Chinese based, as most of those just go bust).

The one that's got the most attention is Hotel Chocolat. It's a great name – hell I even want to buy it just because of the name! I could eat chocolate all day long. Who needs Christmas

when you've got the Easter Day excuse? But personally I don't like that sort of posh, organic 70% chocolate kind of thing. Give me a yummy Twix or a Twirl any day. It is a bit worrying to note its "end of season sale".

---

**“THE ONE THAT’S  
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The "Big City Easter Bunny" has hopped down from £7.50 to £3.75. And the Rocky Road Extra Thick Easter Egg didn't sell at its crazy £27, now slashed to £13.50. Meanwhile

the Dark Ostrich Egg which was selling at a staggering £75 (come on!!) is now (just) £37.50. There are pages of these "bargains" so I simply wonder if they overegged the price of their Easter stuff. A lot seems to be left sitting in the bargain bin.

It looks like it makes about £8m and wants to float at £150m. That looks pretty pricey to me but then again so did Fever-Tree when it launched. So it's a kind of "maybe" from me but if first day trading is at a massive premium I may give it a miss till the share price melts a bit. It's possibly one to hold onto for a bit then quit. Thorntons had a pretty torrid time on the market till it was eventually put out of its misery with a bid. My suspicion is it might go too high from the off and it could be worth waiting. And the amount of Easter stuff unsold is a bit of a worry.

The IPO I like the most is **Cerillion (CER)**, which just floated. A £2.1m

**“NEW ISSUES ARE ALWAYS A BIT TOUGH TO VALUE – IT MEANS YOU OFTEN HAVE TO TAKE A BIT OF A CHANCE WITH A VALUATION. I TEND TO GET OUT FAST IF THE SHARE PRICE STARTS TO SINK AND LOAD UP IF IT INCREASES.”**



profit and a 22m market cap at its 76p float looks like value. It installs and supports billing, charging etc. solutions to the telecoms market mainly. It operates across the works and customers include some big boys like Cable & Wireless. It's a nice, steady business. I can see myself doubling my money here over a year or two without losing sleep. It doesn't have the glamour factor of Hotel Chocolat but I always find it's the boring ones that make me money.

I'm not so sure about **Blue Prism (PRSM)**, which has also just floated. This one has tech glamour to it which should excite investors. Sure it looks way more exciting than Cerillion, after all it's all robots... robots!!! Cool!!! But its market cap is more than double Cerillion's and it makes a loss – and only £6m or so revenue last year. But it says current trading is good and "within expectations". Of course, they don't say what those are so valuing it is hard work.

Anyway, chillingly it wants to supply a virtual workforce with robots taking over mundane back office clerical jobs. Yes, folks, it is after your job. Work in the back office for a finance house? Be afraid... be very afraid... So, yes, I guess profits could grow but there must be a lot of competition out there. I'm not really sold on this one so I'm doing a Duncan Bannatyne on it (no, not hooking up with yet another woman half my age: what I mean is, "I'm out!")

One that I have tucked away is **YU Group (YU.)**. This one really is impossible to value with no real figures to go on. However, there are barriers to

entry in its market supplying energy to smaller companies. It had £8.4m of contracted revenues for this financial year (oooo!). It's going to pay a dividend and should throw off plenty of cash. Anyway, I took a chance with it and have tucked some away in the ISA.

Safe and solid is **Watkins Jones (WJG)**, which buys property and lets it to students. It won't be an exciting capital play but it plans 6% dividends. I like to tuck these sorts of property plays away that pay big dividends. Similar examples that I hold are **Tritax Big Box (BBOX)** and **Empiric Student Properties (ESP)**. It's the kind of share overlooked by even Master Investors but with capital growth it could pay 20% a year. I would be happy with a rise from 100p to 120p over the next year netting me around 25% including dividends. You can sleep at night, too, though the students probably won't be, the party animals.

An interesting one coming up in April is Osirium, a UK-based cyber security software provider. Cyber security is a hot sector and this could be an interesting gamble. It's definitely a gamble as it makes bugger all yet. As an old fart I don't understand much about this area but I think part of what it does is stop insiders from causing cyber attacks. So an insider in a bank couldn't use a privileged account to wreak havoc. If you watched "Mr Robot" on Amazon you'll know what I mean. It's a tiny company that might be worth a small gamble.

Now for the **Harwood Wealth Management Group (HW.)**. That wants to advise people who have quite

a bit of cash but are not super rich (£200,000 to £500,000). It says it's a "vertically integrated financial planning wealth management group". I've no idea what that means either – you can imagine the waffle in management meetings can't you? It doesn't really get me going. And I even tried to think out of the box, and had a brainstorm with myself before touching base about it offline. As you see, I always like to give 110% to everything.

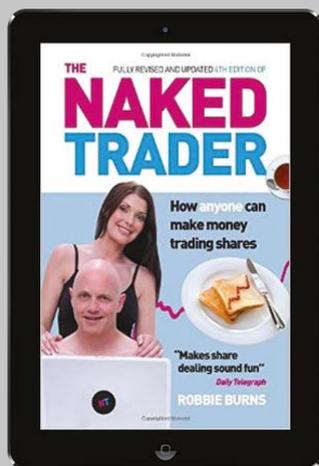
Lots of companies have listed over the years promising to fight cancer. The aim is brilliant but generally punters lose their shirt on these. The next one is **SalvaRx (SALV)**, which wants to develop new therapies to use our own immune systems to fight cancer. I hope it works, but the precedents don't fill me with optimism.

Anyway, it's up to you Master Investors to take your pick (or not)...

**Until next time,  
Robbie**

***I'm currently writing a book on market psychology... if you would like to contribute a story for it please contact me at [robbiethetrader@aol.com](mailto:robbiethetrader@aol.com). Did you lose a lot of money? If so, then why? Did you make a lot of mistakes and learn from them (or not)? If you make good money what makes you such a good trader? How do you think you have used your brain, whether you did well or badly?***

***There will be a free copy of the book for anyone whose story I use.***



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The book updates *The Naked Trader 3* which I wrote in 2011 – a lot has happened in the market since then and I cover all the changes. There are tons of ideas, trader stories, psychology, biggest trading mistakes and 20 trading strategies to make money.

It's only £14.99 and the first 500 who order it get a free pack of Naked Trader T bags made from only the best tea! To get *The Naked Trader 4*, click the link at my website [www.nakedtrader.co.uk](http://www.nakedtrader.co.uk).

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BY RICHARD GILL, CFA

## FROM ACORNS TO OAK TREES

# THE SMALL-CAP DIVIDEND ARISTOCRATS

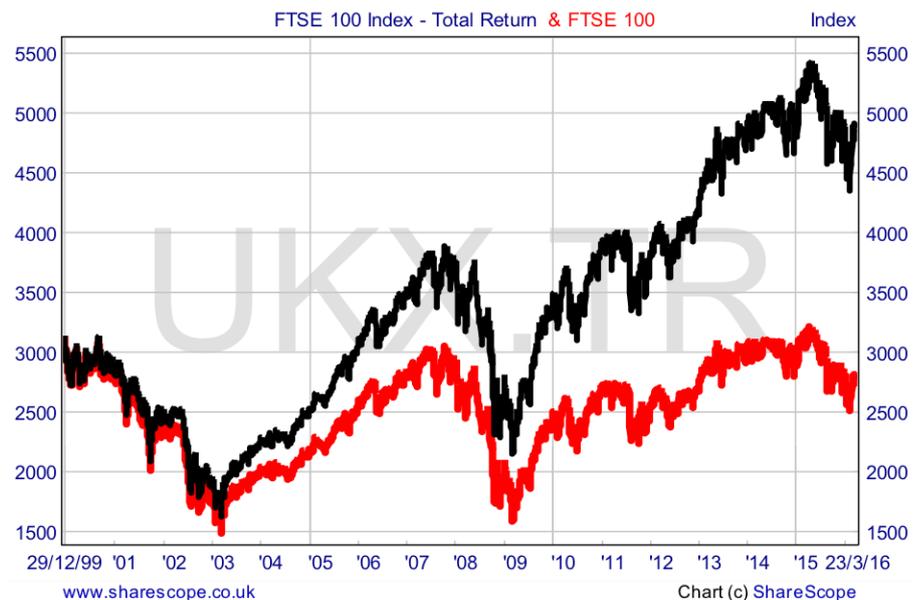
**"The only thing that gives me pleasure is to see my dividend coming in."**

— John D. Rockefeller

Last month on the Master Investor blog I covered **ASOS (ASC)**, a company which has delivered superb capital gains for investors over the past decade. But interestingly, the company has never paid a dividend during its existence. In my analysis I also said that dividends are unlikely to make you rich. Looking back, that comment was probably a bit harsh. It all depends on what you do with those payments.

If dividend income is reinvested back into a decent company investors will enjoy the double effect of a rising share price and annual compounding. This "total return" effect, defined as performance after dividend income is reinvested back into shares, can be powerful. For example, while the FTSE 100 has lost around 11% since 1st January 2000 the FTSE 100 Total Return index has delivered a 56.3% gain over the same period.

In contrast, there is a school of thought which says that companies should never pay dividends. For many firms, especially small ones, cash can be hard to come by. And in contrast to debt and equity internally generated funds have a zero cost of capital. The argument is that all cash should be kept within a business so it can be spent on either working capital or on growth projects.



Some say that the return of cash to shareholders is a sign that a business has run out of ideas and/or opportunities to earn a decent return on its cash.

Master investor Warren Buffet is against paying dividends. His company Berkshire Hathaway has only ever made one (minor) distribution to shareholders with Buffet jesting, "I must have been in the bathroom when the decision was made." His argument was that if investors want to, in effect, create their own dividends, they can simply sell a portion of their holding.

He would much rather keep the cash in the company to continue growing its net asset value.

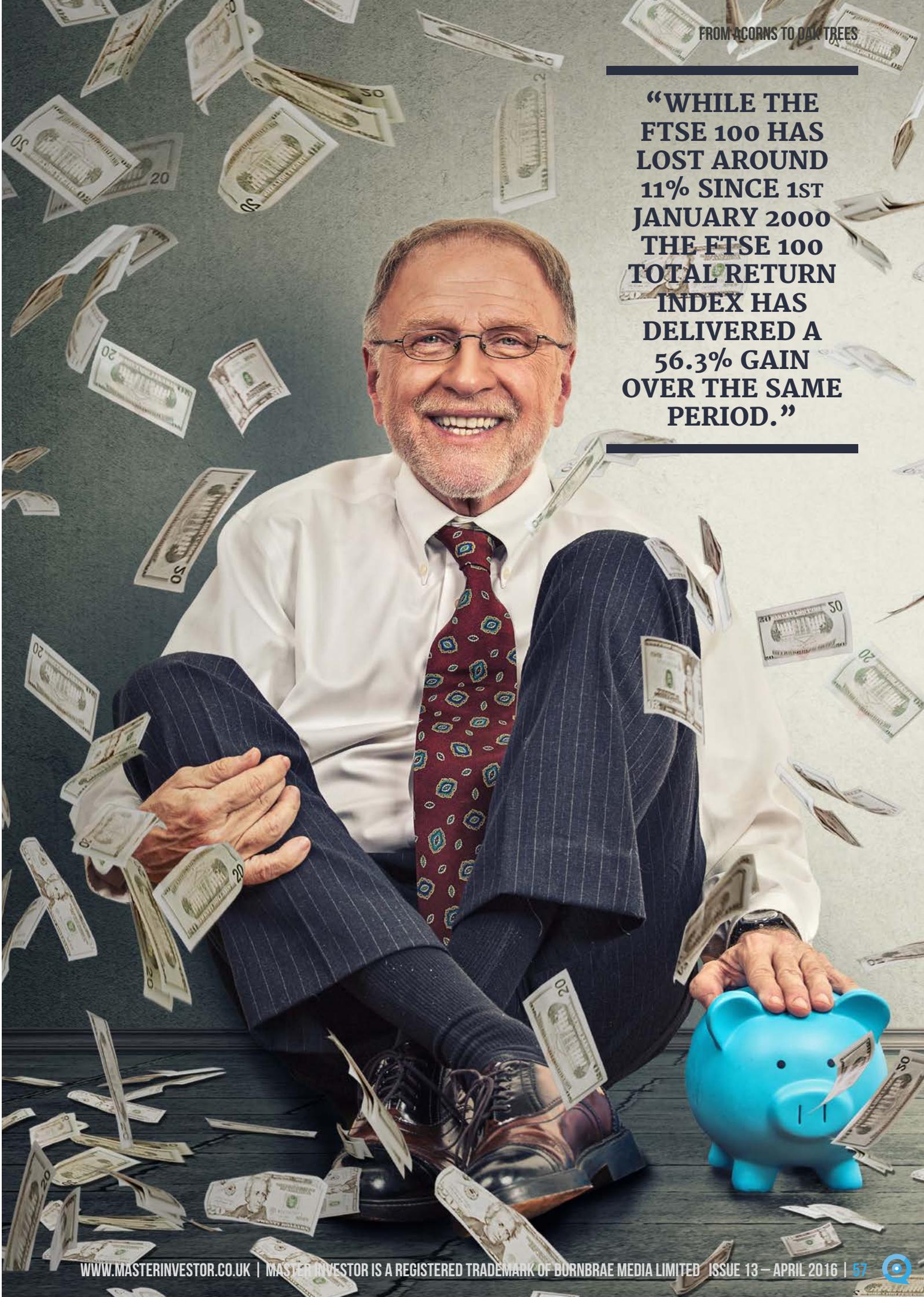
There is also the argument that, given that tax has to be paid on dividends, share buy backs can often be a more efficient use of funds, especially if a company's share price is below book value or cheap on an earnings basis.

But of course there are advantages of owning stocks which pay dividends. The main one being that you can spend the received income on consumption.

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**“WHILE THE  
FTSE 100 HAS  
LOST AROUND  
11% SINCE 1ST  
JANUARY 2000  
THE FTSE 100  
TOTAL RETURN  
INDEX HAS  
DELIVERED A  
56.3% GAIN  
OVER THE SAME  
PERIOD.”**

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A stock could carry on rising for ever but if the gain is only on paper then investors can't enjoy the benefits of their success in the material world.

My analysis of AIM shows that only 28% of companies listed on the junior market currently pay a dividend. Having sifted through them here is my selection of three consistently high paying dividend companies, which crucially have a long track record of increasing the payment and have strong underlying businesses (although one is actually quoted on the Main Market).

Widows and orphans take note, these stocks may be for you!

## JAMES HALSTEAD

**James Halstead (JHD)** is a company I have covered before in this magazine. The firm is a family run business founded over 100 years ago and has grown to become a leading commercial flooring manufacturer and distributor. It operates primarily in the UK and Europe, with recent projects including the Alstrom Epsilon building complex in Lyon and Croydon University Hospital. Capitalised at £885 million the firm is an AIM listed "blue-chip" and currently the eighth largest by market cap. If it was listed on the Main Market of the LSE it would easily make the FTSE 250.

In fact, James Halstead moved from the Main Market to AIM in 2002 and since then the share price has risen by 1,316%, driven by an almost quadrupling of pre-tax profits over 14 years. Investors have also enjoyed 40 years of

increased dividends and several special payments have been distributed due to the highly cash generative nature of the business.



### Further rolling out the profits

Results just released for the six months to December 2015 showed another record set of profits. While revenues for the period actually fell by 2.1% (mainly due to negative currency movements) pre-tax profits grew by a more pronounced 7.5% to £23 million as higher operating margins were enjoyed. Net cash inflow from operations was even higher at £26.4 million, with free cash flow standing at £24.2 million after capex of just £2.2 million. This took net cash to £55.9 million at the period end. As a result of the good numbers the interim dividend was increased by 11.4% to 3.5p per share.

**“JAMES HALSTEAD MOVED FROM THE MAIN MARKET TO AIM IN 2002 AND SINCE THEN THE SHARE PRICE HAS RISEN BY 1,316%.”**

### Assessment

Despite the recent good results James Halstead shares are around 23% off their all-time high of 520p seen in December last year. On forecasts for around 17p of earnings for the full year to June they trade on a multiple of 23.8 times. That remains a high rating but one that is arguably justified given the quality of the business and its track record.

With expectations for a dividend of around 12p this year the yield is a modest 2.97%, but with the cash continuing to build up there is the potential for the company to pay another one of its special dividends.

**As they have been for many years, James Halstead shares look like a long-term buy and hold.**

### S&U

Another jewel of the small cap markets is **S&U (SUS)**, a specialist finance provider which has a history going back to 1938. Founded by Clifford Coombs (and still run by his descendants) the company has delivered significant returns to shareholders during its history.

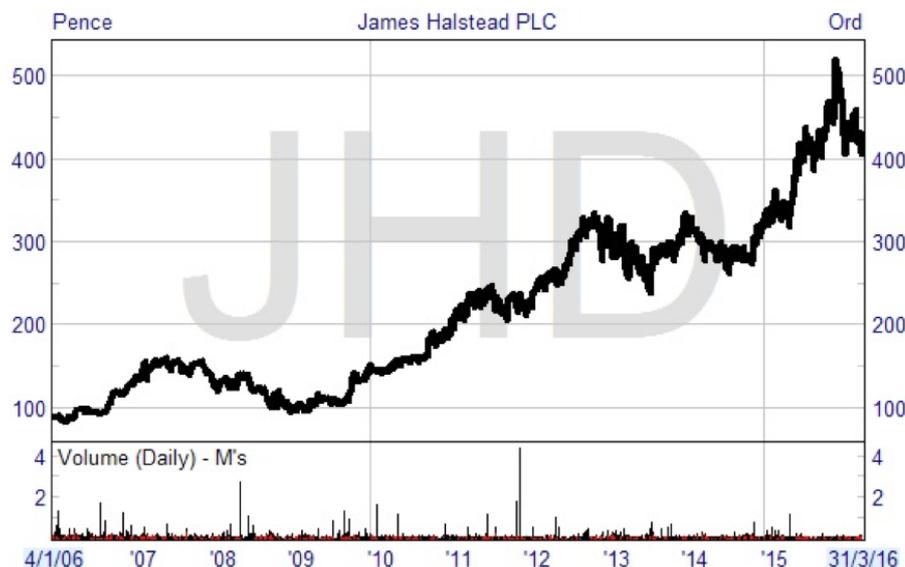
On a capital basis, since bottoming out at 242.5p at the start of 2009, the shares have risen almost tenfold. Dividend returns have also been strong – from 1988 the company increased its annual distribution to shareholders every year for 30 years.

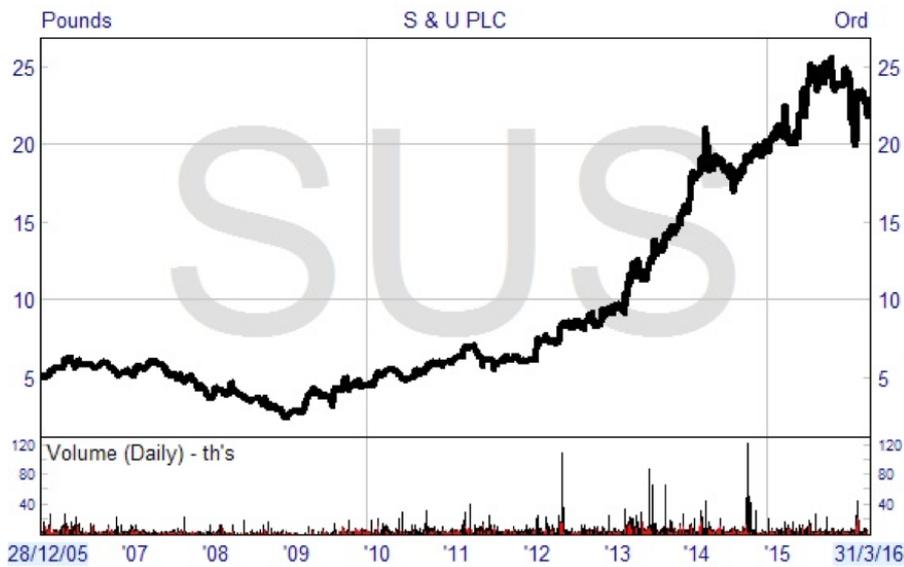


But in 2008 the payment was held flat at 32p per share after "turbulent" trading was seen during the financial crisis of that year. The payment was once again hiked in 2010 and since then has grown at an average compound rate of 14.35% to hit 76p for 2016.

### Going it a-loan

S&U was fundamentally changed last year when it sold home credit business Loansathome4u, for a net £80





**“THE SALE OF THE HOME CREDIT BUSINESS WILL OBVIOUSLY REDUCE S&U’S EARNINGS IN THE SHORT-TERM BUT THE CASH DERIVED FROM IT PROVIDES OPPORTUNITIES TO GROW LONG-TERM EARNINGS AT A FASTER RATE.”**

million. The decision was made as the directors believed the price realised fair value for shareholders, especially given increasing regulatory pressures in the industry and that growth over the past three years in the business had been slow.

This now leaves S&U with one main area of operation. Founded by the group in 1999 Advantage is a motor finance business based in Grimsby. The firm, via a network of UK motor dealers, supplies specialist finance facilities that help customers to buy new and used personal vehicles such as cars, vans, motorbikes and caravans.

Since its formation Advantage has delivered 16 years of consistent profit growth, although this has accelerated markedly in the past five years. In the last financial year, to 31st January 2016, Advantage posted another record set of numbers, with new transactions up by 27% to 15,100, taking live customer numbers up by 33% to 32,600 at the period end. The loan book was up by 37% at £145 million, driving revenues up by 25% to £45.2 million and pre-tax profits up by 22% to £20.4 million.

#### Driving growth

Funds received from the home credit business sale have already been used to pay a 125p per share exceptional dividend to S&U investors. But crucially, an additional £34 million is expected to be invested into Advantage in order to further drive growth. This seems to be a sensible decision for the business – one sign of a good management team is their willingness to move capital to opportunities with the best prospects.

According to the company the used car finance market saw 1.1 million completed transactions last year. And new car finance has been showing excellent growth recently, with figures from the Finance & Leasing Association suggesting new business growth of 20% by value and 14% by volume in January this year. Given Advantage's wide network of brokers and underwriting expertise the potential for continuing growth here looks excellent.

Elsewhere, S&U has earmarked £13 million of the disposal funds to invest in its SME vehicle lending product. This

business is expected to be developed into a broader small scale business lender, providing secured loans of around £12,000 on average. While no specific funding has been set aside, S&U is also looking at expanding into areas of personal finance, initially in partnership with established operators.

#### Assessment

The sale of the home credit business will obviously reduce S&U's earnings in the short-term but the cash derived from it provides opportunities to grow long-term earnings at a faster rate. Evidencing this, the company has recently stated that current trading is showing accelerated growth.

Despite the operational change, comments in S&U's stock market statements suggest that it is committed to its dividend payment, although from now on dividend cover will return to the historic average of two times earnings. Therefore, if we very conservatively assume that Advantage makes the same profits as last year, then we are looking at a dividend for 2017 of at least 67p per share. At the current price of 2,185p this equates to a yield of 3.07% and PE of around 16 times.

That is a (perhaps too negative) base case scenario which in my opinion looks very good value for a business which has large cash resources to spend on further expansion in a strongly growing market. **Like James Halstead, S&U shares look like a long-term buy and hold.**

#### ALTERNATIVE NETWORKS

Having covered two companies which have consistently delivered over the years we now move on to one which has had a bit of a wobble in recent times.

**Alternative Networks (AN.)** is an AIM listed provider of IT and telecommunications services. It operates via three divisions:

**Advanced Solutions** – making over 50% of group revenues Advanced Solutions provides its mainly SME customer base with IT and Voice products via on premise and cloud based services. It



also helps customers control expenses with call management and billing services.

**Mobile Voice** – provides a range of mobile workspace products, including mobile networks, smartphones, mobile desktop access, application management, email, data and security via commercial arrangements with Vodafone and O2 and all the major handset and tablet manufacturers.

**Fixed Voice** – provides a range of fixed line telephony services that allow customers to deliver business critical services via partners BT Openreach, Vodafone and Gamma.

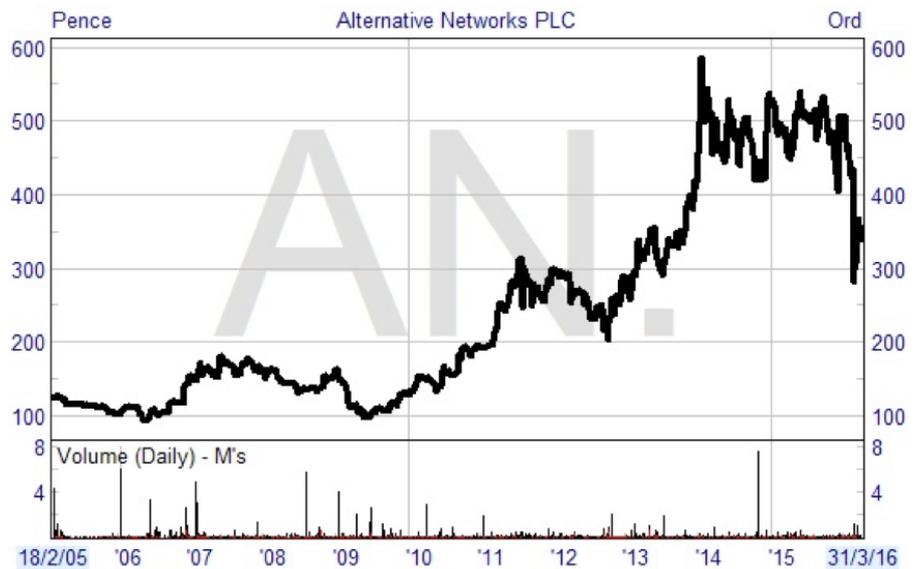
Having listed on AIM in February 2005 the company has been a good performer, having grown pre-tax profits by 316% over the past ten years. This has come via organic growth and also on the back of six acquisitions. Since the first day of dealings the shares have delivered a 238% gain.

**Alternative not-works?**

But the company is no longer the stock market darling it once was, with the shares having fallen by almost 26% in the year to date on the back of a February profits warning. In that statement it was announced that results for the six months to March would be below previous expectations and lower than in H1 2015 due to ongoing pressures in the mobile business. These were especially focussed on roaming revenues, due to increased competition and regulatory pressures.



Alternative Networks has historically made a large percentage of mobile profits from roaming, especially from outside of the EU, so has been hit particularly hard by the forcing through of lower tariffs across the industry. In reaction, costs have been cut to improve profitability. It wasn't all bad news, however, and in the rest of the business trading remains in line with expectations. Crucially, cash generation was said to have remained strong.



**Time to make an Alternative investment?**

What is interesting about Alternative Networks is its dividend policy. For an AIM listed company, indeed for any company, it provides very specific details on what investors should expect. Current guidance is that the full year dividend for 2016 will be at least 10% above 2015, with a 15% annual increase targeted in the medium term.

That implies a dividend payment for the current year of 18p, rising to at least 19.8p in 2017 and then 21.8p in 2018. At the current price of 356p that implies respective yields of 5.1%, 5.6% and 6.1%.

**But given the recent warning are these figures achievable?**

The answer looks to be yes given the solid financial position of the company and its strong operational cashflow. In the last financial year the cash inflow from operations was £21.9 million, representing 99% of adjusted operating profits. Free cash flow was £16.7 million, easily covering dividend payments of £7.2 million. Net debt was £18.7 million at the period end, down from a peak of £41.3 million at the time of the firm's 2014 acquisitions and below management's previous target of £20 million, with interest payments covered 17 times by EBITDA. That is a comfortable position to be in.

I also note that capital expenditure is relatively low – the firm does not have to spend large amounts on upgrading network assets due to its relationships

with the network operators. Capex was just £5.3 million last year and is expected to fall in the current financial year.

**“WHAT IS INTERESTING ABOUT ALTERNATIVE NETWORKS IS ITS DIVIDEND POLICY. FOR AN AIM LISTED COMPANY, INDEED FOR ANY COMPANY, IT PROVIDES VERY SPECIFIC DETAILS ON WHAT INVESTORS SHOULD EXPECT.”**

While the shares have bounced off their post profits warning low of 282p there still looks to be further upside here. They trade on a multiple of 13 times forecasts for the current financial year, which looks reasonably good value given the firm's track record and potential for recovery. However, management will have to prove that the company is back on the growth track before the shares are meaningfully re-rated. **Alternative Networks is a risky buy.**



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BY JAMES FAULKNER

## AN INTERVIEW WITH

# LORNE ABONY

### CEO OF FASTFORWARD

**James Faulkner:** Hi Lorne. Thank you for taking the time to speak to Master Investor. Although many of our readers will be familiar with the name FastForward from Jim Mellon's eponymous book, some of them may be unacquainted with FastForward plc (FFWD). Please can you give us a brief introduction to the company and what it's all about?

**Lorne Abony:** *FastForward is an investment company whose aim is to invest in early stage technology companies that have the opportunity to completely disrupt massive industries and innovate hugely to create new ones.*

*The absolute best investment or asset class in the last 20 years has been early-stage technology companies – absolutely the best – and we believe that is not only going to continue but accelerate. We believe overall that technology and the speed of its development will continue to bring about the largest improvements to humanity and the world, and that early-stage technology companies provide the greatest avenue to support that change and of course profit from it. Our goal is to partner with the very best companies and entrepreneurs to support their mission and help them build the best companies possible.*

**JF:** The startup scene – particularly in the technology sector – is dominated by a clique of venture capitalist outfits and large investors. As such, ordinary retail investors have been locked out of many current

technology behemoths such as Facebook and Google during their early days, thereby missing out on some of the biggest gains. Would it be fair to say that FastForward is aimed at democratising this market?

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**“THE ABSOLUTE BEST INVESTMENT OR ASSET CLASS IN THE LAST 20 YEARS HAS BEEN EARLY-STAGE TECHNOLOGY COMPANIES – ABSOLUTELY THE BEST – AND WE BELIEVE THAT IS NOT ONLY GOING TO CONTINUE BUT ACCELERATE.”**

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**LA:** Yes, definitely. Silicon Valley is very much a Closed Circle, where the best startups want investment from marquis investors and in turn those investors use a lot of predatory tactics to ensure they remain at the top but also use that to bully investors. My fellow board members and I are big believers in the free market and the public capital markets, and we think that being a listed company not only disrupts the venture capital industry but will attract the best entrepreneurs. Furthermore, we think that being public

*allows us to attract some of the best leaders from the high-tech fields, and that is going to be a very valuable proposition for both our shareholders and the entrepreneurs we choose to invest in.*

**JF:** What capabilities and expertise does FastForward possess that make it uniquely placed to invest in such cutting-edge areas? Once invested, does FastForward take an active or a passive approach to managing its portfolio investments?

**LA:** Generally, we are investing in early-stage companies and we aim to invest in companies where we bring more to the table than just capital (money). If we're able to invest a \$1 into a company and then introduce them to a major client, then we're really able to get a lot more out of our investment. So we really aim to work with our portfolio companies to make sure we are being the best partners they have.

**JF:** Take us through the FastForward investment process. Are there any particular investments you've made thus far that stand out as major successes/failures? Presumably the failure rate is quite high among the type of start-ups that you're investing in?

**LA:** Typically, we receive investment opportunities through our network, and to preface this I'll add that I personally receive hundreds of investment opportunities yearly, which is one of the reasons I was really drawn to FastForward, because



**“I’M REALLY EXCITED BY VIRTUAL REALITY, WHICH I THINK IS GOING TO RE-DEFINE THE GAMING AND MEDIA EXPERIENCE, AND IS GOING TO TOUCH ALMOST EVERY SINGLE INDUSTRY IN THE WORLD.”**



*it allows me to bring my entrepreneurial and capital markets skill set along with my network and that of my fellow board members too. Our job is to spot the successes way ahead of the curve, and nurture those companies as they grow to become industry and world-leading entities. I think all our investments are representative of the kinds of companies we want to invest in: big market, big opportunity, great team, right plan.*

**JF:** Anyone who has read *FastForward* by Jim Mellon cannot fail to be blown away by some of the advances in technology that are about to unfold – and in some cases are already unfolding – before our eyes. Which areas of new technology are you personally most excited about? And how does the FastForward portfolio tap into these themes?

**LA:** I think sometimes we forget or don't realise how fast technology is improving and changing our lives. Almost all readers are using a smartphone, and the smartphone has more power than the computer which powered the Apollo missions

*to the moon – how incredible is that? So I think the answer is twofold. What excites me are areas where new technology is going to make a huge mark on society and really disrupt an industry, because at the end of the day that not only benefits us as investors but generally has the greatest benefit on society as a whole. Secondly, I've got a strong gaming and media background, and as such I'm really excited by virtual reality, which I think is going to re-define the gaming and media experience, and is going to touch almost every single industry in the world.*

**JF:** As well as our very own Jim Mellon, the shareholder register of FastForward boasts some pretty extraordinary individuals. Investors include Norbert Teufelberger, co-founder of online bookmaker bwin, which was sold for £1.1 billion recently. You yourself made your fortune as the founder of online games company FUN Technologies. Yet you have gone on record to complain of being locked out from the big Silicon Valley deals, which appear to be sewn up by a handful of private eq-

**uity groups. How will FastForward, which is currently only capitalised in the tens of millions of pounds, change all that?**

**LA:** And it's true – the VCs don't want my money, or Jim's for that matter, so we're doing something about that. I don't think this happens overnight, but what we're doing at FastForward is investing in great companies and great entrepreneurs, and these teams are working very hard, to the point where every few weeks they are making a breakthrough in their business and their industry. We think that as our portfolio companies continue to show their success, that investors will take notice and want to invest with us and be a part of that success. To add to that, there are some lethally bright entrepreneurs all over the UK, and in many other areas of the world outside Silicon Valley. So we think that by bringing together the best entrepreneurs, the right amount of capital and a great team, we are going to be able to mark our territory and be a big success that our shareholders will be rewarded for and that will attract future investors.

# fastforward

**JF:** To read some of the hyperbole in the media you'd think we're on the verge of entering some kind of dystopian future where we're all replaced by machines. While such a scenario may prove to be far-fetched in the near term, should we all be hedging our bets by investing in new technologies? How can the average worker best prepare for the coming technological storm?

**LA:** Great question! I'll state that differently. That future is now and the change is happening right under our feet. Uber just put every taxi dispatcher out of work and in the next few years Google will put every driver out of work and the Tesla sedan nearly drives itself. More or less each and every industry that exists today is up for grabs – market share is up for grabs – and there are entrepreneurs that see a billion dollar turnover company and think "hey, how can I get a 20% piece of that business in one year". That's where we (FFWD) want to be invested and we think all investors should be as well.

**JF:** Biotech is one 'new technology' sector that has seen investors reap huge returns in recent years, although it has cooled off somewhat recently. Are there any areas where we have yet to see valuations take off but where investors may be under-appreciating the near- and/or long-term opportunity at present?

**LA:** I can't point to one specific industry, but I think there are a lot of sectors that are under-represented. I think, generally speaking, great technology-driven businesses are often under-appreciated or misunderstood at their inception and in their early stages. It's our job to identify the opportunities that are currently mis-

understood or underappreciated and invest in those areas, because not only are we going to generate a great return but we can get a better deal on our investment because others aren't interested or don't understand the business model.

**JF:** Clearly when investors purchase shares in FastForward, they're doing it for access to the management capabilities of you and your team as well as access to a ready-made portfolio of start-ups. How much do investors have to pay for that priv-

ilege in terms of management fees etc.?

**LA:** Traditionally, venture capitalists are rewarded like fund managers, whereby they make a percentage on committed capital and a percentage on profit – usually c. 2-3% on committed capital and c. 20-30% of the profit. What's unique about FastForward, is that we have no fees. We make money just like our shareholders do – i.e. when the value of our shares increases.



## About Lorne

Lorne Abony is a technology and media entrepreneur and the CEO of FastForward Innovations, Ltd, an investment company listed on the London Stock Exchange focusing on early stage technology investments. He is also the founder of EdTech companies Vemo Education and Schoold and serves on both companies' boards as Non Executive Chairman. Abony currently owns the Orange County Breakers, a professional sports franchise which competes in World TeamTennis.

Abony is the former CEO of Mood Media Corporation, a public company listed on the Toronto Stock Exchange and the London Stock Exchange. He co-founded FUN Technologies in 2001 and in 2004 as CEO of FUN became the youngest CEO of a listed company on the Toronto Stock Exchange (TSX). Additionally, Abony, whose net worth is estimated at \$300 million, is an accomplished tennis player and is a former member of the Competition Committee of the Association of Tennis Professionals (ATP).





BY SAMUEL RAE

## FORENSIC FOREX

# INVESTIGATING THE US MAJORS

**It's been a wild year in the forex markets so far, and the volatility looks set to continue as we head into the second quarter of 2016 and beyond. Global economies remain fragile, and the impact of low oil, a seemingly overinflated equities market in the US and the continuing (attempted) shift in Chinese focus to a consumption-led economy might have across the various majors is all but impossible to nail down.**

This doesn't mean we can't draw any bias from the fundamentals, however; it just means that said bias has to be constructed through a combination of international scope influences, rather than a single, domestic one. With this said, let's try to figure out what the second quarter holds for some of my top traded pairs, and see if we can't scope out some of the key levels to keep an eye on as price action matures across those in question.

First, however, a quick note on strategy. Those familiar with how I approach the currency markets will be aware that fundamental bias is far less important to me than price action. It's far more interesting, and I like to incorporate it into my operations as a sort of risk tolerance tool, but that's all. I trade candlestick charts, with breakout

entries at or around predefined key levels, with a focus on solid risk management. My fundamental bias comes into it only when determining how aggressive I want to be with my targets, and how tolerant, or accommodative, I want to be with my stops. Specifically, even if my fundamental analysis leads me to believe a currency is set to gain strength against another, I am happy to enter both long and short in the pair in question. If I enter long, however, I might target a dozen more pips than I would if I was to enter short.

With that out of the way, let's get to the good stuff.



So, I'll start with Europe. At the end of March Mario Draghi commented on his outlook for European interest rates and suggested they will remain at current lows – at least for now – to give the ECB time to establish the impact of the recent cut. This has offered some temporary reprieve on the bearish sentiment surrounding Europe, but I don't expect this reprieve to hold over the long term. A host of key German data is set to be reported in early April (by the time this article hits press, it will have been reported); and if this data falls short, which I suspect it might, no amount of passive policy will prop up the single region currency over the coming weeks.

Germany is dogged by what's happening in China (a large portion of its exports in things like machinery, autos etc. head to China) and this is putting serious pressure on the nation's domestic performance. Looking specifically at the Euro, it's up on the 2016 open versus its US counterpart, but hovering at or near 1.3-1.4 resistance at time of writing. I expect a combination of weak data out of Germany and uncertainty as to the efficacy of Draghi's policy actions to strengthen this resistance and catalyse a medium-term reversal towards 1.07, at best, or parity, at worst.



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**“THE VOLATILITY LOOKS SET TO CONTINUE AS WE HEAD INTO THE SECOND QUARTER OF 2016 AND BEYOND.”**

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## “I SEE ONLY DOLLAR STRENGTH GOING FORWARD.”

Shifting now to the US dollar, my outlook for this one is a little rosier than that for the Euro, but not through any real domestic driver. Equities look dangerously inflated, and the US credit machine is once again in full swing. Domestic politics are at their most unstable in years as a result of the Trump campaign, and socioeconomic tensions are high. That said, when compared to global economies, the US looks like the best of a bad bunch. That is, at least, from a potential rate hike perspective. We're not seeing a hike out of Europe any time soon, and despite what some analysts might suggest, the same can be said for Australia and most of Asia (with the possible exception of India). I have no doubt that the true extent of the Chinese slowdown is yet to reveal itself, and as its impact on Australia, Europe and elsewhere becomes apparent, global sentiment will shift to risk off, and in turn, safe haven assets like the greenback. Factor in the potential for two rate hikes before the close of the year and I see only dollar strength going forward.



Looking at the charts backs up this thesis, and gives us something actionable to focus on from a technical perspective. Both the AUD/USD and the USD/JPY have demonstrated a weak US element of late – a weakness that looks set to reverse as we approach key swing points in each. I'm watching a break above 115 flat in the USD/JPY to validate an aggressive long entry towards at least 119, and a break below 0.75 in the Aussie to signal short towards 0.73.





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BY FILIPE R. COSTA

## HOW TO INVEST LIKE...

# BENJAMIN GRAHAM

**"People who invest make money for themselves; people who speculate make money for their brokers."**

— Benjamin Graham, *The Intelligent Investor*

### Are You an Investor?

Investment, speculation and gambling reflect three different approaches towards the equity market that often end with a similar outcome: the enrichment of the broker that makes all the trading involved possible. No matter how a trader positions himself in the market, he often ends up placing random trades, following the crowd, being too concerned with short-term price volatility, trading on others' advice, failing to diversify sufficiently, knowing nothing about the real businesses behind his paper trades, being passive regarding his ownership, and getting seduced by others' optimism and scared away by others' pessimism.

But, according to Benjamin Graham, "an investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return".

Most activity fails to meet these simple criteria and is in fact just speculative. Additionally, Benjamin Graham be-

lieved that investing is a solitary activity that involves profound research and deep patience; one that involves buying from pessimists and selling to optimists; one that involves disregarding the trend-following market consensus and replacing it with realistic historical value and real capability. In this inaugural instalment of our new feature, "How to Invest Like...", we are going to travel back in time to meet the father of value investing, Benjamin Graham.



### The Father of Value Investing

When the concept of value investing comes to mind, the first name that

pops up is Warren Buffett and his immortal buy-and-hold strategy. But, while Buffett should be praised for his own investment success that led him to a personal net worth near £50 billion, the chief credit should be attributed to the most influential man in his investment career, Benjamin Graham. The British-born economist, professional investor and academic was so influential in Buffett's life that Buffett named one of his sons Howard Graham Buffett in honour of his mentor.

Born in London, Benjamin Graham moved to New York City when he was just one year old. He graduated from Columbia University with distinction at the age of 20 and landed a job on Wall Street. In 1928 he began teaching at the Columbia Business School, during which time he came to be known, along with David Dodd, as one of the most influential figures in value investing.

At the time when Graham started out, trading was mainly speculative and/or based on insider information. But Gra-

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**“ACCORDING TO BENJAMIN GRAHAM, ‘AN INVESTMENT OPERATION IS ONE WHICH, UPON THOROUGH ANALYSIS, PROMISES SAFETY OF PRINCIPAL AND AN ADEQUATE RETURN’.”**

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**“ONE OF THE CENTRAL FEATURES OF GRAHAM’S INVESTMENT ATTITUDE WAS THE WAY THAT HE VIEWED STOCK OWNERSHIP. HE BELIEVED THAT, MORE THAN ANYTHING, A SHARE REPRESENTS AN OWNERSHIP STAKE IN A REAL BUSINESS, WHICH ENTITLES THE SHAREHOLDER TO RECEIVE PART OF THE ACCUMULATED PROFITS IN THE FORM OF DIVIDENDS.”**

ham believed that true value could be unlocked through deep research and analysis of a company's statements. Over the years he set about improving his knowledge and taught many Wall Street professionals and Columbia students on the subject of value investing.

Examples of Graham's disciples are Warren Buffett, John Templeton and Irving Kahn. In 1934, Graham and Dodd wrote one of the most influential books (and the first) about value investing, "Security Analysis". Together with "The Intelligent Investor", published in 1949, this book laid the foundations for the concept of value investing. Many today still follow the original ideas advanced at that time. A good example is David Dreman ([MI Magazine, issue 8, November 2015, p. 90-93](#)) and the activist investor David Einhorn.

### **"The Northern Pipeline Affair"**

One of the central features of Graham's investment attitude was the way that he viewed stock ownership. He believed that, more than anything, a share represents an ownership stake in a real business, which entitles the shareholder to receive part of the accumulated profits in the form of dividends. Because of this, he always gave priority to equities with a history of uninterrupted dividend payments. If a company is making money, why not increase cash disbursements to shareholders? This is particularly sensitive in cases where a company is accumulating profits and retaining them as cash and short-term investments, rather than using them in operating activities to expand its profitability. While Graham's reasoning about cash disbursements makes sense, the observation of the real world shows that manage-

ment often prefers to retain the extra earnings, instead of paying them out to investors. This behaviour resembles an episode in Graham's investment life that became known as "The Northern Pipeline Affair".

Northern Pipeline was a company that resulted from a split of Standard Oil (owned by John D. Rockefeller) into several smaller companies. After digging into Northern Pipeline's financial statements, Graham found that the company held \$95 per share in liquid assets (including railroad bonds), while its stock was trading at just \$65. If the company opted to disburse all its cash and cash equivalents to shareholders, its shares would at least be valued at \$95 – a value that wouldn't include the rest of the company's assets, let alone its business as a going concern. Such a massive undervaluation convinced Graham to amass a significant position in the company's stock, expecting that sooner or later management would pay out the cash in the form of a huge dividend.

As the money was not invested in the company's core business there was a good reason for management to disburse it to shareholders. But for that to happen, Graham had to put a lot of effort into persuading them to do so. He then learned an important lesson: persuasion is often not enough to stir management to action.

It sometimes requires a more activist stance, which includes convincing other shareholders to support the cause, accumulating enough voting proxies to be elected to the board, and finally putting management between a rock and a hard place. That was exactly what Graham did in 1927: he convinced other shareholders to back him; he was then elected to the board, and finally forced management to distribute an amount of \$70 per share.

The episode became known as "The Northern Pipeline Affair" and has been one of the most important investment lessons, which even led to the creation of a special category of hedge funds



known as activists. The main idea backing the concept of activism is the fact that a paper ownership also represents a real ownership that entitles its owner to voting rights and to participate in corporate decisions. Investors may use their rights to force companies into taking action, in particular when management action seems unreasonable. David Einhorn's Green Capital is an example of an activist investor/hedge fund. Einhorn and his hedge fund have often accomplished corporate changes through proxy votes they managed to secure. Recently they have been trying to force Apple to distribute part of its accumulated cash pile to shareholders. They managed to achieve a partial success, as Apple has been gradually increasing its disbursements. Einhorn's actions are rooted in those taken by Graham almost one century ago.

## Investment Style

In the book Graham wrote together with Dodd – "Security Analysis" – they laid the foundations for what later became known as value investing.



Published in 1934, the book benefited from the observation of what happened during the Great Depression. On September 3, 1929 the Dow peaked at 381.17 after increasing in value tenfold. On October 29 of the same year, less than two months later, the industrial average closed at 230.07, or 40% below its peak. Later, on July 8, 1932, it had accumulated a peak-to-trough loss of around 89%.

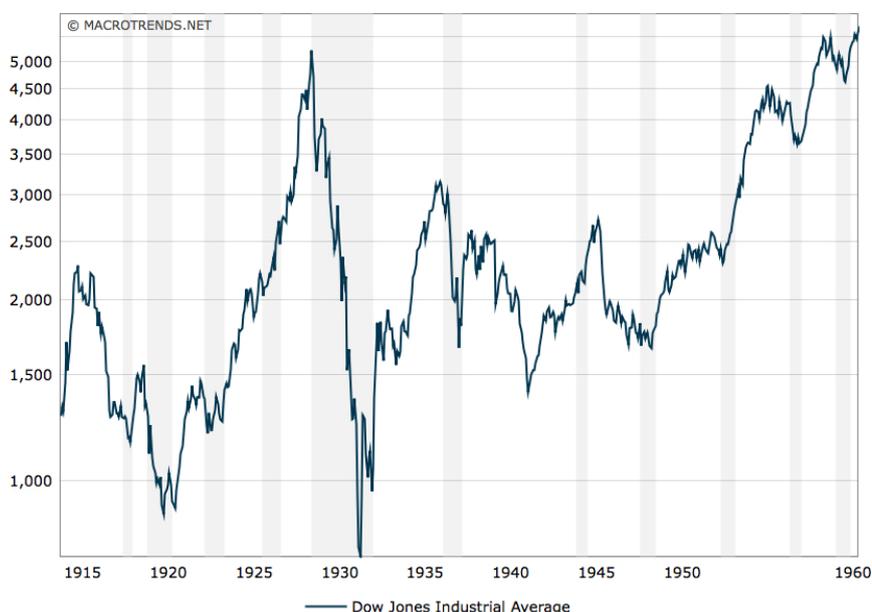
Such massive volatility taught Graham two important lessons that he incorporated into his investment strategies: (1) *the market is not always rational*; and (2) *any value investment should focus on the long term*.

The short-term irrationality was so important for Graham that he created an allegory with the personification of the stock market into Mr. Market, an individual that one day is willing to buy his partner's share of the business for much more than his partner believes his share to be worth, while the next day being so pessimistic that he is willing to sell his stake for much less than fair value. The allegory resembles the irrational short-term behaviour that drives equity prices, often boosted by optimism and depressed by pessimism. This led to an additional lesson that Graham incorporated into his investment style: (3) *psychology plays an important role in the market*, as investors will tend to overreact to any kind of news, exacerbating short-term movements and leading to what today is known as positive feedback loops. In his later book, "The Intelligent Investor", Graham's sensitivity to market psychology is well perceived when he claims "the Intelligent Investor is a realist who sells to optimists and buys from pessimists."

If there is something really different in Graham's investment attitude relative to his contemporaries it is his scientific roots. He turned value investing into an academic discipline because he believed an investor could beat the market by digging deeply into a company's financial statements.

**“HE TURNED VALUE INVESTING INTO AN ACADEMIC DISCIPLINE BECAUSE HE BELIEVED AN INVESTOR COULD BEAT THE MARKET BY DIGGING DEEPLY INTO A COMPANY’S FINANCIAL STATEMENTS.”**

*Inflation-Adjusted DJIA During the Great Depression*



According to Graham, if there is value to be unlocked it is in finding undervalued companies which others ignore. Investors should focus on company statements and reality and not on what they hear from others. "The stock investor is neither right nor wrong because others agreed or disagreed with him; he is right because his facts and analysis are right." From this, another key commandment was born: (4) *look at fundamentals... nothing more.* And speaking of what others do, what they do as a group gives rise to what is known as the market consensus, which is already incorporated into prices, reflecting what is known. What drives price changes is what is not known. In this vein, the Intelligent Investor should buy something others won't, without fearing the unknown, as nobody can tell the future. *The intelligent investor (5) shall not move with the herd.*

**“FOR GRAHAM, THE DISTINCTION BETWEEN AN INVESTOR AND A SPECULATOR IS VERY IMPORTANT AND LIES SUBSTANTIALLY IN THE PROTECTION OF PRINCIPAL.”**

The herd is a victim of market psychology, which overreacts to information. Companies with exceptional profits are often backed by investors, while companies with lower profitability are sold on. But Graham argues that exception-

ally high profits cannot last forever, as these profits would attract other companies into the industry and eventually drive profits lower. The same reasoning could be applied to below-average profits. This leads to one important market feature: (6) *share prices suffer from mean reversion.* In general, analysts fail miserably to predict future profits as they focus too much on the latest earnings release. In the long term a company is constrained by its real capability, and therefore looking at its historical values and significant present developments is a better focus for investors than just looking at the latest numbers. When these numbers are way above or below historical numbers, they usually lead to huge movements in price that just represent a good long-term opportunity in a contrarian direction.

As mentioned at the beginning of this article, for Graham, the distinction between an investor and a speculator is very important and lies substantially in the protection of principal. As Warren Buffett puts it: just "don't lose money". Investors should seek out a margin of safety that acts as a defensive buffer in case things go the wrong way. An investor should look at companies with a few characteristics that help mitigate risk and improve returns. One important step for Graham was to (7) *step away from companies with debt.* The higher the leverage, the higher the profits during economic expansion, but the faster a company would deplete its assets during recession. A company without debt can't go bankrupt, which allows an investor to retain his ownership and wait for better times. Investors must research the market and (8) *invest in companies that offer a significant earnings yield.* The



lower the price relative to historical earnings, the higher the safety given to investors. But, as we already know, a high earnings yield may sometimes not translate into high returns, in particular if management waste the money by retaining it or investing in unprofitable operations. In such cases it becomes possible to invest and (9) *become an activist, to force the company into an efficient direction.* Ultimately, an investor should never forget that statistics may also help mitigate risks and protect principal, through the power of (10) *diversification.*

**The NCAV Strategy**

One of the main strategies espoused by Benjamin Graham is the Net Cur-

**Academic Studies Testing the Performance of Graham's NCAV Investment Strategy**

| Study                          | NCAV Portfolio Annualised Return | Market Index Annualised Return | Filter Used: Price-to-NCAV | Time Period Under Study |
|--------------------------------|----------------------------------|--------------------------------|----------------------------|-------------------------|
| Greenblatt, J. et al (1981)    | 27.10%                           | 1.30%                          | <0.850                     | 1972-1978               |
| Vu, J. (1988)                  | 38.50%                           | 32.10%                         | <1.000                     | 1977-1984               |
| Oppenheimer, H. (1981)         | 24.75%                           | 19.48%                         | <0.667                     | 1949-1976               |
| Oppenheimer, H. (1986)         | 33.70%                           | 12.15%                         | <0.667                     | 1970-1983               |
| Carlisle, T. et al (2010)      | 35.28%                           | 10.69%                         | <0.667                     | 1982-2007               |
| Wendl, V. (2013)               | 19.89%                           | 10.67%                         | <0.750                     | 1951-2009               |
| Arnold G. and Xiao, Y. (2008)* | 31.19%                           | 20.51%                         | <0.751                     | 1951-2010               |

\* Study conducted on British equities

Source: [Valuwalk.com](http://Valuwalk.com)





rent Asset Value (NCAV) strategy. The NCAV measures current assets minus total liabilities (both current and long-term). Graham calculated this value on a per-share basis and picked stocks for which their market price was below 2/3 of their NCAV. The reasoning behind this is straightforward. When NCAV is positive, a company is able to pay all its liabilities with just its most liquid current assets. If this value per share is below the share price, an investor is paying substantially less than the company's liquidation value. If things go wrong, the company could be liquidated and still provide a profit to the shareholder. In a rational market, the explanation for this is that investors are expecting management to employ company resources in a wasteful manner. But Graham argues that market forces would soon reverse the process through two main mechanisms: (1) shareholders would press management (or even replace them) to pay out retained earnings in the form of increased dividends; and (2) the company would very likely be a takeover target, as other companies would certainly be happy to pay at least the liquidation value.

As there is no reliable track record of Graham's strategies, a few academic studies have attempted to replicate

the NCAV strategy to evaluate its performance. The central principle is to build a portfolio of shares with a price-to-NCAV value below a certain threshold and compare its performance with a market index. The table on the previous page summarises the results obtained in seven different studies.

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**“I CHALLENGE THE READER TO FIND STOCKS PRICED AT TWO-THIRDS OF THEIR NCAV VALUE IN TODAY’S MARKET.”**

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In all cases the performance of the NCAV study has greatly exceeded the performance of the market index. In the case of the British market, performance for the NCAV portfolio has been 1.5x greater.

While the results seem great and are often lauded by online businesses providing share tips for a fee, I challenge the reader to find stocks priced at two-thirds of their NCAV value in today's market. In fact, times have changed

and it is extremely difficult to find stocks with that kind of undervaluation. Most of the above studies rely on data from decades ago. If undertaken today, they would lack significance.

## Final Remarks

While some of the main strategies followed by Graham in his time are no longer readily available today, his main commandments should still form the basis for any long-term investment strategy executed today. Investors should focus on fundamentals and ignore others' advice; they should think outside of the box and act against the herd; and they benefit from investing in assets carrying more cash, paying higher dividends, carrying less debt, and trading on low price ratios (price-to-book, price-to-earnings, price-to-cash), as a way of retaining a layer of protection against a potential drop in price. While doing this, investors should be patient, as "in the short run, the market is a voting machine" and sit it out for the long run, when the market "is a weighing machine." But in doing that, they should never forget that "they are owners of a business and not merely owners of a quotation on the stock ticker". It is up to them to change that business.





BY KEVIN MORGAN

# WHAT DOES THE 2016 BUDGET MEAN FOR INVESTORS?

Last year's Autumn Statement made it clear the Chancellor planned to severely limit the bricks-and-mortar investment opportunities traditionally seen as a no-brainer. It was announced that the buy-to-let property market would be subjected to a significant shake up, with a number of important lenders within the industry (including Barclays) tightening their lending criteria in response. Not only must rental income now exceed 135% of interest payments, instead of the previous industry norm of 125%, but landlords are also facing the burden of additional stamp duty, which will be payable on second homes and buy-to-let properties across all bands from 1st April 2016.

This year's Budget, delivered on 16th March 2016, confirmed much of what had been widely predicted, but also threw up a few surprises. And I'm not talking about the sugar tax! There was a suggestion that significant buy-to-let investors with large residential property portfolios would be exempt from the new rules, but that's proved not to be the case. In fact, the primary targets for the higher rates of stamp duty appear to be prolific buy-to-let investors, who will also be hit by cuts to tax relief from 2017. It isn't any wonder professional landlords operating in the private rental sector feel they've been ["knifed in the back"](#) by the Conservatives.

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**“THE PRIMARY TARGETS FOR THE HIGHER RATES OF STAMP DUTY APPEAR TO BE PROLIFIC BUY-TO-LET INVESTORS, WHO WILL ALSO BE HIT BY CUTS TO TAX RELIEF FROM 2017.”**

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## Dividend Tax Change

Business owners and investors are also being hit with a change to the treatment of dividend tax, which will be introduced from 6th April 2016. In short, the notional 10% tax credit on dividends will be scrapped and a new £5,000 tax-free allowance will be introduced.

Under the current rules, a notional tax credit of 10% is applied to dividends paid by UK companies, which is offset against any tax due. Therefore, basic rate taxpayers have nothing to pay, the higher rate is reduced from 32.5% to 25% and the additional rate is 30.5% rather than





37.5%. When the new rules come in, dividends above £5,000 will be taxed at 7.5% (basic rate), 32.5% (higher rate) and 38.1% (additional rate), and dividend income will be treated as the top band of income for that individual. Dividends received by an Individual Savings Account (ISA) or Self-Invested Personal Pension (SIPP) will be unaffected, regardless of the status of the taxpayer.

### Pension Allowance Cut

Speaking of pensions, the tax-free lifetime allowance will also be reduced from £1.25 million to an even £1 million from 6th April 2016. So you can't invest your money in residential property without being penalised, you can stash less away in your pension pot, and if you take a significant dividend from a company you've invested in you'll pay more tax. With the prospect of negative interest rates in the not too distant future, where are you supposed to invest your money to yield a decent return?

### CGT Offers a Glimmer of Hope...

Alternative investments like precious metals, art, wine, antiques, coins and stamps could be a worthwhile consideration, but it seems private equity and venture capital could be your best bet.

Despite speculation that Capital Gains Tax (CGT) might be increased to match income tax bands, Mr Osborne actually announced that CGT would be reduced from April 2016. Basic rate taxpayers will now pay 10% rather than 18% and higher rate taxpayers will pay 20% rather than 28%. Trust CGT will also be reduced from 28% to 20%. The annual tax-free allowance for capital gains remains at £11,100.



Twocom / Shutterstock.com

Compounding the misery for buy-to-let investors, the higher 28% and 18% rates will still apply to carried interest and gains on residential property that do not qualify for private residence relief. Interestingly, commercial property appears to be subject to the new, lower CGT rates and there's also been

a reduction in the stamp duty payable on smaller commercial properties. This may well lead to an increasing number of property investors entering the commercial market, as properties worth up to £1 million will now be subject to less stamp duty.

### Investors' Relief

Arguably, the biggest gain for professional investors announced in this Budget is [the extension of Entrepreneurs' Relief \(ER\)](#). Long-term external investors (other than employees or officers of the company) in unlisted trading companies will qualify for the 10% CGT rate under the newly introduced *investors' relief*. However, the following conditions apply:

- Shares must be newly issued and subscribed for by the individual for new consideration
- Be in an unlisted trading company, or an unlisted holding company of a trading group
- Have been issued by the company on or after 17th March 2016 and have been held for a period of three years from 6th April 2016
- Have been held continuously for a period of three years before disposal

**“THE INTRODUCTION OF INVESTORS’ RELIEF IS CLEARLY DESIGNED TO ATTRACT NEW CAPITAL INVESTMENT INTO COMPANIES, PARTICULARLY SMALL COMPANIES WITH AMBITIONS FOR HIGH, RAPID GROWTH.”**

As with ER, an individual's qualifying gains for investors' relief will be subject to a lifetime cap of £10 million.

If you're not familiar with the concept, an unlisted trading company is a company whose shares are not available on the open market. The introduction of investors' relief is clearly designed to attract new capital investment into companies, particularly small companies with ambitions for high, rapid growth.

Most start-ups require additional financial investment to take the business to the next level, but they also need the expertise, contacts and management support afforded by more experienced private investors or syndicates of investors. Funding for such high-risk enterprises is not necessarily easy to come by (outside of *Dragons' Den*), but investors' relief should provide more of an incentive to would-be business angels. An injection of private equity into a very young company could also purchase a seat on the board – creating an exciting, long-term project, which could yield a spectacular return.

Investing directly into an unquoted business is not for the faint-hearted as it does carry considerable risk. It can also be difficult to get your money out at short notice, so it's typically seen as being for more sophisticated, high-net-worth investors with other sources of

wealth. However, investors' relief is also applicable to more modest investments.

**Is George Osborne Forcing Us to Invest in Companies over Property?**

It certainly appears so. What he's taken away with the dividend tax change, he's given back via the extension to Entrepreneurs' Relief, but there's no such *quid pro quo* or "sugaring the pill" for residential property investors and buy-to-let landlords. It remains to be seen if there'll be a seismic shift towards commercial property or whether investors will dance to the chancellor's tune and start backing new companies. However, the high-risk nature of venture capital means it is unlikely to have broad appeal, regardless of tax incentives.

**About Kevin**

Kevin Morgan is the Managing Director of payment collection specialists London & Zurich ([www.landz.co.uk](http://www.landz.co.uk)). He has 15 years of experience working with a variety of businesses across a broad range of sectors, securing and streamlining payment operations.





BY SWEN LORENZ

EXHIBITOR IN FOCUS

# AVIATION

Everybody knows that air travel is the safest and cheapest way to travel long distances. The logistics of airline travel are truly astonishing. Every day close to 100,000 flights take off around the world carrying approximately 10 million people per day. This effectively means that a plane takes off somewhere around the world every second of every day of the year. This adds up to over 3.5 billion individual aircraft journeys every year provided by the current global fleet of more than 25,000 commercial passenger aircraft.



Moreover, our appetite for air travel has grown at a rate where passenger traffic doubles every 15 years. Truly remarkable! This means that the global fleet of aircraft to carry these passengers has to grow accordingly. How do the airlines pay for all these new aircraft, given that new aircraft typically cost between US\$50-\$200 million? The answer is that they don't – well at least not for about half of these aircraft, as today airlines choose to lease every second new aircraft that is manufactured. Every year over 1,500 new commercial passenger aircraft are manufactured with a total value of around \$150 billion.

The ownership of this half of the commercial passenger aircraft fleet sits with aircraft lessors. These are businesses whose business models will be very familiar to anyone who has considered investment property for their portfolio. Aircraft, like a house or an apartment, are typically funded by bank debt at loan-to-value ratios of around 75%. Airlines will sign long-term leases on aircraft, up to 12 years, and provide all maintenance, crew and fuel throughout the term of the lease, effectively providing the lessor with a rent cheque per month for use of the asset – again very similar to an invest-

ment property. When you consider that the lease yield on an aircraft can average more than 12% per year it is easy to see that an aircraft, which can have a useful life of 25-30 years, can effectively pay itself off less than halfway through its economic life. This simple payback rule of thumb suggests why returns for aircraft lessors might exceed those of property investors.

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**“AN AIRCRAFT, WHICH CAN HAVE A USEFUL LIFE OF 25-30 YEARS, CAN EFFECTIVELY PAY ITSELF OFF LESS THAN HALFWAY THROUGH ITS ECONOMIC LIFE. THIS SIMPLE PAYBACK RULE OF THUMB SUGGESTS WHY RETURNS FOR AIRCRAFT LESSORS MIGHT EXCEED THOSE OF PROPERTY INVESTORS.”**

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Unfortunately for UK investors, most of the large aircraft lessors are listed in the US on the NYSE. However, a company that is listed on the LSE that runs this exact business model is **Avation Plc (LSE: AVAP)**. Avation is Singapore based, but listed in the UK. The company owns a fleet of commercial passenger aircraft which are on operating leases to airlines in Asia/Pacific and European regions. Aircraft are typically leased to airlines for periods as long as 12 years, resulting in high visibility of future earnings for shareholders.

Avation has grown significantly since it first came to our attention in July 2015 having added eight aircraft to the fleet, taking the total aircraft fleet to 37 aircraft today. Avation has also added new well known airline customers including Flybe, Air France and Air Berlin. This represents improvements in both scale and diversification of the leasing business and has significantly increased the contracted lease revenue for 2017 and beyond.

The company was founded in 2006 by Executive Chairman Jeff Chatfield, the former Executive Chairman of a regional Australian airline Skywest Airlines, to provide leasing facilities to Skywest. Avation developed a very





profitable business model, and evolved the business to target the global airline market, which has resulted in high fleet-growth and a dramatic increase in revenues in recent years.

The global airline industry is currently enjoying record profitability after a difficult 15-year period that has included high fuel prices and business cycle downturns, as well as exogenous factors such as the terrorist attacks of 9/11 and international epidemics such as SARS and Ebola. This underlying industry resilience has been driven by a doubling of passenger traffic in the same period, which has resulted in high demand for new aircraft, with the trend set to continue over the longer term. Current profitability in the airline industry is derived from a trifecta of drivers which includes increased efficiency, with global airlines reporting load factors in excess of 80%, low fuel prices and continued passenger growth.

Avation's growth stems from an inflexion point in May 2015 when the company successfully issued unsecured bonds under a Global Medium Term Note programme to raise US\$100 million. This successful debt issue was a massive step forward for the company. When combined with low priced senior debt attached to each new aircraft delivery it has provided the funding for the fleet growth over the past nine months.

The business model is very simple. Aircraft have an economic life of around 25 years. Income is earned on the lease rate, less expenses related to the depreciation of the aircraft over time as well as the financing costs related to

**“AVATION’S GROWTH STEMS FROM AN INFLEXION POINT IN MAY 2015 WHEN THE COMPANY SUCCESSFULLY ISSUED UNSECURED BONDS UNDER A GLOBAL MEDIUM TERM NOTE PROGRAMME TO RAISE US\$100 MILLION.”**

the acquisition of the aircraft fleet and the administration costs. As a result, the long-term, fixed-rate cash flows generated by the leasing model lend themselves to relatively high earnings visibility. After the initial lease period the aircraft are re-let or can be sold. Avation's business model is such that the aircraft are typically fully owned before the first lease has expired, which is less than half way through the asset's economic life. The aircraft can then generate unlevered returns for the remainder of its life or can be refinanced to release capital to fund further growth. It is also important to note that the airline is responsible for all other costs including maintenance, insurance, fuel, pilots and crew.

Avation was instrumental in introducing the ATR-72 aircraft to Australian skies as a result of its leasing activity with Virgin Australia in 2011. This forged a strong relationship with the manufacturer ATR, which is a subsidiary of Airbus. Since then, Avation has grown to become the second largest ATR lessor in the world.

The ATR-72 is the best-selling under-90-seat regional aircraft in the world since 2005. ATR has sold more than 1,500 aircraft since its inception. ATRs are currently flown by over 200 operators in more than 100 countries in more than 5,000 flights per day.

Looking beyond the significant growth that has been delivered in 2016, Avation also holds 10 current orders and options on 27 additional ATR-72s that the company can exercise starting in 2017. These further aircraft will be a source of meaningful growth over the next several years and continue to support Avation's growth story.

This is an opportune time for equity investors to be introduced to the Avation business as it is the growth already executed in 2016 that will deliver significant improvements to revenues and earnings in the 2017 financial year, which for Avation commences on 1 July 2016. As the business model is to derive lease revenue from aircraft assets, in a year of high growth like 2016, there is a timing lag where new aircraft have immediate impact to the balance sheet but are only able to deliver revenues and earnings for the portion of the year from date of delivery. The eight aircraft delivered so far in 2016, will generate a full year's revenue and earnings in 2017, which is thus likely to see a boost to both revenues and earnings.

With few peers located in the UK, peer comparisons are available with counterparts in the US. Financials can be found at [www.avation.net](http://www.avation.net).

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MARCH 2016

# BEST OF THE BLOG

## The City of London Will Survive Brexit

This morning the French Minister for the Economy, Emmanuel Macron, has announced that, post-Brexit, Paris will *roll out the red carpet* for the mass exodus of persecuted banker-refugees and traumatised hedge-fund-manager-asylum-seekers who will be thronging through the Channel Tunnel. One can im-

agine the pitiable scenes of these unfortunates, desperate to be reunited with their Swiss bank accounts, fleeing the odious tyranny of a nation that has had the temerity to question the beneficence of the *European Banking Union*.

No doubt makeshift camps will have to be erected on the White Cliffs of Dover as these desperate victims assemble to flee... And Ms Yvette

Cooper MP will ask probing questions in the House of Commons in tones of deep moral disquiet about the welfare of the bankers' progeny...*Surely the Government will agree to alleviate the condition of children who have been abandoned at public school...?*

But nice as it is to conjure with this idea, it's just not going to happen, Monsieur. And by the way, even

**“THE UK TRADE SURPLUS IN FINANCIAL SERVICES IS ABOUT £60 BILLION, OF WHICH ROUGHLY ONE THIRD IS WITH THE EU. THE CITY PLUS CANARY WHARF EMPLOY SOME HALF A MILLION PEOPLE. NO WONDER THE FRENCH WOULD LIKE TO GET A PIECE OF THE ACTION.”**

in your homeland, *la belle France*, everyone knows you're a plonker!

The UK trade surplus in financial services is about £60 billion, of which roughly one third is with the EU. The City plus Canary Wharf employ some half a million people. No wonder the French would like to get a piece of the action.

My take on the much discussed is-

sue of whether Brexit would toll the demise of the City of London, much to the advantage of Paris and Frankfurt, is simple. The French, and to a lesser extent, the Germans, have been doing all they could to attract financial services away from London for years and have failed thus far. If it was going to happen, it would have happened already.

**By Victor Hill**



**Click here  
to read the  
full article**



## Sirius Minerals – Private Investors Take Care!

With a £2.5bn programme to build its potash (strictly – polyhalite) mine in Yorkshire, **Sirius Minerals (AIM:SSX)** plans to become by 2022 the largest operating underground mine in Britain, if not in the British Isles. Promising also to be one of the cheapest suppliers of a unique multi-nutrient fertiliser to a hungry world agricultural market for approaching 100 years, it should also become a highly profitable one, and as such, of great interest to UK institutional investors. When, that is, they are allowed to invest, which will only be when Sirius moves up from AIM, where it listed in 2005 at 5p, or when they sign up to a financing deal that is now under discussion.

As the chart shows, there has just been a sharp flurry of interest. On 16th March over £8 million worth of shares were traded – pretty large for an AIM stock – as investors looked forward to a key piece of news the next day – the updated Definitive Feasibility Study, which for the first time (partly because its design has changed since previous studies) has put solid (within 10% accuracy) numbers to the long-term economics of Sirius's project. Based on some brokers' original 'targets'



(my regular readers will know what is coming) of some 50p or 70p per share, investors on the bulletin boards were talking excitedly of the shares – having closed at 23p on the 16th – doubling the next day.

I could of course have told them they were due to be disappointed (I wrote these opening paragraphs on the evening of 16th March!) – as they duly were, with the shares losing 24% on the announcement next morning and even more today as I write – and not just because the project capital cost is turning out higher than expected.

**By John Cornford**



**Click here  
to read the  
full article**

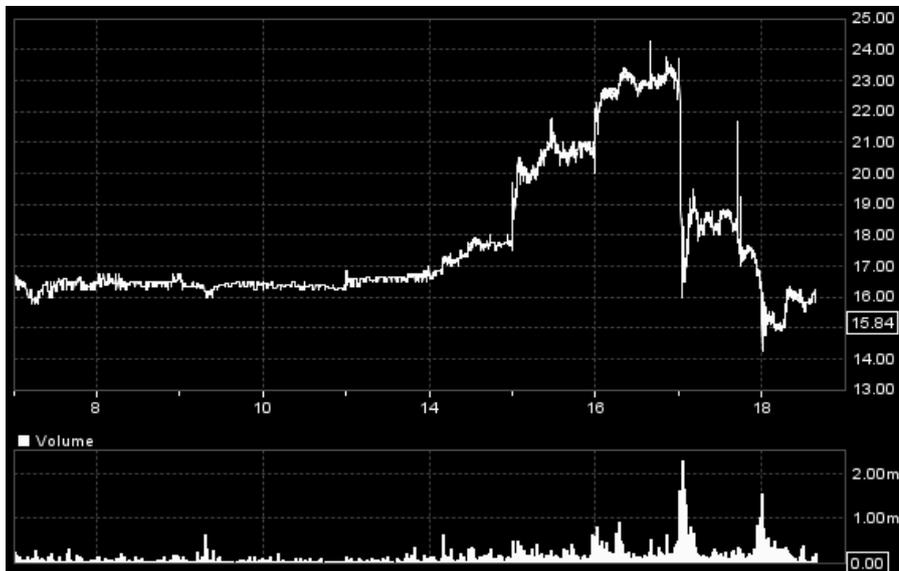
## Morrisons: Failure and Hostile Take-Over Ahead?

What a week last week was. The Tories voted to cut disability benefits by £30 per week, yet the back bench revolt prevents the liberalising of Sunday trading hours because apparently, in the House of Commons at least, it's still 1950. To be fair it's Labour that has the Keep Sunday Difficult campaign. Make Sunday a day worth being alive for I say. The only day many of us get off at complete leisure and it's not even a real day because everything's shut or closing early.

Well it's certainly not good news for supermarkets. Talk of Morrisons' recovery is quite possibly premature. I rather think all the majors were hoping for the vote to succeed. Morrisons cut their recent dividend, which at least means they're not borrowing to maintain it, from either Peter or Paul. They say recovery will take time. The big question is how long?

The **WM Morrison (MRW)** chart is at a crossroads. The weekly chart illustrates very well how we could be at a reversal point, although I'm not a big fan of double bottoms, let alone in a poor economy, during a massive competitive war between rival supermarkets, and what looks very much like a congestion area rather than a reversal.

**“SIRIUS MINERALS (AIM:SSX) PLANS TO BECOME BY 2022 THE LARGEST OPERATING UNDERGROUND MINE IN BRITAIN, IF NOT IN THE BRITISH ISLES.”**





## “TALK OF MORRISONS’ RECOVERY IS QUITE POSSIBLY PREMATURE.”

It's failed at the 200p mark now, rather than shooting through it which would have been a cause for thinking long. Morrisons rattled along in a congestion area for most of the first half of the noughties, so I wouldn't hold your breath to see a resolution one way or the other. The recent highs and lows from '14-'16 are progressively lower, a weak sign itself. The Stochastic is very topy, although one must always remember with a stochastic that it is limited to 100, so it isn't as 'high' as it can go just because it's around 100. It can stay there too.

By Adrian Kempton-Cumber



### Commodities - A Real Recovery or a Dead Cat Bounce?

The Saudis are breathing a sigh of relief, as their oil exports are now valued 45% higher than they were earlier in the year. That is a sentiment no doubt shared by commodities exporters, as iron ore, copper, gold, and many other raw materials experienced two-digit

appreciations over the last four weeks. But with the global economy not really showing signs of a strong performance, one wonders if what we're witnessing is a real recovery in sentiment that will drive the commodities markets higher, or just a dead cat bounce that will soon revert to its prior state. Market fundamentals convince me of the latter.

When we take the two-year price chart as a baseline, commodities exhibit a terrible performance. Almost all commodities experienced an epic bear market during the period between early 2014 and the end of 2015. Take oil, for example. It declined by 75% between June 2014 and mid January 2016. Take iron ore, alternatively. It saw its price crash 70% between 2014 and 2015. There are plenty of other examples, as the inversion in interest rate expectations in the US, combined with a cooling of the Chinese economy,

quickly drove demand expectations for commodities down, which ultimately impacted prices.

But, when we look at the market starting in 2016 (or, even better, starting at the end of January), what we see is a stunning bullish trend for all commodities except agricultural commodities. Iron ore leads the table with an accumulated gain of 39% YTD. The next positions in the list are taken by gold and silver, which both benefited from the increasing possibility of the FED delaying its second rate rise to 2017 and from the currency wars unfolding in Asia. In general, all industrial commodities are up YTD. Brent crude, for example, is up 9.1% YTD, but is up 45% since hitting a low near \$28 on 20 January.

By Filipe R. Costa





BY VICTOR HILL

READ TO SUCCEED

# THE END OF ALCHEMY

## MONEY, BANKING AND THE FUTURE OF THE GLOBAL ECONOMY

BY MERVYN KING, PUBLISHED BY LITTLE, BROWN, 2016

### Confessions of a (Central) Bank Manager

**Mervyn King was the Governor of the Bank of England from 2003 to 2013 - a critical decade which encompassed the Credit Crunch and its aftermath. He may look like a retired bank manager, but this book finally reads like one of those rather endearingly urgent 1950s public information broadcasts. He has written this book to save the world from future folly.**

The alchemy to which the title of the book refers is nothing less than the ability of banks to create money in the economy just by taking deposits and then lending them to third parties. The money economy in which we still live came about in the 18th century and has endured even in an age when very little money in the system exists in the form of notes and coin. Mervyn King has written not a memoir of the Credit Crunch as we had been expecting, but an argument in favour of a (slightly) new kind of economic system. This is a work of polemical economics in the tradition of JM Keynes but it contains no mathematics, or even graphs. In fact, in his efforts to make the book accessible to non-economists, King can become laboured, as when he finds

it necessary to explain to his readers what a balance sheet is.

Yet the scope of the book is broad: the causes of the crisis; the history of money and banking; the toolkits available to modern central banks; the relationship between international finance and politics in the modern world; and why another financial crisis is inevitable unless the system is reformed. King puts forward a modest proposal which he believes could bring about radical change.

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**“MERVYN KING HAS WRITTEN, NOT A MEMOIR OF THE CREDIT CRUNCH AS WE HAD BEEN EXPECTING, BUT AN ARGUMENT IN FAVOUR OF A (SLIGHTLY) NEW KIND OF ECONOMIC SYSTEM.”**

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Much scorn has been directed at central bankers in recent years. But this former central banker is acutely concerned that the current policy across the West of super-low interest rates may have negative long-term consequences. A low rate environment intensifies the desperate *search for yield* which was itself one of the causes of the Credit Crunch. None of the central bankers who were in charge in 2008 expected zero rates to persist for eight years (and counting). *After a point, monetary policy confronts diminishing returns.* (I was pleased to read that because I wrote almost the same words in the February 2016 edition of MI magazine.) Now is the time for a re-think, which this book is intended to ignite.

During the 1970s and '80s Western countries embarked on a bold experiment. Central banks were given independence to run monetary policy without interference by finance ministries. Capital controls were largely abandoned. And the banking system was deregulated. At first things went swimmingly. King calls the period 1990-2007 *The Great Stability* as steady growth and low inflation obtained. But debt levels rose at the same time that European Monetary Union (EMU), in abolishing flexible exchange rates within

the Eurozone, fostered growing trade surpluses (Germany, the Netherlands) and deficits (Southern Europe). Meanwhile, bank leverage soared as bank balance sheets swelled faster than capital. Eventually, in 2008, the whole system came crashing down. The crippling of the financial system produced the largest fall in world trade since the 1930s with the loss of about 10 million jobs in Europe and America.

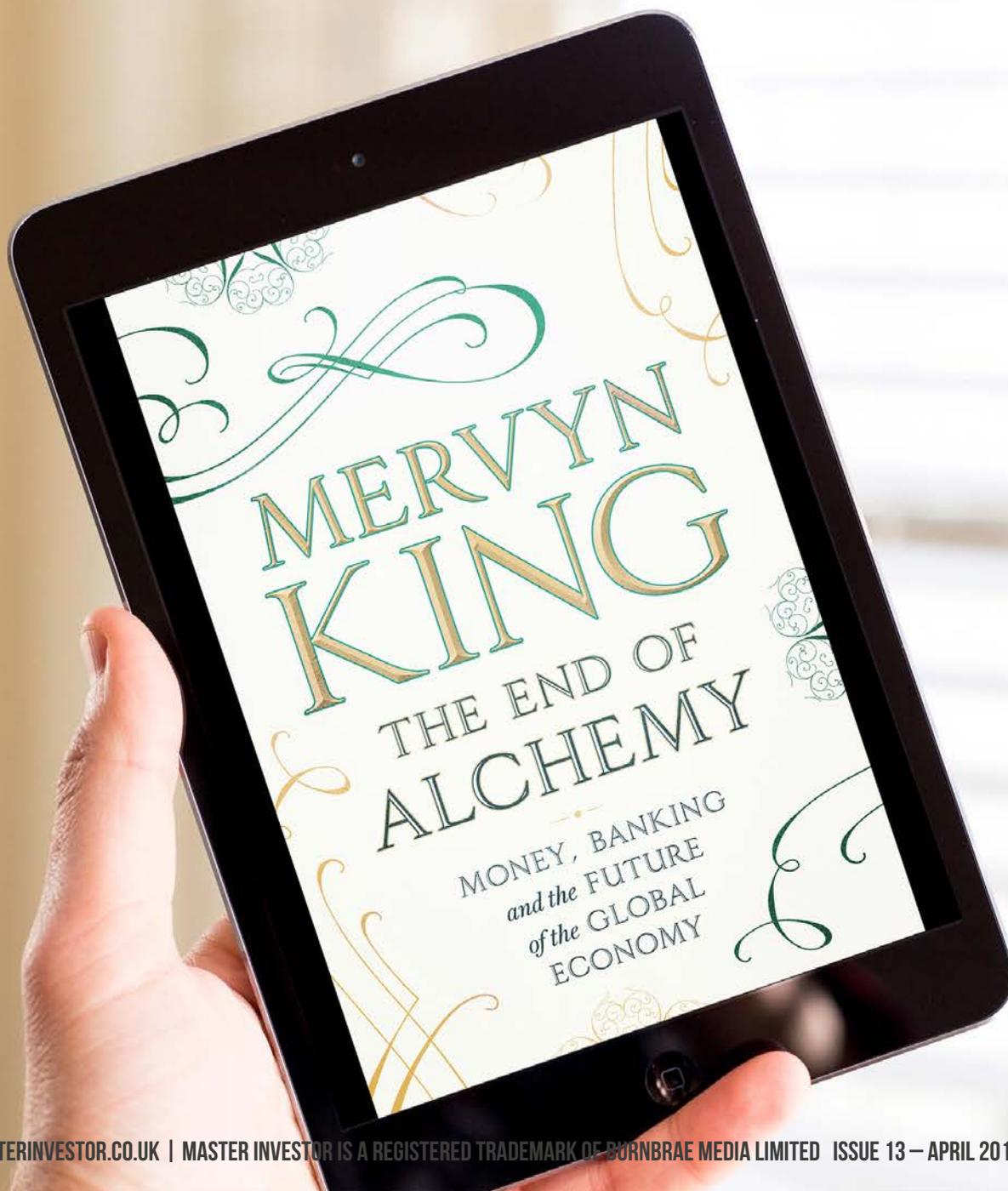
If King can find one word to explain the fundamental causes of the crisis it is *disequilibrium*. A savings glut in the developing world (especially China) depressed longer-term interest rates and facilitated a debt-financed consumer boom in the West. This in turn exacerbated trade imbalances between the West and the Far East. The precise causation of the crisis is complex; but

it was precipitated at the point where banks, no longer able to determine the precise credit standing of their counterparts, stopped lending to one another. After the collapse of Lehman Brothers on 15 September 2008, the entire global financial system suffered cardiac arrest. For a time, the only true *liquid assets* were cash and bank deposits; thus the system required a huge injection of *emergency money* (central bank reserves) which is still, in fact, ongoing with QE.

Ironically, since the crisis, the US Dollar, still the world's reserve currency, has been largely held aloft by China's willingness to hoard greenbacks so that, by the end of 2014, China's foreign exchange reserves exceeded US\$4 trillion. So, despite the fact that the banks have patched up their balance sheets,

the underlying disequilibrium of the world economy has still not been resolved. In fact, says King, *nothing has really changed*. That may be why, even after the biggest monetary stimulus in the history of finance, resumption of *The Great Stability* still eludes us.

So why has global demand remained so weak and real interest rates so low (if not negative), such that growth rates are well below their pre-2008 trend rates? One reason is the contraction of the banking system, about which King has little to say. This has a knock-on effect. Contrary to expectations, governments have been getting more in debt than forecast. Mr Osborne, who had planned to eliminate the budget deficit by 2015, will now be hard pressed to balance the books by 2020.



Lord King asserts throughout that low interest rates *before* the crisis distorted investment decisions, but they were in fact at historically "normal" levels (around 5% in the UK). The problem is that the "cure" – super-low and now negative rates – may be lethal in the long term. He analyses the nature of the current global monetary system, compared and contrasted with its gold-based progenitors. But a return to the gold standard (recently advocated by Senator Cruz) is not going to happen. The stock of gold is effectively fixed and cannot accommodate future economic growth. Gold is a reasonable store of value, but an unreliable medium of exchange.

What I like about King is his breadth – he is much more than a central banker. Just as modern theologians have found ways to discuss theology without mentioning the word "God", he says, modern economists have contrived to discuss the modern financial system without using the word "money". In so doing they have dodged a bullet but let the central problem fester. Anyone who was around in the 1980s will recall that the economic debate was about how to control the "money supply". Then, after inflation was tamed, everyone ignored it. They also ignored that (despite the arrogation to the state the issuance of notes and coin) the creation of money by credit had been taken over by commercial banks and was now out of control. The top 20 banks of the world accounted for US\$42 trillion of assets in 2014, which was over half the then global GDP of US\$80 trillion.

Lord King embarks on a long and thorough history of the global monetary system. But this ground has already been covered by numerous economists recently – notably by Philip Coggan in *Paper Promises*. He then elides into a history of modern banking with a strong focus on his own prime of life: the 1980s and '90s. Then we get a history of central banks and their policy variables – wry and dry. The account of the causes of the First World War and its financial aftermath is erudite – yet unilluminating. The problems of mone-



**“THIS IS A WORTHY BOOK WHICH ECONOMIC HISTORIANS WILL PROBABLY READ FOR SOME TIME TO COME.”**

tary union and the European Sovereign Debt Crisis (Part the First) are kind of old hat. And Basel II was a cringing embarrassment. Yes, we know.

Ultimately, I suspect that Lord King is a neo-Keynesian who believes that effective demand management could solve all our economic woes if only we could put the money men back in their boxes. His last chapter entitled *The Audacity of Pessimism* (a provocative play on the title of President Obama's book), is about our need to prepare for the worst with all skills and experience we can muster.

The *Big Idea* is that the Lender of Last Resort (LOLR) should become the Pawnbroker for All Seasons (PFAS). This is the idea that the central bank should guarantee, not deposits and bank capital in its jurisdiction, but banks' short-term liquidity in the event of a crisis. It could do this by exchanging illiquid bank assets for central bank cash. As it happens, thanks to QE, central banks have plenty of liquidity on their balance sheets, so that's no prob-

lem. Since there is a tacit understanding that central banks will always provide the necessary liquidity to avert a systemic banking crisis, I don't see why that should not be made explicit. Mark Carney: over to you.

This is a worthy book which economic historians will probably read for some time to come. But there is nothing new, as far as I can judge. And there is an inevitable degree of self-exculpation on behalf of the central banking community, a generally under-appreciated breed. Policymakers, King elaborately explains, are trapped in a *prisoner's dilemma* under conditions of *radical uncertainty*. Translation: even the so-called experts don't really know what the f\*\*\* is going on.

*Evil is the root of all money. Liquidity is an illusion. There is a massive implicit subsidy to risk-taking by banks. There is a real risk of a currency war. A future crisis is probably inevitable. If a retired general of the international monetary system is this gloomy, then God help the poor bloody infantry.*

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BY ADRIAN KEMPTON-CUMBER

## THE FINAL WORD

# THE BLACK MARKET HOW CAN WE INVEST IN IT?

**There are board meetings at regular intervals for all companies. Of course there are. They'll no doubt discuss business opportunities and also the cost of new regulation. Perhaps how the sugar tax will impact revenue and profit. Across town the same meeting is happening in reverse. Organised crime is as well organised as any business, perhaps better since there is more likely to be some form of physical reprimand for failure. Perhaps they'll even sit around a big board room table as well. They may well be discussing the new sugar tax too, and how it will put soft drinks on the hit list, alongside alcohol, if there's a tax free source to be found.**

The minimum wage will have been on the agenda of both groups too. The thing to bear in mind about organised crime is that they aren't hindered, but rather helped, by all this over-regulation. The minimum wage, which I wrote about in [this column in September 2015](#), doesn't make people at the lower end better off for more than a very short time – if at all – but creates more unemployment, and more 'off balance sheet' slave labour. If you

have a differential in standard of living it must be maintained by other people accepting less and supporting your lifestyle. It should be machines doing all this work, but Luddites keep resisting progress and insisting that jobs are good. They're not. Jobs are in essence slavery in themselves. But the mentality of the electorate, and thus politicians, is highly conservative at the best of times, and rarely progressive in any sense. We have plenty of people from overseas here in the UK, scared of being deported, or of their families back home being murdered, and so willing to work for a few tens of pounds per week, or even minimal accommodation and sustenance. Obviously not Brits, as it's simple for Brits to claim benefits, and in any case they'd squeal and expose the operation. Brits are priced out of the black labour market.

It's not really as simple as black and white though. As humans, we have a tendency to polarise ideas rather dramatically. I think this is a consequence of our physiology: two eyes, two ears, two hands. We interact with the world in the planes up/down, left/right and backwards/forwards. I don't imagine if we were spiders with compound eyes

there'd be this binary approach to problems and philosophy. Then we'd be saying something like "oh that argument is soooo third eye in, third eye round, I'm not even going to give it the time of day!" When I host debates I dispense with the 'this house thinks...' format as it is entirely limiting, and something of a straight-jacket on possible outcomes. There is then one economy with many, many facets ranging from at least Black to White.

Government, rather like alcohol, is a great servant but a terrible master. There's a picture of Dorian Gray somewhere, which is the Black Market, while the government pretends it doesn't exist, and that the whole economy is green, clean and always growing. But anyone who's seen Panorama often enough in the last year or two will have seen the exposés on donkey burgers, poor hygiene in our main supermarket suppliers' factories, duty free cigarettes being sold under the counter, slave conditions in Asian factories supplying clothes to our High St chains, and so on. It's a disaster. The Black Market in the UK is determined to be 10% of economic activity, according to the Institute of Economic Affairs (IEA),





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and the Bank of England says half of our printed bank notes are either overseas or in the Black Market. This is no small anomaly.

So in the same way that most charity shops on the High Street identify and expose a failure in government policy, so the existence of a Black Market in everyday items exposes a failure in government policy too. Or perhaps more starkly the presence of government policy as opposed to its absence. Bizarrely, the greenest developments in society in the last few years have brought harsh criticism from some quarters. The first is zero hours contracts, which obviously make the workforce of a company flexible enough to maintain efficient numbers for their flexible workload. It also enables companies to afford to pay the minimum wage, and not be pushed into off-the-books undocumented labour. This is game theory at work creating equilibrium. The point is government policy usually has unintended consequences. What those consequences will be may be hard or impossible to predict, but what is entirely predictable is that there will be unintended consequences.

The second green development is Uber, which seeks to make the best use of private transport resources. It should be welcomed with open arms by a government that has emissions targets to meet. It's also much closer to the model that will be in place when mini cabs and taxis drive themselves. Then it really is just a matrix algebra job to deploy them to the required point.

Creating jobs and economic activity is not in the least bit green. This is the paradox government faces.

The first Anti-Slavery Commissioner is Kevin Hyland. He said that, according to the government's own figures, there are "between 10,000 and 13,000 in modern day slavery at any given time". There doesn't seem to be much information about him and his department online, save for announcing his appointment, so it's hard to either contact him or his department to find out what he's been doing about it. I'd suggest that if the Black Market is 10% of the economy that 10k-13k, being a very small fraction of 10% of the work-



**“ACCORDING TO THE GOVERNMENT’S OWN FIGURES, THERE ARE ‘BETWEEN 10,000 AND 13,000 IN MODERN DAY SLAVERY AT ANY GIVEN TIME’.”**

force, is probably a massive underestimation. 140k migrants disappeared in Germany this winter. That's around 15% of the total influx. Well, I wonder where they're literally slaving away to pay off their debt to the people trafficker travel agents.

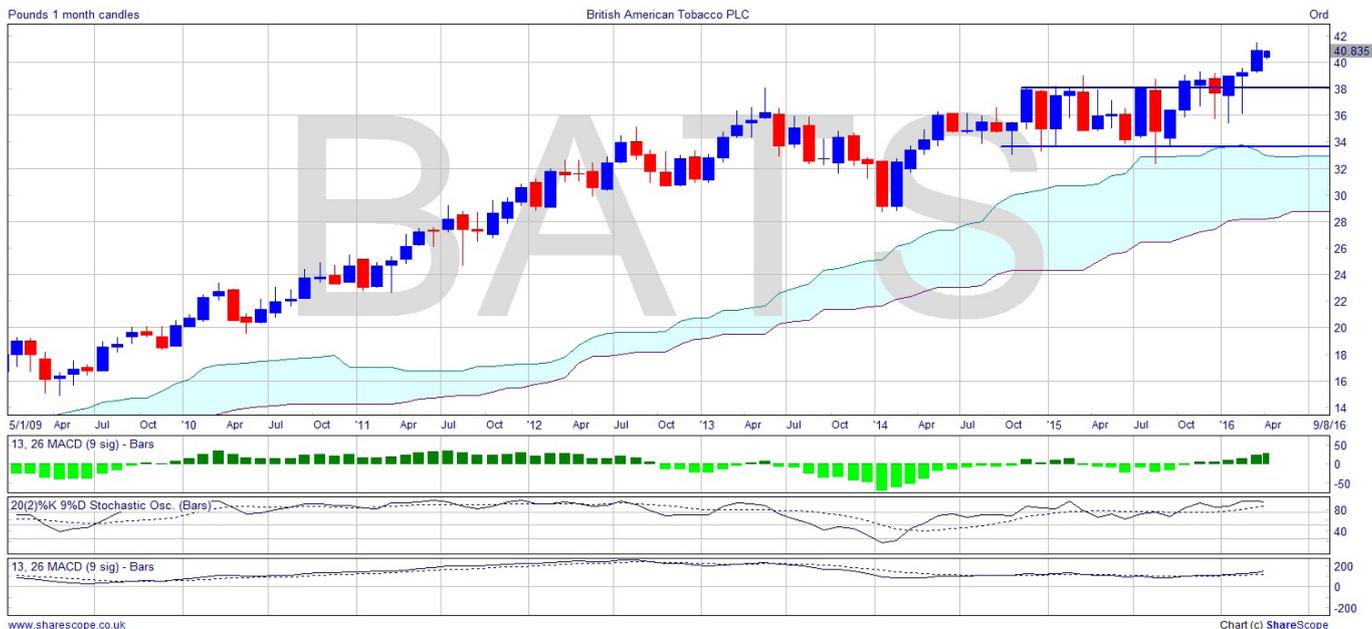
We have a notion that it was Britain that led the abolition of slavery, and that it was done because we became more civilised. I would put an alternative theory forward: it suited Britain very well, having started the Industrial Revolution, to enhance its technological advantage by making competing countries, like the US, abolish slavery. In other words, abolishing slavery was a technological and economic advance, not a social one. A case in point is that jobs which can't yet be done by machines, like prostitution, for example, feature highly as areas where slavery still thrives. Interestingly, in Greece, where there still hasn't been a revolution, an article in The Times suggested hookers there are charging €2 for 30 minutes, whereas it had been €50 prior to the financial crisis. According to the author of the report, Gregory Lazos, a professor of sociology at Panteion University in Athens, the market place is becoming saturated due to the high levels of unemployment in Greece.

So, far from slavery being a thing of the past, people trafficking is in a growth phase, while drugs and sex are already well established. The question is how can we invest in these areas we are

denied access to by legislation, short of handing money to people who are inevitably involved in crime? Well we know that the duty free cigarette under-the-counter business is reselling real cigarettes, so **British American Tobacco (LON:BATS)** is a good way to get at that market (foreign manufactured cigarettes simply being illegally imported without the duty being paid). It could be argued that this Black Market in cigarettes reduces crime, as if there were no parallel discounted market to buy these, then crime may



well have to provide the funds to buy them at the full market price. It could even be argued that this non-violent essentially victimless crime is protecting us from more violent crime. BAT plc is performing very well indeed. I wrote about BAT on the Master Investor Blog last June in a piece called '[British American Tobacco – The Future Is Lit Up](#)', and suggested it as a great pension share as they have huge potential for growth in poorer countries. There's a great looking chart, as you can see, and the share is quite possibly playing out a measured move upwards.



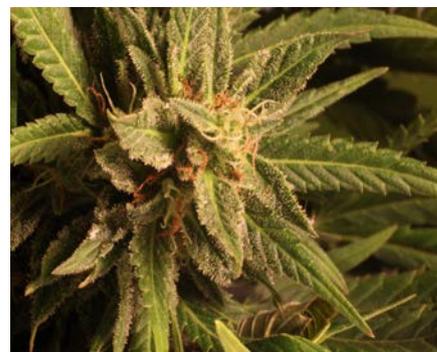
Another area we can invest in is the drugs arena, albeit somewhat obliquely. **GW Pharmaceuticals (AIM: GWP)** is a company I've dabbled in over the last 15 years. They are involved in the pharmaceutical applications of cannabinoid products. Happy days. An opportunity to make money out of society's pathetic inability to accept report after report recommending decriminalising drugs, and instead GWP are making money jumping through society's pointless self-inflicted hoops. The chart shows a volatile share price that does offer opportunities, but really must be treated with humility if you don't want to catch cold.

Economies are a lie unless they rely on abundant providence. But with over seven billion of us that is not

possible. As a result we humans are a Ponzi scheme. A population that only appears to be economically successful as long as there are more and more of us, and thus the illusion of growth can be created by printing more money and still having inflation, even if there is no actual growth. And the only way to avoid this fact becoming obvious is to keep moving the goal posts – rather like new publicans may do when they change everything about their pub so any scam they run won't be easily detected. In the past this has usually been achieved by fairly regular wars.

Politicians must know all of this, so I'm saying that they regard unintended consequences rather like military generals regard collateral damage, and that their actions are equally responsi-

ble for the Black Market as any other part of the social economy. Over-regulation of many industries has created so many opportunities for crime that the old phrase 'prohibition never works' might be replaced with 'over-regulation never works'. On the bright side, at least we can invest in trafficked fags and medicinal whacky baccy.



## MARKETS IN FOCUS

# MAR 2016

### GLOBAL EQUITIES

| Index                  | Last Month % | YTD % | Proximity to 52w High* |
|------------------------|--------------|-------|------------------------|
| Bovespa                | 19.8         | 18.2  |                        |
| Russian Trading System | 14.6         | 15.9  |                        |
| Hang Seng              | 8.7          | -5.2  |                        |
| Dow Jones              | 7.1          | 1.5   |                        |
| NASDAQ 100             | 6.7          | -2.4  |                        |
| S&P 500                | 6.6          | 0.8   |                        |
| DAX Xetra              | 5.0          | -7.2  |                        |
| Nikkei 225             | 4.6          | -12.0 |                        |
| S&P/ASX 200            | 4.1          | -4.0  |                        |
| IBEX 35                | 3.1          | -8.6  |                        |
| Euronext 100           | 1.7          | -4.6  |                        |
| FTSE 100               | 1.3          | -1.1  |                        |
| CAC 40                 | 0.7          | -5.4  |                        |

### COMMODITIES

| Commodity               | Last Month % | YTD % | Proximity to 52w High* |
|-------------------------|--------------|-------|------------------------|
| Natural Gas             | 15.8         | -16.2 |                        |
| Palladium               | 14.8         | 0.5   |                        |
| Crude oil (Light Sweet) | 13.2         | 3.1   |                        |
| Coffee                  | 10.8         | 1.3   |                        |
| Crude oil (Brent)       | 10.2         | 7.9   |                        |
| Iron Ore                | 9.1          | 23.3  |                        |
| Sugar (No. 11)          | 6.9          | -0.3  |                        |
| Soybean                 | 5.5          | 5.3   |                        |
| Platinum                | 4.5          | 9.3   |                        |
| Silver                  | 3.6          | 11.7  |                        |
| Copper                  | 2.5          | 2.6   |                        |
| Cocoa                   | 0.0          | -8.6  |                        |
| Gold                    | -0.6         | 16.3  |                        |

### FOREX

| Pair/Cross | Last Month % | YTD % | Proximity to 52w High* |
|------------|--------------|-------|------------------------|
| AUD/USD    | 7.4          | 5.2   |                        |
| EUR/JPY    | 4.6          | -1.9  |                        |
| EUR/USD    | 4.5          | 4.8   |                        |
| GBP/USD    | 3.1          | -2.5  |                        |
| EUR/GBP    | 1.3          | 7.5   |                        |
| EUR/CHF    | 0.7          | 0.5   |                        |
| USD/JPY    | 0.1          | -6.4  |                        |
| USD/CHF    | -3.7         | -4.0  |                        |
| GBP/AUD    | -4.0         | -7.1  |                        |
| USD/CAD    | -4.1         | -6.1  |                        |

### CENTRAL BANKS - RATES & MEETINGS

| Central Bank | Key Rate | Next   | After  |
|--------------|----------|--------|--------|
| BOE          | 0.50%    | Apr 14 | May 12 |
| ECB          | 0.00%    | Apr 21 | Jun 02 |
| FED          | 0.50%    | Apr 17 | Jun 15 |
| BOJ          | -0.10%   | Apr 28 | Jun 16 |
| SNB          | -0.75%   | Jun 16 | Sep 15 |
| BOC          | 0.50%    | Apr 13 | May 25 |
| RBA          | 2.00%    | May 03 | Jun 07 |
| RBNZ         | 2.25%    | Apr 28 | Jun 09 |
| BOS          | -0.50%   | Apr 20 | Jul 05 |
| BON          | 0.50%    | May 12 | Jun 23 |

**FTSE 350 TOP**

| Sector                | Last Month % | YTD % | Proximity to 52w High*          |
|-----------------------|--------------|-------|---------------------------------|
| Allied Minds PLC      | 56.7         | 18.4  | <div style="width: 20%;"></div> |
| Evrax PLC             | 31.5         | 22.9  | <div style="width: 15%;"></div> |
| Ashmore Group PLC     | 24.3         | 12.2  | <div style="width: 30%;"></div> |
| Vedanta Resources PLC | 24.2         | 24.6  | <div style="width: 10%;"></div> |
| Cairn Energy PLC      | 22.0         | 26.8  | <div style="width: 40%;"></div> |

**FTSE 350 BOTTOM**

| Sector               | Last Month % | YTD % | Proximity to 52w High*          |
|----------------------|--------------|-------|---------------------------------|
| Restaurant Group PLC | -27.6        | -42.7 | <div style="width: 5%;"></div>  |
| William Hill PLC     | -20.3        | -17.4 | <div style="width: 10%;"></div> |
| Next PLC             | -20.2        | -25.9 | <div style="width: 15%;"></div> |
| Cobham PLC           | -16.0        | -23.3 | <div style="width: 20%;"></div> |
| Ladbrokes PLC        | -15.0        | -2.5  | <div style="width: 35%;"></div> |

**FTSE 350 SECTORS TOP**

| Sector                 | Last Month % | YTD % | Proximity to 52w High*          |
|------------------------|--------------|-------|---------------------------------|
| Industrial Metals      | 31.5         | 22.9  | <div style="width: 15%;"></div> |
| Industrial Engineering | 13.2         | 10.3  | <div style="width: 25%;"></div> |
| Electricity            | 8.3          | -1.5  | <div style="width: 35%;"></div> |
| Mining                 | 7.4          | 22.5  | <div style="width: 10%;"></div> |
| Chemicals              | 6.0          | 1.9   | <div style="width: 40%;"></div> |

**FTSE 350 SECTORS BOTTOM**

| Sector              | Last Month % | YTD % | Proximity to 52w High*          |
|---------------------|--------------|-------|---------------------------------|
| Fixed Line Telecom  | -8.5         | -5.8  | <div style="width: 10%;"></div> |
| Banks               | -5.5         | -18.5 | <div style="width: 15%;"></div> |
| General Retailers   | -3.7         | -7.9  | <div style="width: 20%;"></div> |
| Travel & Leisure    | -2.2         | -5.2  | <div style="width: 30%;"></div> |
| Aerospace & Defense | -1.5         | 3.8   | <div style="width: 45%;"></div> |



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