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MAGAZINE

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TIME FOR TAKE-OFF

HOW GROWTH IN GLOBAL AIR TRAVEL CAN LIFT YOUR PORTFOLIO

PLUS...

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THE FUNDS THAT HOPE TO PROFIT FROM AN AGEING POPULATION

WELCOME

Out of the EU, and into the world!

Dear Reader,

This e-magazine was, from day one, proudly associated with the campaign to see the United Kingdom leave the European Union. It was a bold step at the time. Back when we first started writing about "Brexit", the upcoming referendum had barely started to register on the mainstream media's radar. Anyone I asked about the subject told me: "The status quo always wins in referenda; there will never be a majority to leave the EU."

How wrong they were!

Master Investor isn't a political organisation, nor will we aim to call other elections. We do, however, feel strongly about Britain as an investment destination. Short-term adjustments aside, our team, on the whole, feels strongly that Britain will benefit economically from the decision to cut itself loose from the decaying political union that the EU has become. This is a nation of free enterprise, risk taking, and innovation. The City of London is the world's biggest financial centre and one that offers countless opportunities to private investors.

We expect Britain's lead in the world of finance to only become bigger. With it will come an even broader choice of investment opportunities. When this nation turns its primary focus away from the low-growth EU and toward high-growth markets around the world, it will open up a variety of new investment opportunities that private investors will be able to exploit.

The unwinding of hedge positions; the necessary adjustments at large corporations that chose to base their planning on one-sided politics rather than responsible scenario planning; and the temporary period of uncertainty over certain issues will cause some inevitable volatility. The longer-term outlook, however, is bright.

The real problems now lie with the countries that remain in the EU, where issues such as the insolvency of the Italian banking sector will have to be resolved – without financial contributions from Britain.

Our team and our entire network of contributors will continue to cover these unfolding events during the months to come. We are excited, confident, and optimistic about Britain's future outside of the EU and the prospects that offers for investors.

Best regards,

Swen Lorenz,
Editor, Master Investor

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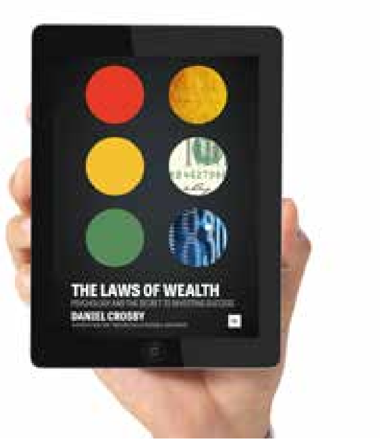


BY JIM MELLON

MELLON ON THE MARKETS

Brexhausted!

I'm now back in Spain after being in the UK on the day of and the morning after the referendum. Wow – what a result!

I went to the area just outside Parliament where the TV and radio stations had set up and had been broadcasting all night till the morning of June 24th. It was surprisingly quiet, with only a glimpse of Liam Fox skipping down the path, and a quick handshake with Nick Ferrari and Andrew Pierce.

Then I held a celebratory breakfast at my pub in Notting Hill for (mostly) likeminded people, though my sister Claire didn't look too happy. This was in sharp contrast to her Danish husband, Lars, who was absolutely delighted!

We had been trading all night, and luckily, our instinct that the Soros doomsday scenario was far too pessimistic proved right. We covered all of our sterling shorts, and also our DAX and S&P shorts and went long. Then, in and out, playing the range till the volatility abated and markets began to settle down.

My sense is there might be a little bit more volatility, but that markets are more or less accurately priced, with the exception of the US, which is still too expensive. Oh, and of course, this excludes bond markets, which are suffering from collective delusion and central bank manipulation.

I was sure Cameron would have to go – and I don't really believe he went voluntarily. I think he was pushed by Tory grandees. He was stupid to call the referendum in the first place, and then to deliver such an abject set of 'reforms'. He also compounded matters by being such a promoter of the backfiring 'Project Fear', which essentially doomed the Remain campaign. As for his mate, George Osborne, he's as toasted as a muffin.

I was interviewed a fair bit over the last week or so, and I kept making the economic case for Leave – one that, in my view, had not been well articulated, as the Leave camp preferred to focus on sovereignty and, of course, immigration.

There is no doubt that immigration is a big issue for many people who felt disenfranchised and who couldn't see any benefits from the free movement of people. The *scale* of inward migration to the UK has been too high, and the strain on the exchequer and on public services has been too severe.

It is also a fallacy to suppose that immigrants are net contributors to the public purse. My friend James Ferguson has done great work showing that the entirety of the British government fiscal deficit of between £70 and £80 billion is due to transfer payments (the UK has already got all of its money back from the banks).

Of this, about 40% is payments to workers on short working hours (16 hours, generally) who are "topped up", and much of that goes to EU immigrants, a minority of whom "game" the system. This is something that needs to be addressed – and presumably can be in the coming months or years.

My general view is that not much will happen immediately; life will go on. The economy was already slowing, with or without Brexit, and the pound has been overvalued for too long, especially with the large current account deficit that we run, par-

"MY SENSE IS THERE MIGHT BE A LITTLE BIT MORE VOLATILITY, BUT THAT MARKETS ARE MORE OR LESS ACCURATELY PRICED, WITH THE EXCEPTION OF THE US, WHICH IS STILL TOO EXPENSIVE."

> **"A 'PUNISHMENT' OF BRITAIN IS UNLIKELY TO WORK. IT WOULD, IN MY OPINION, ONLY ENCOURAGE MORE REFERENDA IN OTHER EU COUNTRIES."**

ticularly with Europe. And as for housing, it has been stopped in its tracks by Osborne's meddling and by the fact that it remains overvalued.

So, a sterling rate of 1.35 to 1.40 against the US dollar seems right to me. As for the stock markets – which ended higher on the week of the referendum than at the start (so much for the doom-mongers!) – the UK and continental ones seem about correctly priced. And Japan is mighty cheap.

So what will happen now?

I think Britain will delay the invocation of Article 50 (the two year stopwatch) for as long as possible, probably six months to a year. In that time, there will be frantic negotiations to try to do five things:

1) Get some outline trade deals done – and I think this could be done with the US, despite Obama's ill-judged intervention. It is much easier for us to do such deals with the US and others, believe it or not, than for the EU. This is because we don't have all the vested interests of European nations with respect to, for instance, agriculture and "culture" (i.e. non English) industries.

2) Offer to pay £5 billion a year into the EU budget for 10 years, without requiring anything back. This will still be a good saving for the UK.

3) Immediately have a fiscal stimulus. To spike Ireland and Luxembourg's guns, go to a 10% corporate tax rate at once. This will encourage more multinationals to come to the UK. It is easily affordable.

4) Put the Scottish question to bed. I am pretty sure that in the same way that turkeys don't vote for Christmas, the Scots (with an average subvention of £3,000 per head, a poorly diversified economy, and a declining oil industry) won't go for independence. This, despite Nicola Sturgeon's defiant stance. In any case, they won't get into the EU (Catalonia being the main reason), and they wouldn't be allowed either the pound or the Euro. (The Bawbee, maybe?)

5) Most importantly we need to do a deal with Europe, in outline and BEFORE the invocation of Article 50.

My preferred deal would be for some form of "associate" membership, which might consist of the following:

1) Visa free travel and a LOTTERY for the admission of up to 100,000 EU citizens a year into the UK, who would have rights to work and to stay permanently. Or an Australian style points system for the same numbers. In return, the EU would allow an equivalent number of British people to have the same opportunity in the EU. This would allow the absorption of immigrants at a more acceptable rate.

2) A free trade customs Union continues, but the UK is free to make its own bilateral trade deals.

3) The UK and EU agree to work together on common standards, and a range of other issues.

Why would the EU agree to this? Well, a "punishment" of Britain is unlikely to work. It would, in my opinion, only encourage more referenda in other EU countries.

A form of associate membership would restore some sort of stability, and allow for face-saving for all parties concerned. Other countries inclined to leave (Denmark, Sweden, Holland) could seek this similar arrangement.

I intend to write this idea up properly in the next couple of weeks, and Master Investor subscribers will be the first to get it.

This may just work out OK, and I am hopeful. My instinct is to buy selectively in the next few days.

My top tip short term is **Lloyds Bank (LON:LLOY)**, which fell by a fifth on the day but looks cheap and rock solid. I also like the **Nikkei**, which for some bizarre Japanese reason fell more than the UK market on the Brexit news.

Fun times ahead!

Happy hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter

BY VICTOR HILL

ALL ABOARD THE BREXIT BIG DIPPER!

INVESTING IN THE UK PRE AND POST BREXIT

At 04:39 on Friday, 24 June David Dimbleby announced that the BBC forecast was that REMAIN could not now win. Cut to a beaming Nigel Farage at a party somewhere talking about the British people getting their country back.

"WE ARE IN TERRA INCOGNITA. BUT I WANT TO PEER THROUGH THE FOG OF UNCERTAINTY AND TO SPECULATE ON POSSIBLE OUTCOMES SO THAT SENSIBLE INVESTORS CAN AT LEAST GET THEIR BEARINGS."

As the enormity of the news sunk in, a stunned nation (actually four stunned nations) began to emote. The degree of recrimination and acrimony first evident on Friday morning only got worse over the weekend. Facebook almost crashed at times, such was the volume of posts: many of them expressing hurt and apprehension; many giving vent to vile abuse. An old friend of mine spent the Saturday morning *unfriending* most of his Facebook network. The love-fest at Glastonbury went sombre (the knee-deep mud didn't help). Even London's *Gay Pride* march was downbeat – despite the salute from the Red Arrows.

Mr Cameron resigned even before most City types had reached their work stations. Mark Carney went on a live international newsfeed "to calm" the markets with a promise of £250 billion of additional liquidity. But the markets had already gone haywire.

As a "stop Boris" bandwagon started rolling within Tory ranks over the weekend, so the Labour Party imploded. Jeremy Corbyn faced the prospect of sitting alone on the Opposition front bench. Mr Cameron, a lame-duck Prime Minister, was presiding over a political class in disarray.

With no government to negotiate with, Mr Juncker, President of the European Commission ventured that the UK should be jostled towards *la sortie* in the shortest order. Frau Merkel demurred, saying that negotiations on Brexit should not be rushed and should not be "nasty". The French started to mutter that the UK border controls at Calais should be removed.

Meanwhile, the Scottish question was re-articulated in shriller tones than ever. If the UK as a whole voted 51.9 percent to 48.1 percent in favour of LEAVE (a margin that even the über-Brexiteer Dan Hannan described as "slight"), Scotland voted 62 percent to 38 percent in favour of REMAIN. Over the post-ballot weekend Ms Sturgeon swept across the airwaves in a frenzy of busy-ness. The Scottish cabinet resolved to open negotiations directly with Brussels (something that Brussels wisely rebuffed); to consider holding a second referendum on independence; and then intriguingly unveiled an obscure House of Lords amendment to the Scotland Act requiring that any Westminster bill which enacted Brexit would be subject to the "consent" of the Scottish Parliament. Which Ms Sturgeon told us, in case we needed to know, would *not* be forthcoming.

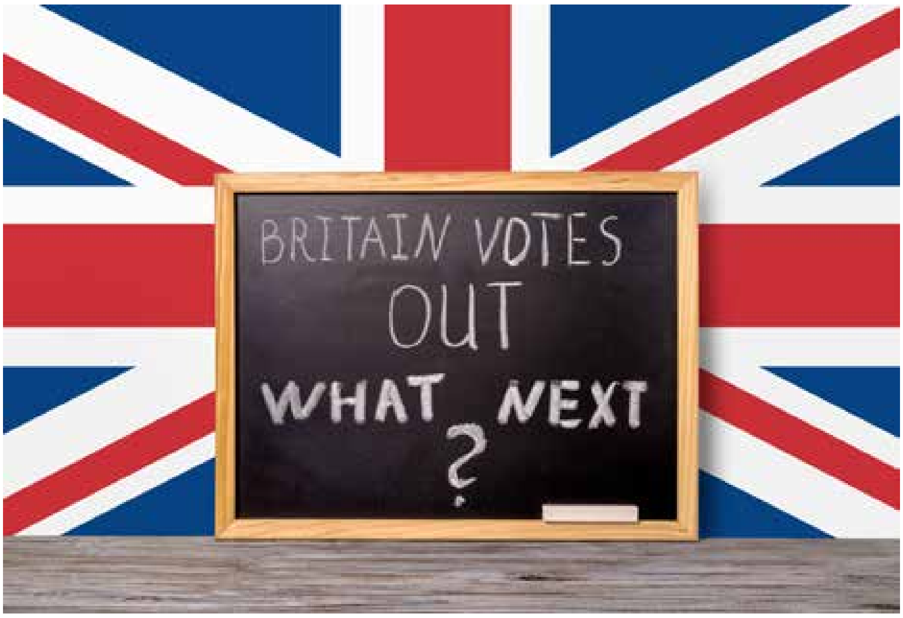
Incidentally, it is questionable whether, constitutionally, Ms Sturgeon can trigger a second independence referendum without Westminster consent; and even more questionable that she would win it given that the economic case for independence advanced in 2014 has since been trashed. Though many Scots, so it seems, wish to be Greeks.

I will not explore here why the result was what it was. But I observe that the torrent of contempt from the European elites was deafening. Rather than take a moment to stand back and reflect on what has gone wrong in Europe – where a far-right candidate nearly became President of Austria last month – there was a rush to judgment. Bernard Henri-Lévy, the esteemed French philosopher, said it was *the triumph of ignorance over knowledge.*

May I remind readers where I stood throughout this process? I thought first out that the idea of referendum on Europe was a reckless gamble. I thought that Mr Cameron' deal with Brussels in February, having promised a reformed Europe, was derisory. It confirmed our suspicions that Europe was un-reformable. I thought and wrote that Project Fear was contemptible – especially insofar as the impact on the City was

concerned. (Apparently Lord (Mervyn) King agrees). I thought that the City types and the political establishment had severely underestimated the capacity of the great unwashed to turn around and bite them on the bottom. And I have consistently argued that the UK has alternative strategies for the future.

If the result had been REMAIN the Euro-train would have chugged on towards a thoroughly undemocratic and illiberal destination. That knowledge does not make me joyous about the result, however. We are in *terra incognita.* But I want to peer through the fog of uncertainty and to speculate



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on possible outcomes so that sensible investors can at least get their bearings.

We are faced with an extreme intersection between political and market risk stretching some way into the future. Britain has voted to leave the EU, but until such time as Brexit treaty comes into force (normally supposed to be two years away), the UK remains a fully functioning member of the EU. We are not likely even to invoke *Article 50* until we have a new PM – perhaps longer. Further, we really don't know what the precise terms of the Brexit treaty might be (though I shall hazard a few guesses). In fact we can't actually be sure that Brexit will happen at all.

The referendum outcome has no force in British law. David Lammy MP has proposed that Parliament just ignore it – remember that out of 650 MPs only about 150 to maximum 200 are paid-up Brexiteers. And as I write (27 June) there are 3.6 million signatures on a petition that the referendum should be re-run. (If the number of signatories were to get to 17 million then that could be interesting. There is a lot of *buyers' remorse*, or so it is said. Mind you, as I write there are more than 200,000 signatures supporting *Londependence*...) Or indeed it may yet turn out that the devolved assemblies have the right to veto a Brexit enacted by Westminster.

So where might we might go from here? The key issue for British business and finance is how to negotiate through four scenarios which I call, in order of their potential short-term negative market impact: **Zero Brexit, Soft Brexit, Hard Brexit** and **Fuzzy Brexit**. Each of these has numerous variants of differing adversity.

Zero Brexit means that Brexit doesn't actually happen; rather some form of words is devised that would entail a very high degree of continuity between the current dispensation and the next. This might come about by means of a reversal of the referendum (or if it is, for example, struck down by the Supreme Court). Tony Blair has already called in an article in the New York Times for a second referendum. Or it could entail a rearrangement of the furniture with mild concessions of a new deal from Brussels. For example, the British government could be offered the notional right to restrict benefits to new migrants (the so-called *emergency brake*).

This all sounds rather fluffy but the political risks of just consigning the referendum result to the dustbin of history might be dire. It would not be just Mr Farage & Co. who would kick up a stink. There could be a revolution.

Soft Brexit might entail a new status while retaining most of the institutional and structural links between the UK and the EU. The UK could be offered *Associate Membership* of the EU – a special status not available to others states. This would ensure freedom of movement but the UK would have the right to impose quotas on work permits issued to foreign nationals who would be assessed according to the much vaunted Australian style points system. The UK would pay to get access to the Single Market, like Norway. The British would largely escape the tyranny of the European Court of Justice.

The reason that I don't think this is likely is that, if available to the UK, the Scandinavians and the Dutch would agitate for a similar status. Mind you, there may come a point where it is less painful for Brussels to concede that than to risk the implosion of the entire European project.

Hard Brexit would mean none of the above. The Brussels elite play hardball and the UK retaliates. The UK is locked out of the Single Market – meaning that of course we can trade but there will be tariff barriers on both sides. Freedom of movement in both directions might be restricted with holiday-makers requiring visas. Retired British citizens living in Spain would be charged for using the Spanish health system. (There are those who argue that this is effectively happening anyway and that "health tourism" is an issue for the UK which has not been addressed.) The UK would be free to conclude its own trade deals not least with the USA and the Commonwealth. It's very unlikely that President Obama's successor would block this.

Fuzzy Brexit is the notion that Europe might yet turn out to be Hotel California – *you can check out, but you can never leave.* Note that each EU member state will have a veto on the final Brexit package. It is quite possible that no unanimous agreement will be achieved. That means that there may never be a formal deal but rather that we have to make it up as we go along (something which the British are good at). We'd have to get used to radical uncertainty. Mind you, life was never certain anyway.

One of the reasons why the pound fell so sharply in the days after the referendum result was not so much the angst about the future of the UK economy but the fact that the foreign exchange market had called the outcome wrongly and had bid up Sterling to artificially high levels (it hit nearly $1.50 in New York on 23 June). When markets

"WHEN THE DUST BEGINS TO SETTLE THE FIRST RECOVERY PLAYS MIGHT BE BANKS AND AIRLINES, WHICH ARE ALREADY OVERSOLD."

get things wrong the downside is amplified.

When the dust begins to settle the first recovery plays might be banks and airlines, which are already oversold. **Lloyds Bank (LON:LLOY)** is already looking cheap. Dealing in **Barclays (LON:BARC)** and **RBS (LON:RBS)** shares has been suspended as I write. This has been a drag on European bank shares – not least the Italians. They will recover – eventually. **EasyJet (LON:EZJ)** could easily bounce back when the markets realise that the Brits will never stop taking holidays – even if they are more expensive. In this space, the cruise sector could prove more attractive to higher end budget sensitive travellers. Check out **All Leisure Group (LON:ALLG)**.

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Safe haven assets include US Treasuries, though yields are pitiful, gold and specific currencies, especially the Yen. As I write the Pound is still under pressure but the Yen has become the currency port in the storm – exactly what the Bank of Japan did not want! Paradoxically, the Tokyo stock market is down more than virtually all of the European bourses. And London's FTSE-250 index is down less than the DAX and the CAC-40. The downside in the European markets is probably as bad as in the UK.

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The best trade has been and gone. That was to have shorted the Pound on 21 June – as I intimated in my piece that day.

And what about the new PM whom we now expect to take office by 02 September? Boris Johnson is the favourite – he was the life and soul of the Brexit campaign. But, in the numbers game, he didn't seem to have done his homework. The problem with Boris is that he knows he is sufficiently intelligent to sail through most interrogations and to be confident that the exuberance of his own verbosity (as Disraeli put it) will be enough, without getting into boring old numbers. That doesn't cut the mustard with the sort of people who read *Master Investor*.

It would be better if the Brexiteers had come out and said: *It's pointless discussing numbers because nobody remotely knows what they are*... But from now on numbers are critical. I have read over the weekend that the UK, which has not negotiated a trade deal in its own name for more than 40 years, possesses no more than 12-20 senior civil servants with the skills and experience to send into the fray. We will need hundreds. Moreover, the entire ethos of the Foreign Office (and other governmental departments) is almost slavishly Europhile. Maybe this is a good moment for a *bonfire of the vanities* – to re-staff the top of the civil service with high calibre outsiders.

In the first instance, the new Prime Minister should appoint Michael Gove (who, whatever you think of him, has a genius level IQ) to head up a task force charged with the hugely complex business of negotiation. He should be supported by Gisela Stuart – a mother-tongue German speaker. He will most probably set out aiming for one of the four scenarios outlined above – probably Soft Brexit. We don't know what the Johnson-Gove game plan is. And whether they get what they want is another matter.

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Lord King has just said there is no need to panic. The economy was heading for a downturn anyway. I wish I could say that all will be clear in three months' time but it will take much longer than that for the dust to settle. This is the end of the Western world as we knew it. But where there is risk, there is opportunity. And, as Boris and The Donald will tell you, there's never an excuse for a bad hair day.

BY JAMES FAULKNER

TIME FOR TAKE-OFF — HOW GROWTH IN GLOBAL AIR TRAVEL CAN LIFT YOUR PORTFOLIO

Since the dawn of civilisation humans have been fascinated with the concept of flight. From the legendary flight of Icarus in Ancient Greece and the Renaissance sketches of Leonardo da Vinci, to the Wright Brothers' first successful manned flight in 1903, we have literally reached for the skies in order to fulfil our ambitions. Yet after more than a hundred years of aviation history, our enthusiasm for air travel shows no sign of abating. In fact, the aviation industry looks set to enter a glorious new era. The world is indeed getting smaller. Here's how to profit from it...

The world is spreading its wings

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.

World GDP growth may be slowing, but the $1.8 trillion global aviation sector shows no sign of losing altitude. Last year passenger numbers rose by 6.5%, surpassing the 5.5% average annual growth of the last decade, according to the International Air Transport Association (IATA). Incredibly, the demand for air travel will likely double by 2035, according to PwC's recent annual report on the state of the worldwide airline industry.

> **"THE DEMAND FOR AIR TRAVEL WILL LIKELY DOUBLE BY 2035."**

While much of this growth will be accounted for by the major jet-setting nations of today, what's really striking about these predictions is the growth in air travel to and from developing nations. According to ADS Group, the organisation which represents the UK's aerospace, defence, security and space industries, passenger numbers on UK airlines will grow by 80% over the next 20 years, to 218 million. However, drilling down into those numbers, we find that the UK airline share of the Rest of the World Market (that is flights to and from the UK to markets outside N. America and Europe) is set to grow at an annual growth rate of 5.5%. This means an increase of 27 million passengers by 2034, with regions such as the Middle East, Far East and Indian Sub-Continent set to drive such growth.

In global terms, 2015 saw Asia Pacific carriers record a demand increase of 8.2% compared to 2014, which was the largest increase among the three largest regions. Meanwhile, Latin American carriers' traffic rose 9.3%, and Middle-Eastern carriers exhibited the strongest annual traffic growth at 10.5%. Even the European market, which is otherwise mired in stagnation, saw traffic growth of 5%, while the North American market put in a more modest 3.2% rise.

The higher growth rates in developing markets look set to continue to be a feature of the aviation industry for some time. China's government recently announced plans to build more than 500 airports by 2020, with total aircraft (helicopters, private jets as well as passenger and freight aircraft) forecast to rise from 1,874 to about 5,000. Aircraft makers clearly have Asia in their sights, with **Boeing (NYSE:BA)** bagging an order for 100 of its 737 Max aircraft from Vietnam as part of Barrack Obama's visit in May.

Airline profitability takes off

It has often been claimed that, in its entire hundred year history, the US airline industry has made a net profit of zero. However, airline profitability has risen markedly of late. At its annual general meeting in Miami last year, the IATA forecast that the industry would reap a $29.3 billion net profit in 2015, up from $16.4 billion in 2014.

Clearly, the strong performance owes a lot to the weakness in the oil price, which has more than halved over the past couple of years, but there are other factors in play here too. Mergers and acquisitions (M&A) have helped increase the efficiencies of the major airlines, reduced the number of competitors, and thus decreased the overall supply of options for the customer. Other reasons for the strength of the airlines industry include strong demand, sticky airfare prices, and lower input costs which haven't all been passed down to the consumer. On top of all that, the icing on the cake is that cheaper fuel prices mean that airlines collectively spent around $70 billion less on fuel in 2015 than they did the year before.

"CHEAPER FUEL PRICES MEAN THAT AIRLINES COLLECTIVELY SPENT AROUND $70 BILLION LESS ON FUEL IN 2015."

According to the IATA, the industry's cost of capital is just under 7 percent, and its expectation is for airlines to achieve a return on capital of 8.6 percent in 2016. So finally, after years of destroying capital, the airline industry as a whole has begun to generate a return for investors. However, we note that even with today's elevated levels of profitability the spread between the cost of capital and the return on capital

ROLLS-ROYCE (LON:RR.) – STREAMLINING OPERATIONS

Rolls-Royce shares have more than halved since January 2014 after the firm issued no fewer than five profit warnings in under two years. The firm has been hit by falling demand for corporate jets in emerging markets, cuts to defence budgets and plunging oil prices that have prompted energy companies to scale back investment plans. In response, CEO Warren East is spearheading a cost-cutting campaign which is targeting savings of £150-200 million per annum, not least via streamlining Rolls' byzantine management structure.

While there is certainly a lot left for management to do here, we note that Rolls' Civil Aviation segment – which accounts for more than half of revenues and profits – has continued to exhibit a robust performance, with underlying revenue up 3% and the order book up by £3.8 billion in 2015. Notably, 50% of Rolls' £67 billion Civil Aerospace order book is for the XWB engine, touted by Rolls as "the world's most efficient large aero engine", which puts it in good stead to capitalise on the drive for greater fuel efficiency.

A break-up of Rolls, which could entail the sell-off of the troublesome Marine and Power Systems divisions can't be ruled out, especially now that US activist investor ValueAct has a seat on the board. At its core, the business model of selling state of the art technology with "Total Care" servicing agreements providing considerable repeat custom is a strong one. If and when Rolls is nursed back to health, there is likely to be scope for considerable share price appreciation.

B/E AEROSPACE (NASDAQ:BEAV) – A PERMANENT FIXTURE OF THE AVIATION WORLD

Along with French company Zodiac, B/E Aerospace pretty much has the market for aircraft fixtures and fittings sewn up. The firm manufactures everything from seats and in-flight entertainment packages to oxygen systems, kitchen galleys and toilets. Although these might not be the most hi-spec parts of the aircraft, they are nevertheless the product of rigorous testing and are produced to demanding criteria. The decades-long relationships B/E has built up with airplane manufacturers acts as another significant barrier to entry to this market, which is something of a sweet spot in the sector. B/E exhibits high levels of profitability as R&D costs are low compared to other parts makers and pricing power is relatively strong.

Full-year results for 2015 saw B/E report a 5% increase in revenues and an 8% increase in operating income, with operating margins of 18.4%. Free cash flow has been held down in recent years by spending to build out direct-to-manufacturer sales capabilities and the lavatory business, but management expects free cash flow to move towards 100% of earnings next year. With the shares trading way off 2014 highs, a prospective 10% free cash flow yield for 2017 leaves shares in this market leader looking rather good value.

is negligible. For this reason we believe that investors should look elsewhere to invest on the back of this growth.

But the pressure for more energy efficient technologies isn't letting up

Although airlines may be enjoying a windfall from lower fuel prices at present, there is every chance that the oil price may rebound in the coming years. However, should it do so, the impetus for more efficient technologies would certainly continue to gain momentum. In any case, fuel remains one of the biggest costs for airlines, which puts fuel efficiency savings at the forefront of the minds of aircraft manufacturers.

One major area of growth is the market for carbon fibre composites, which are gradually replacing sheet metal as the key material in aircraft body construction. In 2014, the global market for pure carbon fibre products was estimated at $1.8 billion, but that is forecast to reach $3.5 billion by 2020. The market for composite carbon fibre materials of the kind used in airplane design was $17.3 billion in 2014, and is set to grow to $34.2 billion by 2020.

For now, aircraft manufacturers are choosing not to make the fuselages of smaller, narrow-bodied aircraft from carbon fibre as designs will need significant modification, but usage is increasing in components such as engine blades and containment cases. With the composite industry dominated by a small number of large manufacturers, and with projections for 2020 suggesting a CAGR (Compound Annual

"THE MARKET FOR COMPOSITE CARBON FIBRE MATERIALS OF THE KIND USED IN AIRPLANE DESIGN WAS $17.3 BILLION IN 2014, AND IS SET TO GROW TO $34.2 BILLION BY 2020."

Growth Rate) of 11.4% for carbon fibres and 12.3% for reinforced parts, the composites sector looks likely to enjoy a strong performance in the years to come.

How to Invest

Clearly the most obvious place to begin is with the airplane manufacturers themselves. This space is dominated by the titanic struggle between the duopoly of Boeing and **Airbus (EPA:AIR)**. Airbus claimed to have edged ahead of its rival last year as it won orders for more than 1,000 new planes, although Boeing made and delivered more aircraft. Airbus said it had 57% of the market overall by units ordered, with the 1,036 orders in 2015 making its cumulative order book total more than $1 trillion, securing production for a decade to come. Airbus seems to have the upper hand in the market for single-aisle short-haul aircraft, whereas Boeing is doing better in the widebody market – despite the fact that its rival now numbers the largest passenger plane in the world, the Airbus A380, in its arsenal.

While Airbus and Boeing boast gargantuan order books and are very obvious beneficiaries of the growth in air travel, both are already very large companies and are unlikely to see a transformational impact on their share prices. We believe there are less obvious ways to gain exposure that could be more lucrative over the long term, as the impact of the growth in demand is being felt much further afield than Boeing and Airbus. Both of these titans have huge supply chains with literally thousands of companies involved in the production process. Aircraft production is also a global affair, with Boeing 787's composite carbon fibre body shell, for example, made in the US, Japan, Italy, Korea and Australia.

Toray Industries (TYO:3402), the largest composite producer, has a multi-year contract with Boeing, and prompted by growing vehicle applications, it bought US carbon-fibre maker Zoltec for $584 million last year. Other major players include **Hexcel Corporation (NYSE:HXL)**, which manufactures everything from carbon fibre to finished aircraft structures; and **Victrex (LON:VCT)**, a leading supplier of a plastic polymer called PEEK, one tonne of which goes into each 787 aircraft.

Ever advancing technology means that aircraft aren't getting any cheaper – which brings us to another niche area of the aviation sector: aircraft leasing. These days, airlines choose to lease every second new aircraft that is manufactured, as a means of helping them maintain efficient balance sheets and manage risk. Companies such as GECAS (a subsidiary of **General Electric (NYSE:GE)**) and **Air Lease Corp (NYSE:AL)** have built highly lucrative businesses offering hire purchase agreements similar to those available

"AIRBUS CLAIMED TO HAVE EDGED AHEAD OF ITS RIVAL LAST YEAR AS IT WON ORDERS FOR MORE THAN 1,000 NEW PLANES, ALTHOUGH BOEING MADE AND DELIVERED MORE AIRCRAFT."

Thor Jorgen Udvang / Shutterstock.com

INMARSAT (LON:ISAT) – AVIATION DRIVES GROWTH AT SATELLITE OPERATOR

Satellite communications provider Inmarsat has had a torrid time of late as downturns in both the energy and marine markets have hit revenues. This has seen the shares lose around a third of their value, which could prove to be a buying opportunity for investors prepared to take a longer-term view.

The demand for satellite data capacity is growing exponentially along with our insatiable appetite to consume an ever larger amount of data. Increasingly, more of us are using mobile devices while we're on the move – and that includes while we're in the air. In its Global Xpress (GX) Aviation solution, Inmarsat has created the world's first high-speed passenger in-flight connectivity solution with end-to-end global coverage, delivered through a single operator. Meanwhile, Inmarsat's European Aviation Network (EAN) will be the first aviation passenger connectivity solution across European airspace to integrate an advanced satellite network and LTE-based ground network (the latter will be operated by Deutsche Telekom). Aircraft will switch automatically between satellite and terrestrial connectivity using an onboard network communicator for optimal service delivery. The first commercial EAN trials are expected in mid-2017.

In its recent first-quarter results, Inmarsat posted a 15.1% rise in revenues at its Aviation division, which it said remains a major growth market, with broadband connectivity – particularly into the cabins of commercial aircraft – expected to see strong growth over the coming years. It argues that this will be driven by the increasing number of aircraft in the sky, the rapidly expanding demand for passenger connectivity and the need for more capable and sophisticated operational and safety services in the cockpit. Moreover, the combination of GX and the EAN is expected to provide Inmarsat with the global coverage, high bandwidth and price competitiveness necessary to compete effectively in this market. As such, short-term problems could be an opportunity for investors to make long-term gains.

to consumers on privately owned cars. 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.

Another way airlines are becoming more efficient is through outsourcing their MRO (maintenance, repair and overhaul) activities to companies like **AAR Corp. (NYSE:AIR)**. Analysts expect the aviation MRO sector to grow at a compound annual rate of 4% over the coming decade, which should see companies like AAR continue to secure a greater share of the market. As well as helping airlines to become more capital efficient and cost effective, AAR is also at the forefront of implementing numerous fuel-saving aerodynamic improvements, such as winglets and body strakes, for all types of aircraft. As such, it should continue to see steady growth as airlines continue to seek to cut costs and become more environmentally friendly.

And what about the passengers themselves? Global passenger numbers grew by 6.1% in 2015, well ahead of global GDP growth of around 3%. This makes airports a great place to sell things as they are effectively a captive market and therefore allow much higher profit margins than would be available on the high street. One well known British company that is in the middle of repositioning itself as a travel retailer is **WH Smiths (LON:SMWH)**, whose convenience newsagents are ubiquitous in UK train stations and airports. Although the firm's legacy high street business continues to be a drag on overall performance, it has long ceased to be the main profit centre for the business. Profit growth has been strong in recent years and the firm is also looking to expand into overseas airports.

Finally, if you find yourself compelled to invest in the airline sector in spite of its chequered past, we believe that the budget operators remain the best bet due to their lean cost structures and the notion that consumers are likely to 'trade down' to them in the event of any increase in fuel prices. Of all the budget airlines there are only two major players that can claim to have multi-hub networks servicing most destinations in Europe: they are **Ryanair (LON:RYA)** and **easyJet (LON:EZJ)**. Of the two, we prefer easyJet, which sits on a single-digit PER, boasts a net cash pile of c. £300 million and offers a chunky dividend.

BY FILIPE R. COSTA

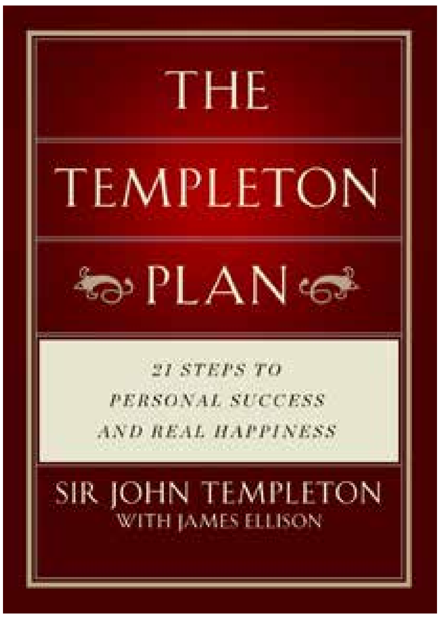
HOW TO INVEST LIKE... JOHN TEMPLETON

"Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria."

— John Templeton

Buy and React

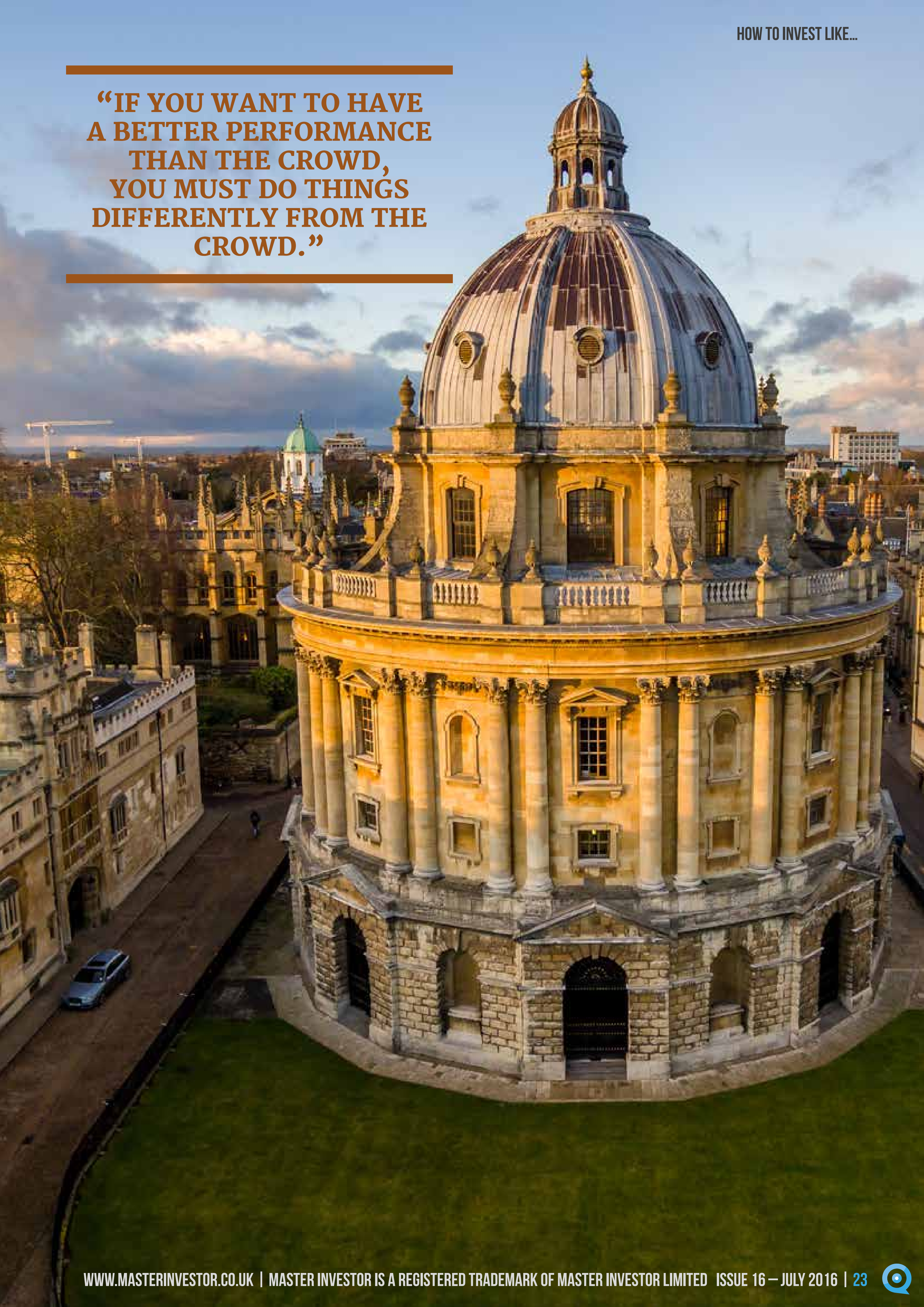
In a fast-paced, ever-changing world, where everyone wants the same things at the same time – whether we're talking about a technology gadget, a TV channel, a vacation destination or a group of stocks – it pays to be a contrarian. In such a world, those betting on unloved things may be anticipating what might be the fashion in the near future. But it is not easy to oppose the crowd. Staying away from others' euphoria and being optimistic when pessimism is at its maximum is the most difficult strategy to adopt, as our actions are heavily influenced by emotions, which are a direct result of the mood surrounding us. Therefore, for the sake of being a successful contrarian investor, perhaps you should eschew a life at the luxurious 432 Park Avenue and exchange it for a life at the sunny and distant Bahamas. How could someone living near Wall Street have escaped the temptation of getting in on the high-flying dot-com revolution during the 1990s? How could that same person have avoided the temptation of dabbling in the unstoppable housing market in the 2000s? *With great difficulty*, is the answer.



John Templeton started life as a US citizen but then moved to the peaceful Bahamas in his early 50s, to manage one of the most successful investment portfolios for more than 30 years. Instead of being influenced by the Wall Street herd, Templeton was moulded by a heterogeneous crowd of business people from around the world, which populates the Bahamas; instead of following the herd, Templeton opposed it while he developed awareness of the need for a new level of portfolio diversification – international diversification. He pioneered the use of globally diversified mutual funds and was among the first investors to seek out opportunities in distant markets like Japan, several years in advance of the Wall Street crowd.

Over the last three editions of the "How to Invest Like..." column, the focus has been on value investing. Benjamin Graham (issue 13), Warren Buffett (issue 14) and Peter Lynch (issue 15) are among the most respected value investors that have helped to dismantle the idea that markets are efficient at all times while investors act rationally. They all invest(ed) against the herd,

"IF YOU WANT TO HAVE A BETTER PERFORMANCE THAN THE CROWD, YOU MUST DO THINGS DIFFERENTLY FROM THE CROWD."



buying when others are selling. But when the time to sell comes, there are a few differences among them. While value investors are long-term players in general, not all agree with the exact time period during which a stock should be kept in a portfolio. If you asked the investors mentioned above about that precise time period, Graham would answer: "buy and hold"; Buffet would recommend: "buy and forget"; and Lynch would say: "buy and rotate". The investor under review in this month's edition, John Templeton, would answer: "buy and react", to reflect the need to adapt a portfolio to a fast-changing world. Value changes over time and there is no absolutely dominant asset class. Investors should quickly react to these changes.

"TEMPLETON SAW THE VALUE OF HIS PORTFOLIO RISE FOUR-FOLD IN JUST FOUR YEARS. WHEN HE SOLD HIS PORTFOLIO IN 1943, ALL BUT FOUR STOCKS HAD TURNED A PROFIT."

The Foundations of a Great Investor

John Templeton was born in Tennessee, USA, in 1912. Son of a self-taught lawyer and a cotton ginner, he attended Yale University, from which he graduated near the top of his class in 1934. Later, he attended Oxford University, earning a Master's degree in Law. He started his career on Wall Street, as a trainee for Fenner & Beane.

Templeton's skills as a contrarian investor as well as his awareness of the need for diversification were soon revealed. In the late 1930s, after the Great Depression, equities were trading at very low prices. Templeton borrowed $10,000 (equivalent to $170,000 today) and bought 100 shares of each NYSE stock that was trading below $1. His total purchase comprised 104 different companies. With the start of World War II, industrial production grew, pushing equity prices higher. Templeton saw the value of his portfolio rise four-fold in just four years. When he sold his portfolio in 1943, all but four stocks had turned a profit. This early trade had already spawned two important commandments in Templeton's trading strategy.

First and foremost, you should "invest at the point of maximum pessimism". The best opportunities arise when others are pessimistic about future prospects, because at that point demand is at its lowest and, consequently, share prices are at their cheapest levels. Second, you shouldn't put all your eggs in the same basket, but instead split the money into several different assets.

With so much success already under his belt, Templeton co-founded an investment advisory firm – Templeton, Dobbrow & Vance. In 1954 he entered the mutual fund industry and set up the legendary Templeton Growth Fund, which still exists today as part of the portfolio of funds of Franklin Templeton Investments, a global investment firm with more than $850 billion (£595 billion) of assets under management. During his tenure between 1954 and 1992, Templeton led the fund to achieve an annual average performance of 14.5%. Someone who invested £10,000 in the Templeton

Source: Morningstar

Growth Fund at the inception date would have had a portfolio worth £2 million by 1992.

In 1956, Templeton, Dobbrow & Vance merged with William Damroth and became Templeton Damroth. In 1962, Templeton sold his stake in the company but kept managing the Templeton Growth Fund. Later he founded Templeton, Galbraith & Hansberger which was finally merged with Franklin Templeton in 1992. John Templeton, his son John Jr. and his partner John Galbraith received $570 million from the deal as they together owned 70% of Templeton, Galbraith & Hansberger. While the original spirit has been retained at Franklin, the returns achieved by the Templeton Growth Fund have declined substantially since Templeton retired. Nevertheless, the fund still shows an average annual return of 12% for a period of more than 60 years, which is an incredible performance for such a well-diversified fund.

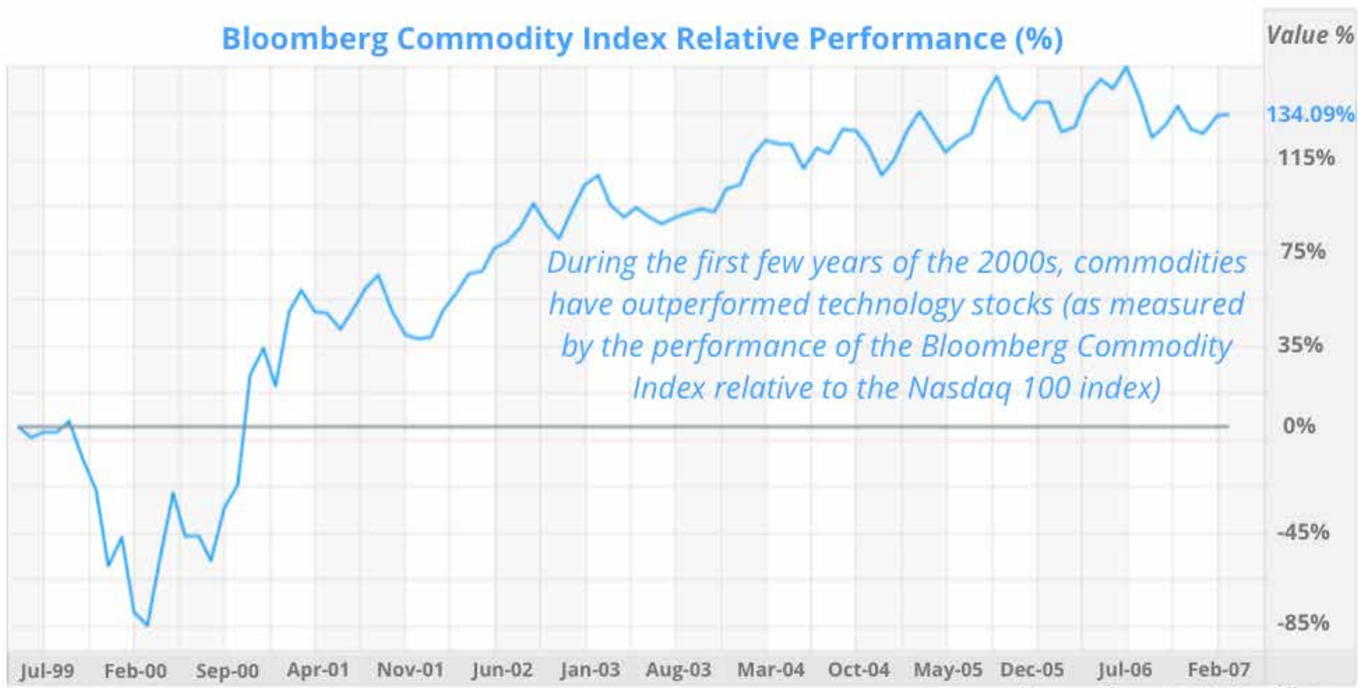
Always in Front

Templeton always believed that "you can't outperform the market if you buy the market". "If you want to have a better performance than the crowd, you must do things differently from the crowd".

An investor must always find value where others are unable to see it and then invest at the point of maximum pessimism. Far away from lower Manhattan, Templeton could not only easily oppose the Wall Street crowd but also find global investment opportunities from the social exchange of information with businessmen in the Bahamas, where he was living. In 1962 he invested in bargain Japanese and Canadian companies. By then, Japan was an emerging market, far from Wall Street's gaze, yet offering the best opportunities available. The lack of global demand for Japanese equities led the Japanese economy to grow much faster than its equity market, improving fundamentals to the point of making the whole market very cheap indeed.

Source: Morningstar

"SOMEONE WHO INVESTED £10,000 IN THE TEMPLETON GROWTH FUND AT THE INCEPTION DATE WOULD HAVE HAD A PORTFOLIO WORTH £2 MILLION BY 1992."



Source: Thompson Reuters Eikon

"BY 1970, TEMPLETON HAD A PORTFOLIO 60% COMPRISED OF JAPANESE EQUITIES. BY 1989, AT THE PEAK OF THE JAPANESE MARKET BUBBLE WHEN THE WALL STREET CROWD WAS HEAVILY INVESTED IN THE HIGH-FLYING NIKKEI 225, TEMPLETON HAD JUST 3% OF HIS PORTFOLIO INVESTED IN THE COUNTRY."

By 1970, Templeton had a portfolio 60% comprised of Japanese equities. By 1989, at the peak of the Japanese market bubble when the Wall Street crowd was heavily invested in the high-flying Nikkei 225, Templeton had just 3% of his portfolio invested in the country.

Templeton's expertise allowed him to almost always identify the irrational exuberance of the crowd. At the beginning of the 2000s, when Wall Street was heavily invested in the dot-com bubble, he opted to pour his money into solid commodity stocks. In 2003 he predicted the housing crash and declared the stock market broken. Unfortunately, he did not live to see it. On July 8, 2008 he died of pneumonia in Nassau, Bahamas. He was 95.

16 Rules for investment Success

Curiously, while Templeton was one of the world's most successful investors, almost all the books he wrote are about spirituality. As a member of the Presbyterian Church, he was dedicated to his faith. But instead of being cloistered in religious dogma, he has always actively supported spiritual progress. Templeton was optimistic about the possibility of acquiring "new spiritual information" by using the same methods used in science. This led him to dedicate a part of his life to spirituality, writing books on several spiritual matters and creating the John Templeton Foundation, which encourages research on the topic by giving away $70 million each year. The foundation has an annual prize of £1 million, which is the highest prize bestowed on an individual, greater even than the Nobel prize.

Templeton shared the most important investment rules behind his strategy after selling his mutual fund business. These rules first appeared in *World Monitor: The Christian Science Monitor Monthly* in 1993.

First of all, you should **(1) invest for maximum total real return**. The main goal of any investment is to make a positive return after inflation and taxes are accounted for. This is particularly important today, when the yields offered by many fixed income instruments are negative or very low. While there is no dominant asset class across all time periods, fixed income has performed poorly across almost all time periods, when inflation and taxes are taken into consideration. An investor must at least keep his purchasing power over time. Second, you should **(2) invest – don't trade or speculate**. While Templeton believed assets should not be held onto forever, he still argued against short-term overtrading. A value investor believes in short-term inefficiency and long-term corrections towards fundamentals. In the short term the market is a casino.

While the US stock market offers several investment opportunities, you should **(3) remain flexible and open-minded about different types of investment**. No asset class is better than all others at all times, thus requiring investors to change from equities to fixed income, from cyclicals to non-cyclicals,

from blue chips to small caps, and from US equities to Japanese equities. Globalisation offers many opportunities that should be taken into consideration. But, you should always remember that the key rule is to **(4) buy low**. If you buy the same thing everyone else is buying, you'll get the same results as everyone else and then, by definition, you can't outperform the market. Buying low means buying when no one else is buying, when there's no demand for that specific asset – when pessimism is at its maximum. But buying low isn't enough: **(5) when buying stocks, search for bargains** among quality stocks. Market leaders, trusted brands, companies with good management teams – all are better positioned to outperform and to overcome difficult times more easily. This feature works like a safety cushion.

> **"SOMETIMES YOU MAY BE CAUGHT IN A CRASH AND LOSE 15% IN A SINGLE DAY. BUT 'DON'T RUSH TO SELL THE NEXT DAY… THE TIME TO SELL IS BEFORE THE CRASH, NOT AFTER.'"**

Some investors, like George Soros, are good at converting market trends into profitable trades, but that isn't usually the case for value investors. In general, value investors conduct a bottom-up analysis and tend to ignore the economic outlook. From this comes the next rule: **(6) buy value, not market trends or the economic outlook**. Then, **(7) diversify, in stocks and bonds, as in much else; there is safety in numbers**. If something is to be learned from Markowitz's Portfolio Theory it is that investors can always reduce the impact of an asset's risk in a portfolio by combining it with many other assets. While market risk is unavoidable, specific risk is diversifiable. Templeton takes diversification to the highest level by mixing asset classes from different countries.

Investing is not like playing roulette at a casino, where no strategy is better than any other. You should **(8) do your homework or hire wise experts to help you, because it makes a difference**.

Because Templeton believes that markets change quite rapidly, requiring investors to react to change instead of buying and holding, he advises you to **(9) aggressively monitor your investments**. And, while you do that **(10) don't panic**. To panic means to sell when everybody else is selling.

Sometimes you may be caught in a crash and lose 15% in a single day. But "don't rush to sell the next day… the time to sell is before the crash, not after". You should only sell if you find better opportunities elsewhere.

A sound investment strategy is the result of a never-ending learning process. Experience will help you understand that this time won't be different. You should **(11) learn from past mistakes to generate profits in the future**. And why not **(12) begin with a prayer**? As a member of the Presbyterian Church and a spiritualist, Templeton believed that a prayer helps a person clear his mind and make fewer errors during a trading session or in stock selection.

While following sound investment rules certainly helps achieve better performance, you should always keep in mind that **(13) outperforming the market is a difficult task**. This rule works like a reality check to remind you that when superior performance is achieved, that's often just the consequence of the extra leverage taken. Many hedge funds will outperform the market when the market rises but then be taken out of business when the market declines. These funds don't really offer alpha but just beta and idiosyncratic risk. Being humble is also important, as **(14) an investor who has all the answers doesn't even understand all the questions**. Overconfidence is a well-known behavioural bias that leads to sentiment-driven trading. A successful investment is about erasing sentiment from the trading equation.

Like Benjamin Graham, Templeton argues you should do your own research or pay for someone else to help you do it. There are no shortcuts to fast profits; **(15) there's no free lunch**. Finally, **(16) do not be fearful or negative too often**. The market will certainly coil through ups and downs but on a positive uptrend. Historically, stocks have performed positively in almost any 10-year time interval or even less. Bearish episodes do occur but the market is bullish most of the time. Don't be over-exposed to fixed income for extended periods.

Final Words

John Templeton has been a pioneer and distinctive figure in both investment and philanthropy. In the latter, he contributed to the advance of knowledge in spirituality, as he always believed we can employ scientific methods in religious matters. In the former, he was a pioneer of global diversification across mutual funds and a leader in value investment. Templeton's legacy helps us refine our perceptions about what constitutes value investment and helps us build a sound investment strategy. At the same time, Templeton's life gives important clues about the role of human behaviour – there is no question that we know too little about one of the most important investment drivers. In terms of investment rules, the best way to summarise Templeton's strategy is by quoting Will Rogers' famous advice: "Don't gamble. Buy some good stock. Hold it till it goes up… and then sell it. If it doesn't go up, don't buy it".

BY JOHN KINGHAM

THE DIVIDEND HUNTER

DEBT-FREE DIVIDEND INVESTING

If there was a league table for reasons why companies cut their dividends, then I'm pretty sure that excessive debts would be somewhere near the top. So the need to avoid companies with too much debt is important, but it's even more important for high yield investors. Why? Because high yields are usually only on offer because the company paying the dividend has run into problems of one sort or another.

To help you avoid debt-laden companies I'm going to run through how I measure debt and how I measure what's "too high". After that I'll follow up with a quick look at a handful of high yield stocks from companies with little or no debt.

A debt ratio for long-term investors

There are lots of different ways to measure debt and some of the most common approaches are to look at the ratios between earnings and debt interest, debt and shareholder equity or debt and assets.

> "WHEN I LOOK AT DEBT I'M MORE CONCERNED ABOUT THE AFFORDABILITY OF A COMPANY'S DEBTS RATHER THAN THE FUNDING STRUCTURE OF THE COMPANY."

When I look at debt I'm more concerned about the affordability of a company's debts rather than the funding structure of the company. So of the ratios mentioned so far, the one relating to earnings and interest payments (or interest cover as it's known) would be my preferred metric, rather than the ones between debt to equity or debt to assets.

However, in my opinion the interest cover ratio is too short term in nature as it compares a company's current earnings (before interest and tax) with its current interest payments. But both earnings and interest payments can be volatile; earnings go up and down from one year to the next and interest payments can change with interest rates when a company rolls over its debts. This means that today's interest cover might not tell you very much about whether a company can afford its interest payments over the next few years.

Because of these limitations I prefer to look at the ratio between a company's total borrowings (both short-term "current" borrowings and longer-term "non-current" borrowings) and its average post-tax profits over the past five years.

Both of those factors are more stable than one year's earnings or interest payments and so, in theory at least, the resulting debt ratio between them should be more stable over time and more informative as well.

Goldilocks debts: Not too much, not too little

Generally speaking I'm happy to invest in a company if this debt ratio is below four, i.e. if its total borrowings are less than four-times its average post-tax profits over the past five years. Companies that operate in defensive sectors are often able to carry more debt because their earnings and cash flows are more stable, and so for defensive sector companies I raise that debt ratio limit to five.


GBP
CHF
UAH
KZT
RUB
RUB

But those are upper limits and in most cases I prefer debts to be much lower than that.

On the flipside, companies that totally avoid debt might be operating inefficiently. Most companies can comfortably handle some amount of debt and so – as long as a company can generate significantly higher returns on capital than it has to pay to borrow that capital – a conservative amount of debt can be more sensible than being completely debt free.

Okay, let's switch from theory to practice and have a look at a few stocks which combine high yields, fairly consistent dividend growth and very little in the way of debt.

The Restaurant Group (RTN): Yield = 5.1%; Growth rate = 10%; Debt ratio = 0.6

The Restaurant Group (which I'll refer to as TRG) is the largest independent operator of branded restaurants in the UK, including brands such as Café Uno, Garfunkel's, Deep Pan Pizza and Frankie & Benny's. The company has more than 500 outlets at sites ranging from high street restaurants, pubs, leisure parks and airport concessions and is listed in the FTSE 250.

> **"THE YIELD AT THE TIME OF WRITING IS HIGH AT 5.1%, SO OBVIOUSLY MR MARKET IS NOT HAPPY WITH TRG; YOU JUST DON'T GET A 5% YIELD FROM A COMPANY WITH A TRACK RECORD OF GROWING AT 10% A YEAR UNLESS THE MARKET EXPECTS THAT GROWTH RATE TO DISAPPEAR."**

The company's track record over the past decade has been impressive. Its revenues, earnings and dividends have increased in every single year and its growth rate has been close to 10% per year on average. Profitability has also been high with an average return on capital employed (ROCE) of 20% and of course its debts are low, with total borrowings of slightly more than £30m compared to average profits of more than £50m.

The yield at the time of writing is high at 5.1%, so obviously Mr Market is not happy with TRG; you just don't get a 5% yield from a company with a track record of growing at 10% a year unless the market expects that growth rate to disappear.

In this case TRG has recently mentioned weakening consumer demand and its outlook for next year is for a slight fall in revenues and profits. Whether or not this creates a material risk to the dividend I'll leave for you to decide, but I will say that I own shares in TRG and currently I'm not overly pessimistic.

XP Power (XPP): Yield = 4.3%; Growth rate = 15%; Debt ratio = 0.5

XP Power is a designer and manufacturer of electrical power controllers which are then fitted inside its customers' products. Its customers are, for the most part, original equipment manufacturers (OEMs) in the industrial, healthcare and technology sectors. In practice that means its products can be found controlling power for hospital equipment, military equipment, train ticket machines, lifts, elevators and many other places where the control of power is critically important. XP is listed in the FTSE Small-Cap index but is relatively large for a small cap with a market value of almost £300 million.

At first I thought power controllers would be a commodity product – i.e. they're all basically the same – but apparently that is often not the case for non-consumer electronics. In many cases OEMs have specific requirements for power output (e.g. voltage and other factors which I will not pretend to understand), efficiency, weight, size and various aspects relating to packaging. In these situations off-the-shelf power controllers will not do and this is where XP Power is focusing most of its efforts.

The company's track record is impressive. Over the past decade it had a growth rate of about 15% a year, although revenue and earnings growth have slowed somewhat more recently. Dividend growth is still going strong though, with the company announcing an 8% increase in its latest quarterly update. Profitability has also been strong with average ROCE coming in at almost 20%; that's almost double the average of most companies.

Having carried out a brief analysis I can't see any obvious downsides, or reasons why a company with a dividend which is still growing at 8% would have a yield of more than 4%. Perhaps Mr Market knows something I don't, but I would say this is definitely a low debt, high yield company which is worth investigating in more detail.

PayPoint (PAY): Yield = 4.4%; Growth rate = 8%; Debt ratio = 0.0

PayPoint is a payment processing company focusing primarily on providing payment terminals to small shops and other retailers. These terminals allow people to conduct a wide variety of transactions in cash, such as paying utility bills, topping up mobile phones or energy meter pre-payment devices and even buying bus tickets. The terminals can also be used to withdraw cash like an ATM or send cash to someone else who can then withdraw it from their local PayPoint terminal.

Historically Paypoint has performed very well. Over the last decade its average growth rate has been almost 8% and its average return on capital employed has been exceptionally high at more than 30%.

However, virtually all of the company's growth has been on the profit and dividend side of things as revenues have been flat for a number of years. This of course means profit margins have been increasing, but with margins now close to 50% it seems unlikely that they'll keep going up for much longer. At some point revenue growth must surely return if the company is to avoid stagnation.

Unlike The Restaurant Group and XP Power, there are more obvious reasons why this relatively high growth company has a dividend yield of well over 4%.

> **“HISTORICALLY PAYPOINT HAS PERFORMED VERY WELL. OVER THE LAST DECADE ITS AVERAGE GROWTH RATE HAS BEEN ALMOST 8% AND ITS AVERAGE RETURN ON CAPITAL EMPLOYED HAS BEEN EXCEPTIONALLY HIGH AT MORE THAN 30%. ”**

As noted in its latest annual results, PayPoint is currently going through some significant changes. Perhaps the most significant impending change is the sale of its online and mobile payments business, where management hope this will lead to a simpler business which is focused on its network of retail terminals. However, simplifying a business can still involve a lot of disruption and change, neither of which are good in the short term.

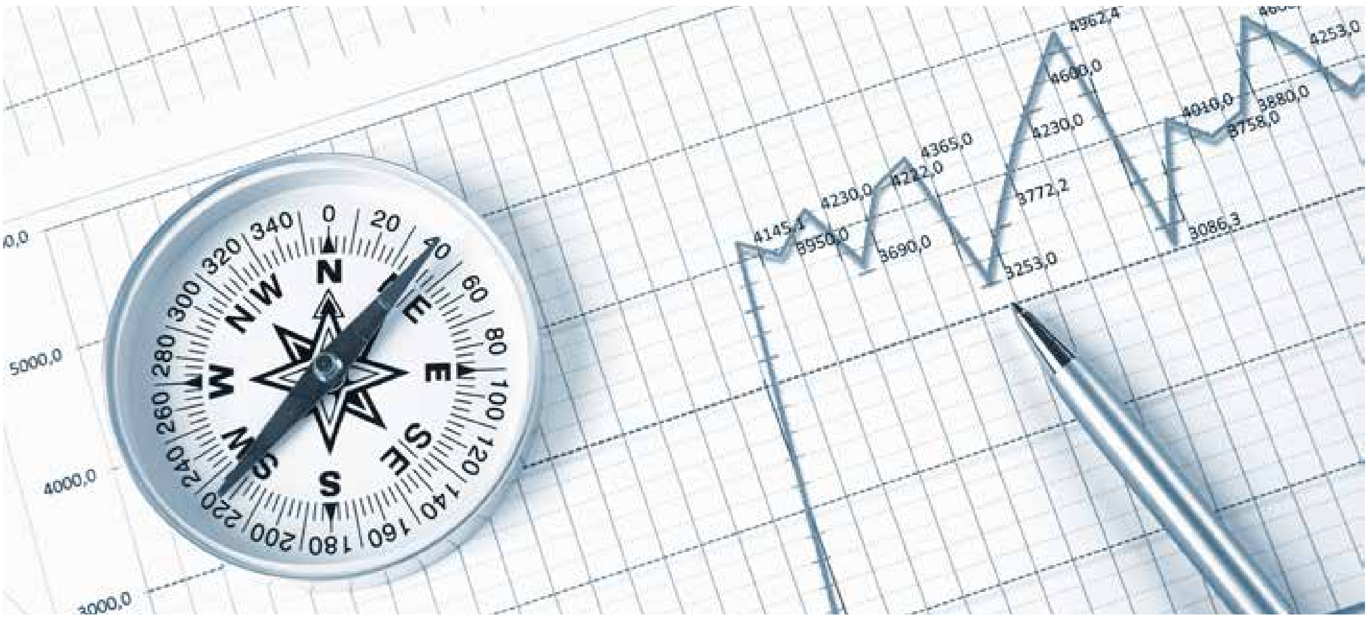
The company is also just starting the process of replacing its existing and long-running terminal with a new terminal which has the ability to replace existing till systems in many of its clients' stores. Yet more uncertainty surrounds PayPoint's parcel collection business, Collect+. This is a 50/50 joint venture with a company called Yodel and the two parties are in discussion over the future structure of this business (or whether it has any future at all).

So all in all there is a lot of uncertainty around PayPoint's medium-term future, but on the plus side there could be a series of special dividends over the next few years as the company expects to return some excess capital back to shareholders.

UK Mail Group (UKM): Yield = 5.2%; Growth rate = 3%; Debt ratio = 0.3

UK Mail is the UK's largest independent postal company, delivering mail and parcels for businesses and individuals throughout the UK and across the globe. As you might expect, postal delivery is a very steady business and UK Mail has not disappointed in that regard; its revenues, earnings and dividends barely changed through most of the last decade.

However, that stability came to an end in 2014 as the company optimistically raised its dividend by more than 13% on the back of that year's good results, which were partly driven by an increase in home parcel deliveries as a result of the continued shift towards online shopping and home delivery. As part of that optimistic outlook UK Mail also began a major new investment programme to create a new and highly automated national sorting hub near



Coventry. This hub, through the use of modern automated sortation technology, would be designed to significantly increase the capacity, efficiency and flexibility of the company's postal operations.

By the end of the 2015 financial year the company had sunk more than £35m into the new hub, which was by then partially operational. A degree of disruption was expected as operations were moved from the company's old national hub to the new one, but at least the company hadn't saddled itself with lots of debt in order to pay for this major capital investment (it had instead burned through the vast majority of its not inconsiderable £27m cash pile).

"AT THE TIME OF WRITING UK MAIL'S DIVIDEND YIELD IS 5.2%, LARGELY THANKS TO THE UNCERTAINTY AROUND ITS NEW HUB AND THE STIGMA ATTACHED TO DIVIDEND CUTTERS."

Fast forward to the recently announced 2016 annual results and the dividend has been reduced by 25%, which more than negates the (over) optimistic 13% increase in 2014 and takes the dividend to its lowest level in more than a decade. So why has the dividend been cut? The answer, somewhat predictably, is that new hub.

In the real world it is rare for events to go exactly as planned and in my experience the more critical the event the more likely it is to go wrong. For UK Mail this meant a large number of parcels which the automated sortation equipment couldn't sort, and that, along with other teething problems, led to lost customers and higher operating costs.

Longer term though the company still expects the hub to be extremely beneficial, and on top of that there is still the continued shift towards everyone buying everything online and then having it delivered. At the time of writing UK Mail's dividend yield is 5.2%, largely thanks to the uncertainty around its new hub and the stigma attached to dividend cutters. However, if you have the stomach to invest in dividend cutters then this one could be worth investigating further.

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.

Master Investor readers can purchase The Defensive Value Investor by John Kingham for 25% off when buying direct through the publisher, Harriman House.

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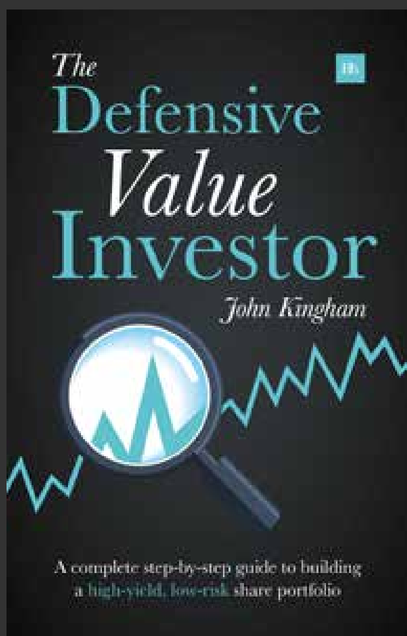


BY NICK SUDBURY

FUNDS IN FOCUS

IF YOU CAN'T BEAT THEM, JOIN THEM

THE FUNDS THAT WILL BENEFIT FROM AN AGEING POPULATION

It is estimated that the number of older people in the world – defined as those aged 60 or over – will increase from 901 million to more than 1.4 billion over the fifteen years to 2030. By the end of this period they will be more common than children under 9, while those in the 80 plus bracket will have passed the 200 million mark.

The ageing population will create many challenges, especially for governments who will have to pay for the pension and medical needs of the growing number of retirees out of the taxes generated by a smaller workforce, but there will also be opportunities.

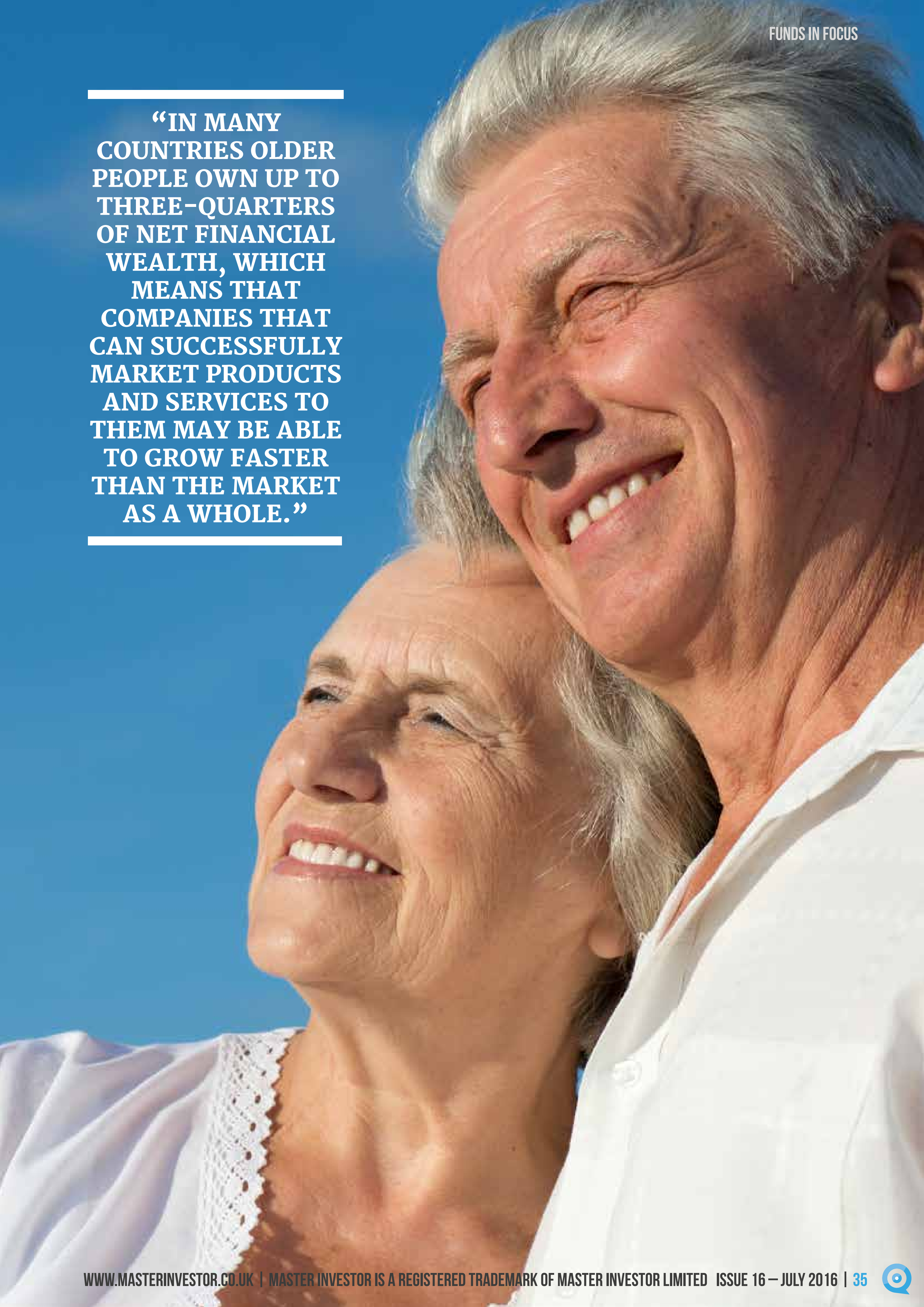
In many countries older people own up to three-quarters of net financial wealth, which means that companies that can successfully market products and services to them may be able to grow faster than the market as a whole. Businesses operating in the healthcare, pensions, insurance and leisure industries could all be major beneficiaries.

One way to take advantage is to invest in a fund that specifically aims to make money out of this trend. A good example is **Lombard Odier Golden Age**, which was launched in March 2003 and has attracted $638 million in assets under management.

Johan Utterman, the fund manager, has put together a concentrated portfolio of 48 stocks from around the world with 85% of the exposure divided between the US and Developed Europe. His largest sector weighting is the 47% allocation to Healthcare that includes major positions in Medtronic, Thermo Fisher Scientific, Allergan – the maker of Botox – and Roche.

The portfolio has been built from the bottom up and reflects the best investment opportunities that Utterman and his team can come up with. These include the providers of consumer goods and services, as well as financial stocks, which could all benefit from the wealth of older people. Over the last five years the sterling hedged share class has risen by 40.6%.

Another option is the £1 billion **CPR Silver Age** fund, which was launched in December 2009 and is domiciled in France. This is almost entirely invested in Europe and the UK, but provides exposure to the same sort of sectors as the Lombard Odier fund. The largest holdings include Roche, Sky and Renault, although the performance has been modest with a five-year return of just 9%. You may need to speak to a financial advisor if you want to invest as it is



"IN MANY COUNTRIES OLDER PEOPLE OWN UP TO THREE-QUARTERS OF NET FINANCIAL WEALTH, WHICH MEANS THAT COMPANIES THAT CAN SUCCESSFULLY MARKET PRODUCTS AND SERVICES TO THEM MAY BE ABLE TO GROW FASTER THAN THE MARKET AS A WHOLE."

not directly available to private investors.

More discretion

Niche mandates can be a bit hit or miss, so it might be better to invest in a fund that has a higher than average exposure to Healthcare stocks so as to benefit from the general trend while giving the manager more leeway when looking for opportunities.

The highest profile example is the £8.9bn **Woodford Equity Income** fund where Neil Woodford has consistently maintained a large overweight position in the sector. At the end of May, Healthcare stocks accounted for 36.49% of the portfolio, well ahead of their 8.68% weighting in the FTSE All-Share benchmark. This was largely due to significant positions in companies such as AstraZeneca, GlaxoSmithKline, Roche and AbbVie.

Since it was created in June 2014 the Woodford Equity Income fund has returned 20.95%, which is significantly better than the 1.26% increase in the benchmark. The performance in the last few months has been fairly lacklustre, but nobody can doubt Woodford's long-term record.

The **Artemis Global Select** fund has more of a thematic approach with 'rising healthcare costs' and 'retiree spending power' each accounting for 11% to 13% of the portfolio. It has a decent long-term track record and is one of the better performing funds in the Global Sector with a three-year return of 32.8%.

"NICHE MANDATES CAN BE A BIT HIT OR MISS, SO IT MIGHT BE BETTER TO INVEST IN A FUND THAT HAS A HIGHER THAN AVERAGE EXPOSURE TO HEALTHCARE STOCKS SO AS TO BENEFIT FROM THE GENERAL TREND WHILE GIVING THE MANAGER MORE LEEWAY WHEN LOOKING FOR OPPORTUNITIES."

The idea behind the healthcare theme is that companies that can make treatments more affordable, such as generic drug manufacturers and distributors, should benefit from the growing demand from the emerging markets and from the debt laden governments in the developed world.

'Retiree spending power' is slightly different. This targets businesses that the managers think will benefit from the increasing number of healthier and wealthier retirees who have the resources to enjoy holidays and other leisure activities.

Specialist healthcare funds

There are also a number of specialist Healthcare funds. These are not specifically designed to benefit from the ageing population, but the companies they invest in should do well from the extra demand from older people.

The most successful open-ended examples include **Polar Capital Healthcare Opportunities**, **AXA Framlington Health** and **Pictet Health**, which are all near the top of the Specialist sector with five-year returns of 170.6%, 111.5% and 89.5% respectively.

The Polar Capital fund is managed by Daniel Mahony and Gareth Powell, who have put together a concentrated global portfolio of 40 to 45 stocks based on the underlying fundamentals. These provide exposure to all aspects of the Healthcare sector, including equipment, services, drugs, pharmaceuticals and biotech.

It was launched in December 2007 and by the end of May 2016 had generated a cumulative return of 148%, which was well ahead of the 70% produced by its MSCI All Country World Index/Healthcare benchmark. The impressive performance has enabled the fund to attract $921 million of assets under management.

AXA Framlington Health has a longer track record having been created in February 1987, but it is only about half the size of the Polar Capital fund. Over the last five years the gain of 108.7% has failed to keep up with the 121.9% return from the MSCI World Healthcare index.

At the end of April it had a 25.7% exposure to biotech stocks. This was much larger than the 14.4% weighting in the Polar Capital fund and is where many of the strongest returns have come from with the major holdings including Amgen, Celgene and Gilead Sciences.

Closed-ended options

There are two specialist healthcare investment trusts that provide a general exposure to the sector, with the best performer being **Worldwide Healthcare Trust (LON:WWH)**, which can boast a share price gain of 157.3% in the last five years. **Polar Capital Global Healthcare Growth and Income (LON:PCGH)** has lagged significantly behind with a return of just 74.6%, although this could be partly due to its greater emphasis on income.

WWH is managed by Frostrow Capital, which has appointed the specialist team at OrbiMed Capital to run the portfolio. They currently have 62 separate holdings with the top 10 including stocks such as the ONO Pharmaceutical Company, Allergan, Bristol-Myers Squibb and AbbVie.

The managers expect the Healthcare sector to benefit from the greater demand for medication and treatment from the ageing population, as well as the huge amount of innovation around areas such as gene therapy. There should also be a significant level of M&A activity as the large pharmaceutical companies expand their drug pipelines by buying smaller rivals.

Worldwide Healthcare Trust has had a difficult 12 months, with the shares down around 5% and the discount to net asset value (NAV) widening to 8%, but this shouldn't detract from its long-term track record, which has been excellent since it was created more than 20 years ago.

"AGE UK ESTIMATES THAT THE NUMBER OF PEOPLE THAT ARE OVER 85 IN THIS COUNTRY WILL DOUBLE IN THE NEXT 20 YEARS AND TREBLE IN THE NEXT 30."

Healthcare property funds

You may also want to consider the two specialist property funds that invest in this area. Age UK estimates that the number of people that are over 85 in this country will double in the next 20 years and treble in the next 30. This should result in a massive increase in the demand for care homes and other medical facilities.

The £270 million **Target Healthcare Real-Estate Investment Trust (LON:THRL)** aims to provide an attractive level of income, with capital and income growth, by investing in a diversified portfolio of freehold and long leasehold care homes and other healthcare assets in the UK.

At the end of 2015 the fund owned 31 properties valued at £167.2m and it has since bought a further three. These are typically let out to specialist care home providers and generate a high and reliable source of income. THRL has been paying quarterly dividends of 1.545 pence per share, which gives it a yield of 5.67% and explains why the shares are trading at an 8.7% premium to NAV. It has been a fairly volatile performer but is up 23.89% in the last three years.

The other option is the **MedicX Fund Limited (LON:MXF)**. This aims to achieve rising rental income and capital growth by investing in a portfolio of modern, purpose built primary healthcare properties. The £327 million fund owns 148 different buildings of which 143 have been let out with the other five under construction.

Investors have been receiving quarterly dividends of 1.4875 pence per share, which based on the latest share price is equivalent to a yield of 7.21%. They have also enjoyed a decent capital gain with the shares up 27% over three years and 49% over five years. The main problem is that the shares trade on a massive 48% premium to NAV because of the solid government-backed revenue, which could make the share price extremely vulnerable.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

SPECIAL-DIVIDEND SPECIAL

EARN A BONUS FROM THESE SMALL-CAP INCOME KINGS

Most investors enjoy a dividend payment. Not only do they provide a useful source of income, they can be a sign that a company you have invested in is in good shape, is able to return cash to shareholders, and perhaps more importantly, is willing to give back to its investors. Special dividends, a rarer and often larger form of shareholder distribution, can be even more valuable.

As I see it there are two categories of special dividend. The first, and most common, occurs when a company has put in a good performance over a period of time and as a result has accumulated a large cash reserve. The reserves have been built up to such a level that a proportion is considered to be surplus to the company's working capital, capex and investment requirements. In other words, the company has performed so well that it has more cash than it needs to keep running successfully.

As a result the decision is then made to make a bonus distribution to shareholders which is usually far and above that of the usual annual dividend. While these types of special dividends are usually considered to be a one off, some companies have built up a reputation for regularly making these kinds of payments. One such company is AIM listed floorings business **James Halstead (LON:JHD)**, which I covered in more detail in the April issue of Master Investor Magazine. The firm's latest special payment was in February this year, so investors might have to wait a while for the next one. But with a strong balance sheet and cash generative operations, another distribution does look likely in the coming years.

Then there are special dividends which truly are a one off, typically related to special situations. These are usually rarer than the type of payments mentioned above and may come after an exceptional company event occurs, such as the sale of a subsidiary. For example, AIM listed challenger bank **Secure Trust Bank (LON:STB)** – covered in my blog HERE – recently declared a special dividend of 165p per share following the sale of its consumer lending business Everyday Loans. This payment alone equates to a yield of 6.9%.

A special payment may also come following the receipt of a tax rebate or receipt of damages from legal claims. On the tax side, miner **Gem Diamonds (LON:GED)** announced a special payment of 3.5 cents per share earlier this year relating to a cash saving from the settlement of a previous tax assessment. In these situations there is often the opportunity for investors to exploit mis-pricings, as the market can heavily discount the probability of such cash returns actually occurring, especially when long legal processes are involved.

For example, AIM listed **Avesco Group (LON:AVS)** famously received a large award from previously owned subsidiary Celador after US entertainment giant Walt Disney was forced to make a payment relating to the US profits from Celador's TV show "*Who Wants To Be A Millionaire?*" When the jury first found in favour of Celador in July 2010 Avesco's award was estimated at c.$50 million, which was worth c.£33 million at the time. Yet investors could still pick up Avesco shares at around the 80p level following the news. This valued the company at c.£20 million, a 40% discount to the value of the award alone.

"THE DISTRIBUTION OF CASH REDUCES THE LIKELIHOOD OF MANAGEMENT TAKING ON UNATTRACTIVE AND VALUE DESTROYING PROJECTS."

The reason for the large discount is that Disney retained the right to appeal and thus the receipt of the award was uncertain. Appeal they did but Celador won out in the end, resulting in Avesco eventually receiving a net £44.6 million payment in June 2013. Subsequently, a 110p per share special distribution was made to Avesco shareholders, meaning that those investors who took the risk back in 2010 made a substantial return.

> **"SPECIAL DISTRIBUTIONS CAN PROVIDE A WELCOME BOOST TO INVESTORS WHO ENJOY INCOME RETURNS AND ALSO SIGNAL A QUALITY COMPANY WORTH INVESTING IN."**

At the beginning of this article I said that "most" investors enjoy dividends. This is because a school of thought exists which suggests a return of cash in any form implies that management of a company has run out of new investment opportunities or ideas. Warren Buffett famously dislikes dividends, preferring instead that the cash be used in growing the business.

One example of this comes in the form of Fully Listed alcoholic drinks business **Stock Spirits (LON:STK)**. The troubled Eastern/Central European vodka seller, which has recently seen a shareholder revolt topple the CEO, announced a 10p special dividend in late-June. But this only comes because the firm hasn't been able to find a "meaningful" acquisition in order to expand its operations. The current yield of 9.6% (special + forecast annual dividend of c. 5p) may look attractive. But with the firm seeing market share in its core Polish market plunge from 38.1% to 30.9% in 2015, pre-tax profits down by 46%, and with the shares trading higher than most broker targets, Stock Spirits may best be avoided.

There is also the argument that the payment of a special dividend, as opposed to a share buy-back, indicates that management of a company believes the share price is either fairly valued or over-valued. As a counter argument it could be said that the distribution of cash reduces the likelihood of management taking on unattractive and value destroying projects.

Regardless of either viewpoint, special distributions can provide a welcome boost to investors who enjoy income returns and also signal a quality company worth investing in. For those with that belief here are a pair of small cap companies, one of which is about to make a special dividend payment and one which might have the potential to do so in the near future.

CASTINGS

Castings (LON:CGS) is a West Midlands based foundry business which manufactures and sells a range of cast iron products, mainly for the commercial vehicle and automotive sectors. Its operations consist of the foundry businesses Castings PLC and William Lee and machining business CNC Speedwell. As a result of a strong financial performance in the year to March 2016 it has recently decided to make a special dividend payment worth 30p per share. Unfortunately, the special dividend is only being paid to shareholders who were on the list as at 24th June, and they will enjoy a one off yield of 6.8%. However, I believe that the company is worthy of a further look for a number of reasons.

Firstly, while trading over the past five years at Castings has not shown steady growth, it has been relatively consistent, with the firm constantly posting strong profits – pre-tax profits have ranged between £19.2 million and £23.1 million since 2012. More importantly, the cash flow from operations has been strong, enabling the company to invest in new machinery for its foundries, pay increasingly large dividends and build up cash reserves on its balance sheet. Castings is debt free, and with £40.4 million of net cash as at 31st March 2016 (including £10 million of interest bearing deposits) was able to make the recent decision to pay a special dividend. While this distribution will remove c.£13.1 million from the balance sheet, if trading continues to be consistent over the coming years there should be another opportunity for investors to enjoy a bonus distribution.

Secondly, Castings may be one company which will in fact benefit from the effects relating to the United Kingdom's exit from the European Union. With exports making up 67% of revenues in the last financial year (with major markets being Sweden, The Netherlands and The Rest of Europe) a weakening of sterling against other currencies, as has been seen post Brexit, could boost demand as a result of lower effective prices. Reflecting this, the company's shares rose by 0.54% on the day following the referendum result compared to a 3.8% fall in the wider FTSE All Share.

Cast iron certainty?

I have always liked Castings as a business. It is run by a sensible management team and the accounts are always very easy to read – you'll rarely find confusing exceptional items, EBITDA this and adjusted profits that, in any of the company's reports.

> **"I HAVE ALWAYS LIKED CASTINGS AS A BUSINESS. IT IS RUN BY A SENSIBLE MANAGEMENT TEAM AND THE ACCOUNTS ARE ALWAYS VERY EASY TO READ."**

In terms of the valuation, at the current price of 440p, Castings is capitalised at £192 million. Remember that the special ex-dividend date is now behind us so the valuation reflects this. Investors buying into the shares now will receive the final dividend payment of 10.33p, which gives a yield of 2.34%. With a full year payment of 14.4p expected for the current year the total yield is a reasonable 3.27%. On forecasts for 33p of earnings in the current year the shares trade on a multiple of 13.3 times, which in my opinion looks pretty good value for a business which has a strikingly good balance sheet and quality cash flows. In addition, given the recent weakening of sterling, and the company's export focus, I believe that earnings forecasts for the current year could well be beaten.

Overall, investors looking for steady long-term income growth, with the potential for both capital growth and further bonus distributions, should look no further than Castings.

SPORTECH

With my next stock, where the situation is a little riskier, I believe there is a mis-pricing opportunity to take advantage of, and the potential to enjoy a substantial special distribution in the coming months or years.

Sportech (LON:SPO) is a Fully Listed business which can trace its history back over 100 years. As of today the company is probably best known for running The Football Pools, a betting game based upon predicting the outcome of football matches. The pools have declined in popularity in recent years, mainly due to the introduction of The National Lottery in the 1990s. But the game still attracts around 300,000 players a week and is a highly profitable division for the company.

Sportech also runs two other divisions. Sportech Venues is a US focussed business which in the state of Connecticut has an exclusive licence to operate all betting on horseracing, greyhound racing and ball game Jai-Alai via retail, telephone, internet and mobile channels. In California the group is developing sports bars, restaurants and betting venues under the brand name "Striders" and in the Netherlands it operates a number of horseracing betting services under an exclusive licence from the Ministry of Justice. Meanwhile, Sportech Racing and Digital provides software, hardware and services for a range of licensed racing, betting operators and casinos around the world. Within the division the acquired business Bump 50:50 provides in-stadia electronic lotteries to professional sports teams.

The main opportunity here comes from a long running legal saga which has been dragging on for seven years. Back in 2009 Sportech submitted a claim to HMRC for the repayment of VAT overpaid on a "Spot The Ball" game which the company ran from 1979 to 1996. The company's case is based on the argument that Spot The Ball is a game of chance and thus, under UK law, is not subject to VAT payments. In contrast, games of skill, which HMRC believes Spot The Ball should be classified as, are required to pay VAT.

The legal battles since 2009 have been long and complicated but this is a brief summary of the situation:

March 2013 – the First-tier Tribunal's Tax Chamber finds in Sportech's favour, with the total claim (including simple interest) valued at an estimated £80 million+.

June to November 2014 – Sportech receives a payment of £93 million from HMRC. But following an appeal by the taxman the Upper Tribunal reversed the decision and ruled in HMRC's favour. Sportech subsequently appeal themselves but are forced to pay back the cash.

May 2016 – Now in the Court of Appeal three judges are unanimous in award-

"HMRC IS STARTING TO LOOK INCREASINGLY DESPERATE HERE GIVEN THAT TWO COURTS HAVE VOTED IN FAVOUR OF SPORTECH."

ing Sportech the overpayments, the value of which, including interest, have now reached £97 million. The Court of Appeal refuses HMRC permission to appeal to the Supreme Court – the final court of appeal in the UK for civil cases.

June 2016 – HMRC applies directly to the Supreme Court for permission to appeal. Sportech files its Notice of Objection and is advised it should hear by Autumn whether the Supreme Court will hear HMRC's case.

What could happen now?

I am no legal expert and of course the final outcome is uncertain but HMRC is starting to look increasingly desperate here given that two courts have voted in favour of Sportech. So it is surprising to me that the markets look to be pricing in a very low probability of Sportech eventually receiving the award. This is reflected in the fact that the £97 million award (which will increase over time as interest is added) represents almost a full year's historic revenues for the company, 82% of the current market cap of £118.1 million and 55% of the firm's £175.8 million enterprise value. To illustrate the potential here let's reasonably assume Sportech receives £100 million as a final settlement, less 10% for legal expenses – so £90 million. Assuming the balance sheet has remained flat since December that would leave the company debt free and with net cash of £32.3 million. Sportech has run its business successfully with large amounts of debt for many years so it looks highly probable there will be some form of special distribution. Even if all the debt is paid off I calculate that the distribution could be as high as 15.66p per share, or a yield of 27% at the current share price. Even if no special payment is made, the shares would thus look very cheap on a forecast ex-cash earnings multiple of just 8.3 times.

And there could be more value to be realised...

Over the past 12 months Sportech has been involved in talks with various parties over potential corporate activity. In December last year the company confirmed it had received a number of indicative proposals to buy its Football Pools business and invited best offers to be submitted by mid-January. One of these proposals came from AIM listed NetPlay TV (but was terminated), with another reportedly coming from Sportech's former Chief Operating Officer Ian Hogg. Amounts bid for the business mentioned in the media were as high as £100 million.

While Sportech has gone quiet on the matter in recent months it stated in its full year results report in March, *"we will continue to investigate any proposals that recognise the value of the inherent potential of these businesses"*.

So with two potentially value creating events in the pipeline, I believe investors with a high risk appetite should consider a punt in Sportech at current levels.

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

FORGET "PHARMACEUTICALS" – THINK IMMUNOLOGY AND SYNTHETIC BIOLOGY

Investors often suppose that biotechnology is all about the development of new wonder drugs which zap bacteria and viruses – pharmacology. But in fact the best investment prospects probably reside in other, newer fields of medicine, of which there are several. Today I'm taking a peek into just two of the emerging disciplines which could transform medicine within our lifetimes: immunotherapy and synthetic biology.

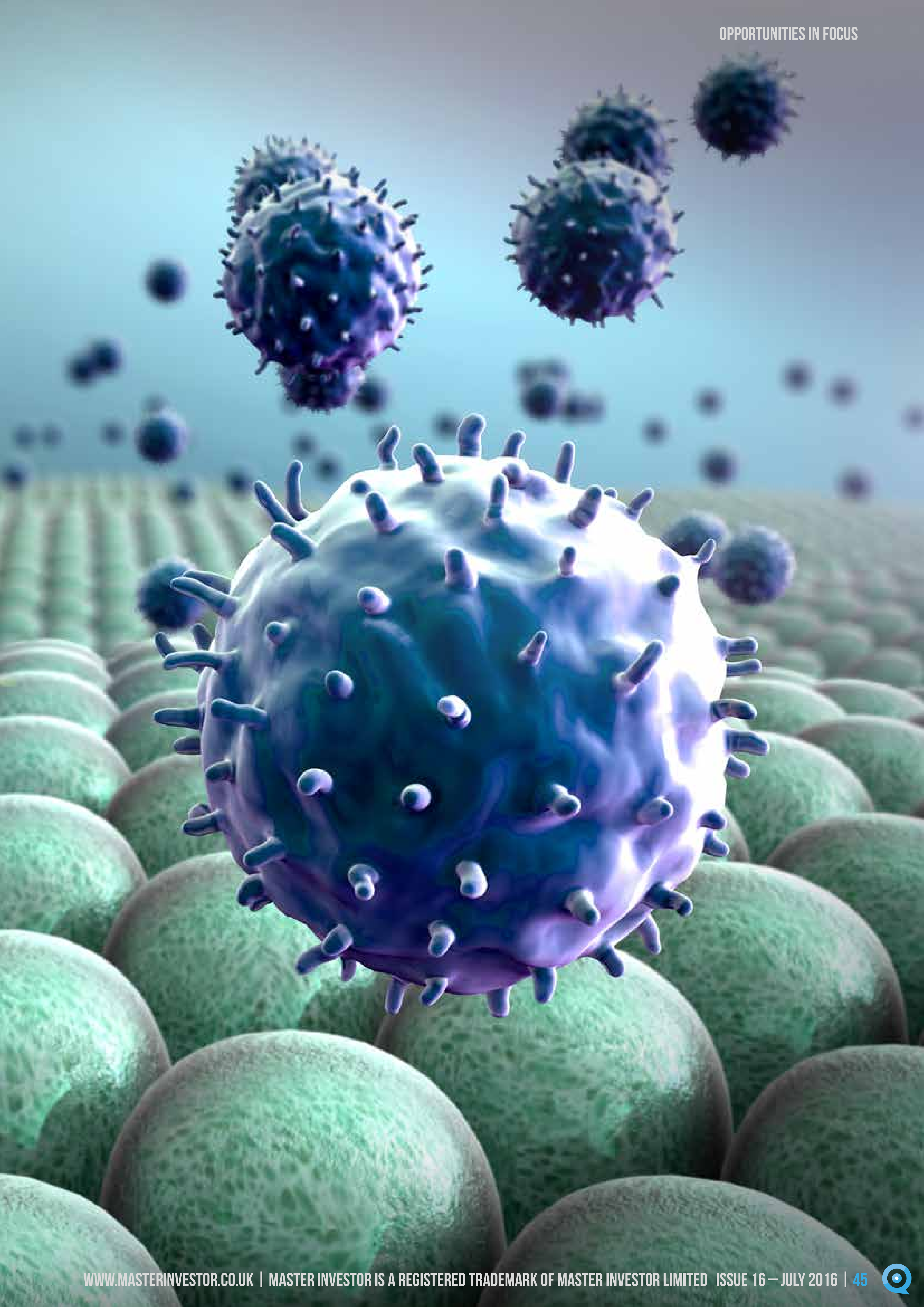
Recently I wrote that Big Pharma has shown itself to be inadequate to the challenge of antibiotic resistance[i] – because the development of new blockbuster drugs no longer pays. The economics of pharmacology have become unfavourable. The typical cost of bringing a new drug to market has soared from US$150 million to at least US$1 billion in the last 20 years. And for every successful drug brought to market there might be a dozen which are never commercialised. The pharmaceutical giant **Pfizer Inc. (NYSE:PFE)** is more interested in producing high margin *multivitamins* than in developing new blockbusters. But I also reflected recently in another piece that the extension of human longevity, which has more than doubled over the last 150 years, has been driven as much by soap as by penicillin[ii].

> **"THE TYPICAL COST OF BRINGING A NEW DRUG TO MARKET HAS SOARED FROM US$150 MILLION TO AT LEAST US$1 BILLION IN THE LAST 20 YEARS."**

Indeed, there is much more to modern medicine than conventional pharmacology. For a start there is immunology – the science of empowering the body to use its own remarkable resources to fight infection. And gene therapies also promise extraordinary advances in medicine in years to come.

Immunology: from Cowpox to Cancer

Immunology starts with vaccines. This branch of medicine has been around since 1796 when Edward Jenner inoculated an eight year old boy with material from the cowpox blisters of a milkmaid. A vaccine (derived from the Latin word for cow) is



"ANALYSTS FORESEE HUGE POTENTIAL GROWTH OF THE VACCINES MARKET IN INDIA (GROWING AT ABOUT 16 PERCENT PER ANNUM) AND CHINA (18 PERCENT) IN THE COMING DECADE."

a biological preparation that improves immunity to a particular disease. A vaccine typically contains an agent that resembles a disease-causing microorganism, and is often made from weakened forms of the microorganism or its toxins. The agent educates the body's immune system – antibodies – to recognize it as foreign, destroy it, and remember it. As a result, the human or animal immune system can recognize and destroy any similar microorganisms encountered thereafter.

This is an example of where human ingenuity helps Mother Nature to do what she does anyway, only in a more timely and precise way. The number of lives that Jenner has enabled humankind to save over eight or so generations is incalculable.

Vaccines can be prophylactic (preventive) or therapeutic (treating an existing condition) and are administered in mind-boggling quantities on a planet of nearly seven and a half billion people. There cannot be an adult alive in any developed country who has not had a vaccination of some kind. And happily, the developing world is catching up fast. Analysts foresee huge potential growth of the vaccines market in India (growing at about 16 percent per annum) and China (18 percent) in the coming decade. Sales of human vaccines are virtually recession-proof and can only rise as sophisticated healthcare systems are rolled out across the developing world.

All the top global pharmaceutical firms offer vaccines in their product portfolios, but three firms dominate this increasingly important segment: Sanofi, GSK and Merck.

The French giant **Sanofi SA (EPA:SAN)** was the number four global pharmaceutical company by revenues in 2014[iii]. It is a diversified player active in pharmaceuticals, vaccines and animal health. Sanofi-Aventis SA was formed in 2004 when Sanofi-Synthélabo (a former subsidiary of the French oil giant Total) acquired Aventis (formerly the organic chemicals division of Rhône-Poulenc). The company lacks high brand recognition in the English-speaking world but some of its leading products are nonetheless global brands like *Gardasil* (the cervical cancer vaccine) and *Frontline Spot On* the world's best-selling anti-parasite treatment for cats and dogs. About 2 billion pipettes of *Frontline* have been sold.

Sanofi-Pasteur, the fully integrated vaccines business, is a world leader in human vaccine production offering a broad range of first-order and booster vaccines: for influenza, paediatric conditions, poliomyelitis, meningitis as well as measles, mumps, and rubella (MMR). Merial, another Sanofi subsidiary, is the global market leader in animal health, dedicated to the research, development, manufacture and delivery of vaccines used by veterinarians, farmers and pet owners. Merial's *Ivermectin* entered pharmaceutical history a while back as the most successful animal health product ever launched. This family of products has been used for more than two decades by cattle ranchers, beef and dairy producers, and veterinarians.

Not all of Big Pharma wants to be in vaccines. In April 2014 **Novartis (VTX:NOVN)** sold its vaccines unit, with the exception of flu vaccines, to **GlaxoSmithKline (LON:GSK)**. Central to the deal was *Bexsero*, Novartis' vaccine for meningitis B – a potentially fatal disease – which currently has EU

Company	Revenues 2014	Market Cap (17/06/2016)	Price Earnings (17/06/2016)
Sanofi SA (EPA:SAN)	US$36.437 billion	US$101.25 billion	20.63
GlaxoSmithKline (LON:GSK)	US$29.580 billion	US$100.03 billion	113.07
Merck AG (FRA:MRK)	US$36.042 billion	US$150.373 billion	27.20

approval and orphan drug designation in the US. Glaxo also inherited 20 or so in-development vaccines to prevent hospital infections, tuberculosis, and a wide range of other maladies. Vaccines will contribute an estimated 14% of Glaxo's revenues going forward.

Merck AG (FRA:MRK) has distinguished itself recently by developing an experimental vaccine for the Ebola virus. Ebola, which caused 11,325 deaths[iv] in the West African epidemic of 2014-15, is particularly tricky as it appears to be able to lurk undetected for a period of about 15 months. Authorities in affected countries have succeeded in stopping transmission of the virus only for fresh outbreaks to appear seemingly out of nowhere. Merck says that it will have 300,000 doses of this vaccine to help control such flare-ups[v].

As new virus mutations arise, such as H1N1 ("Bird Flu"), these three will be at the forefront of preventive immunology.

From Immunology to Immunotherapy

While vaccines boost the ability of the immune system to combat specific infections, immunotherapy involves a new-generation of oncological drugs which are designed to re-activate or boost the body's own immune system to fight cancer. One of the most pernicious features of many cancers is that they trick the body's immune system into thinking that tumour tissue is benign. The main agent in immunotherapy is the *monoclonal antibody*. Monoclonal antibodies are antibodies which are specific to one type of cell or tissue. They are generated by identical immune cells that are all clones of a unique parent cell – in contrast to *polyclonal antibodies*, which are made from several different immune cells.

"IMMUNOTHERAPY HAS BEEN HAILED AS THE BIGGEST BREAKTHROUGH IN CANCER TREATMENT FOR DECADES."

Immunotherapy has been hailed as the biggest breakthrough in cancer treatment for decades. The remarkable clinical efficiency of monoclonal antibodies suggests that immunotherapy has the potential to revolutionise modern medicine. *Innovation Forum Oxford* organised a key conference on the subject at the John Radcliffe Hospital, Oxford, on 11 April this year which was attended by academics, clinicians, industrialists and investors.

Oxford University Hospitals Foundation Trust has recently been trialling *Nivolumab* (known and marketed in the USA as *Opdivo*) on adults in their twenties and thirties suffering from Hodgkin lymphoma (a form of leukaemia). According to a recent report, 66 percent of the 80 participants experienced tumour shrinkage, while ten percent were completely cured[vi]. Nivolumab was discovered and developed by Medarex and brought to market by **Bristol-Myers Squibb Corp. (NYSE:BMS)** which acquired Medarex in 2009 for US$2.4 billion. BMS was the 15th largest pharmaceutical company by revenue 2014 with sales of US$15.88 billion. It should be noted that Medarex licensed Japanese rights to *Nivolumab* to Japan's **Ono Pharmaceutical Co Ltd (TYO:4528)** in 2005.

Nivolumab works as a *checkpoint inhibitor*, blocking a signal that would normally prevent the activation of T-cells from attacking a cancerous tumour, thus allowing the body's immune system to attack the cancer. From April this year, *Nivolumab* has been used for inoperable or metastatic melanoma in combination with a related monoclonal antibody, *Ipilimumab* (marketed

as *Yervoy*). *Nivolumab* is also used as a second-line treatment for squamous non-small cell lung cancer and for renal cell carcinoma.

Nivolumab and *Ipilimumab* both work by interrupting the chemical signals that cancers use to convince the immune system they are healthy tissue. *Nivolumab* blocks the "off-switch" – a protein on the surface of white blood cells (T-cells) called PD-1. *Ipilimumab* blocks a similar switch called CTLA-4. However, there are side effects: the combination can cause inflammation in the bowels and liver as the drugs trigger the immune system to attack healthy tissue.

Promising clinical trial results made public back in 2012 caused excitement among industry analysts. Merck developed *Pembrolizumab (Keytruda)*; and **Roche (VTX:ROG)**, via its subsidiary **Genentech**, comMerialised Atezolizumab. Trials were announced by GSK in collaboration with the Maryland biotech company **Amplimmune**; and by **Teva Pharmaceuticals (TLV:TEVA)** in collaboration with the Israeli biotech company **CureTech**.

Ono Pharmaceuticals received approval from Japanese regulatory authorities to use *Nivolumab* to treat melanoma in July 2014, which was the first regulatory approval of a PD-1 inhibitor anywhere in the world. Merck received its first Food and Drug Administration approval for the PD-1 inhibitor, *Keytruda*, in September 2014. And – while I was writing this – on 17 June 2016 the National Institute for Health and Care Excellence (NICE) announced that the NHS will be permitted to use *Ipilimumab and Nivolumab* in combination[vii] in the UK. These have been shown in recent UK trials to shrink the most aggressive and deadly type of melanoma (skin cancer) in 69 percent of patients. Melanoma kills around 2,000 people in the UK every year.

British Universities Get Entrepreneurial

A number of niche players active in different fields of immunology have emerged out of the research laboratories of British universities.

MedImmune Ltd, a subsidiary of **AstraZeneca (LON:AZN)**, works to boost the immune systems of babies and grown-ups. Its flagship biotech product, *Synagis*, prevents respiratory syncytial virus (RSV), a major cause of pneumonia and other respiratory disease in infants and children. It has also commercialised *FluMist*, a nasal spray flu vaccine, and *Ethyol* which treats the side-effects of chemotherapy. The company is working on dozens of investigative therapies, including monoclonal antibodies, vaccines, and small molecule drugs in the areas of infectious disease, cancer, inflammation, autoimmune conditions and respiratory disorders. *Durvalumab* is now in Phase III clinical trials in a range of cancer types.

Immunocore Ltd offers a highly innovative immuno-oncology platform technology called ImmTACs. These are a novel class of drugs based on the company's proprietary T-cell receptor (TCR) technology, which have the potential to treat diseases including cancer, viral infections and autoimmune diseases. Immunocore, commercialising the discovery of HLA (human leukocyte antigen) targets and T-cell receptor technology, has a pipeline of wholly-owned and partnered development programmes. Partners include Genentech, GlaxoSmithKline, MedImmune, and **Eli Lilly and Co. (NYSE:LLY)**. Founded in 2008 by Oxford University researchers, **Immunocore** now has more than 230 staff. Immunocore's major shareholders include Woodford Investment Management, Malin Corporation, Eli Lilly, RTW Investments and Fidelity Management & Research Company.

Autolus Ltd was founded by Dr Martin Pule in 2014 who remains Chief Scientific Officer. Dr Pule is the Clinical Senior Lecturer in the Department of Haematology at the University College London Cancer Institute. His research is focused on the genetic engineering of T-cells for cancer treatment. As well as being a senior Lecturer at UCL, Dr Pule holds the post of honorary consultant clinical haematologist in the UCL Hospital, lymphoma being his main clinical interest. Autolus Ltd is active in chemotherapy and radiology as well as in synthetic biology (see below).

Vaccitech Ltd will be using "viral vectors" to make new vaccines against emerging pathogens. This is a research area which has gained prominence since the recent Ebola outbreak in West Africa. Sarah Gilbert, Professor of Vaccinology at the Oxford of University, founded Vaccitech in May 2016 to accelerate the rapid clinical development of such vaccines. It was announced on 11 May that the start-up had secured £10 million of seed funding from Oxford Sciences Innovation, Invesco, Lansdowne Capital Partners and Woodford Investment Management[viii]. Vaccitech is one of nine spinoffs so far this year by Oxford University which has been the world's top medical research university for the past five years.

Vaccitech will draw on research from Oxford University. It aspires to generate vaccines which boost cancer immunotherapies as well as a "universal" flu vaccine. The universal flu vaccine theoretically works against all human, avian and swine influenza strains by targeting two proteins inside the virus which do not change. The vaccine is "already showing promise" in Phase II trials.

Other companies in the race to market a universal flu vaccine include Wisconsin-based start-up **FluGen**, Israel's **Biondvax Pharmaceuticals (TLV:BVXV)** and America's **Johnson & Johnson (NYSE:JNJ)**. In the cancer vaccines field, Vaccitech will be up against the likes of Denmark's **Bavarian Nordic A/S (FRA:BV3/CPH:BAVA)**, **Inovio Pharmaceutical Inc. (NASDAQ:INO)** and **Aduro Biotech Inc. (NASDAQ:ADRO)**.

Immunotherapy is already being referred to in the medical profession as the fifth pillar of cancer treatment – the first four being surgery, radiotherapy, chemotherapy and conventional pharmacology. Note that radiotherapy itself is undergoing a revolution with the advent of proton beam therapy (PBT).

“CRISPR WAS NAMED BY THE AMERICAN ASSOCIATION FOR THE ADVANCEMENT OF SCIENCE AS THE MAJOR SCIENTIFIC BREAKTHROUGH OF 2015.”

Gene Therapy: the Future is CRISPR

First, biologists set out to crack the code of human, animal and vegetable animal life by sequencing genomes. But now they have got a technology by means of which they can edit those genomes and splice out "faulty" genes which they know to cause defects in the organism. This technology is called CRISPR – which stands for *clustered regularly interspaced short palindromic repeats*. (Now you know!) CRISPR was named by the American Association for the Advancement of Science as *the* major scientific breakthrough of 2015.

In the jargon of the new science of *synthetic biology*, first we learned to read the code, but now we are developing the tools to write it. CRISPR is thought to offer a technique of tweaking genomes so as to avoid inherited conditions such as Duchenne muscular dystrophy. Most people would think of that as an incontrovertible advance. But many ethicists and scientists believe that this type of therapy may have legal and social implications. For example, some scientists think that depression has a genetic component. But would we feel comfortable if scientists then set about altering the human genome so as to minimise the risk of a disposition towards depression? That

> **"THE VALUE OF THE BIO-ECONOMY IN THE UK WAS ESTIMATED AT AROUND £150 BILLION – AND INCREASING RAPIDLY."**

smacks of biological and social engineering gone too far. And there is the Frankenstein factor: the fear of what we might unleash if we could generate entirely new organisms.

That said, current projects underway in synthetic biology are practical and relatively uncontroversial. For example: to cure people of debilitating genetic diseases; to make mosquitoes (which spread malaria) sterile; to programme microbes to generate biofuels; to increase the nutritional value of plants; to create synthetic meat (great news for vegetarians – and beasts); and to create new materials with remarkable properties.

The cost of sequencing the genome of an organism has plummeted in recent years. According to the National Human Genome Research Institute (NHGRI) the cost of sequencing a string of a billion pieces of DNA has fallen from $10,000 in 2001 to less than one cent today. This is due to huge advances in DNA sequencing machines and in the software that they use. As a result, synthetic biology is not just reserved to Big Pharma. In the USA there are numerous small start-ups and so-called *bio-hackers* working out of laboratories in their garages and basements using cloud computing services to manipulate organisms in order to produce economically viable products.

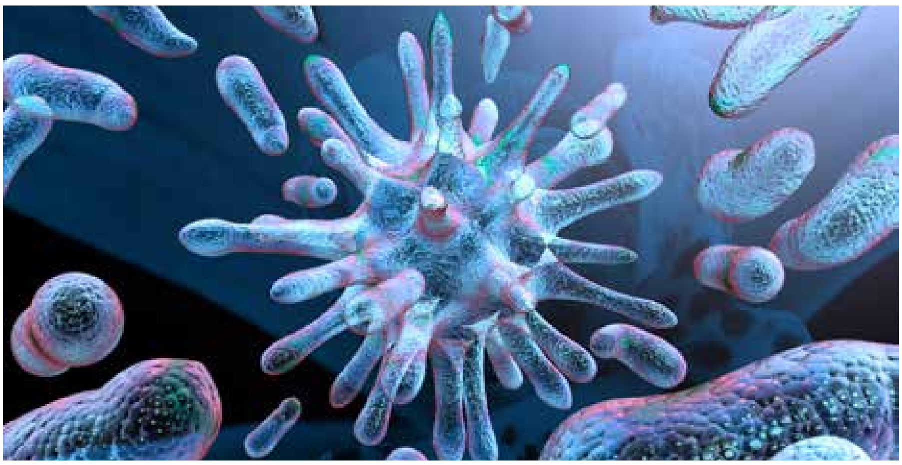
One such outfit, **Lygos**, is altering the DNA of yeast and e-coli to produce nylon, polyester, and polypropylene for clothing. **Refactored Materials** is transforming proteins to create materials that mimic spider silk – a fibre six times tougher than Kevlar. Kevlar and Gore-Tex have been around for years and were developed long before synthetic biology was even possible; but the new fibres that could be engineered using synthetic biology could have even more astonishing applications.

Back in January 2013 David (now Lord) Willets, then Minister for Science, identified synthetic biology as one of the *Eight Great Technologies*[ix]. More recently, the value of the bio-economy in the UK was estimated at around £150 billion – and increasing rapidly.

The Biotech Brit-Pack Leads the Way

On 05 April 2016, the Institution of Engineering and Technology (IET) and SynbiCITE, the UK's synthetic biology consortium of 56 industrial partners and 19 academic institutions based at Imperial College London, organised a one-day seminar in London on synthetic biology[x]. The workshop attracted more than 100 scientists and engineers reflecting the UK government's commitment to the UK's leading position in the world of synthetic biology, in which the UK is second only to the US. The April workshop is to be followed by another, bigger event in December 2016 to be held at the IET headquarters in Savoy Place, London.

SynbiCITE is headed up by Dr Stephen Chambers. Dr Chambers joined **Vertex Pharmaceuticals (NASDAQ:VRTX)** in the US at an early stage as a founding scientist. Vertex subsequently had phenomenal success in commercialising treatments for cystic fibrosis, principally *Orkambi*[xi]. (It now has a market cap of US$22 billion.) Dr Chambers later became a co-founder of **Abpro Inc.**, a Massachusetts biotech company specialising in rapid antibody production, which describes itself as *a complete gene-to-antibody industrial biochemistry platform*. In an interview with the Huffington Post last year, Dr Chambers stated that he came back to the UK for the same reason that he went to the US in the 1980s: *to be where life science start-ups are happening*[xii].



Dr Chambers sees SynbiCITE as a *foundry* for DNA synthesis, assembly and verification. His goal is to help would-be scientist-entrepreneurs to translate their ideas and research in synthetic biology into viable products. SynbiCITE's *Lean Launchpad* is a crash course in entrepreneurship, taking scientists out of their laboratories and providing them with the skills, knowledge and understanding to take their science to market. He tells the boffins to explain, not the pure science, but why there is a market for their product.

Nanocage Technologies is one such company. It has developed a technology that allows drugs to be transported to specific cells in the body inside tiny protein "cages". This opens up the possibility of delivering cancer therapies to the precise location where they are needed thus reducing unpleasant and often debilitating side effects.

ETAL, a skincare manufacturer founded by molecular biologist Gracie Oury, A&E doctor Kieran Latham and pharmaceutical scientist Pitchaya Rungsereechai, found the challenge was the pressure they were under to come up with the right product. After attending *Lean Launchpad* they have used a specific protein to develop a stretch-mark cream for men![xiii]

ACTION

The UK is well placed to commercialise the medical advances made possible by life science technologies that are coming out of its top universities. The leaders of Big Pharma are well positioned to profit from huge growth of existing mature products such as vaccines in developing markets. Sanofi, GSK, Merck and Bristol Myers Squib should be core holdings in a large diversified portfolio with a biotech bias. But it is the start-ups in life science that offer the greatest potential for reward. The early bird catches the worm. Funds which invest in cutting-edge life science start-ups include **Fidelity Select Biotechnology Portfolio (MUTF:FBIOX)** though be aware that this is down by nearly 25% year to date.

In the US, Brad Loncar, who describes himself as an independent biotech investor, has created a new type of biotech index that focuses exclusively on cancer immunotherapy drugs which he feels have been overlooked by conventional biotech funds. Loncar's fund, launched last autumn, is the **Loncar Cancer Immunotherapy ETF (NASDAQ:CNCR)**. This ETF contains companies such as Merck, Bristol-Myers Squibb, Pfizer, Roche/Genentech, **Juno Therapeutics (NASDAQ:JUNO)**, **Kite Pharma (NASDAQ:KITE)**, Novartis and numerous others which are making huge investments in this space. Admittedly, biotech has not had a great year and the ETF is down about 20 percent year to date. But with Bristol Myers Squibb announcing that sales of *Nivolumab/Opdivo* will hit US$1 billion this year, now looks like a good time to buy in.

The products currently being developed with synthetic biology in the UK are remarkably varied. And this segment is almost entirely driven by dynamic new start-ups. A few years ago you had to travel to San Francisco to find this kind of innovation. But today you can just take the tube to SynbiCITE's offices is in South Kensington.

i Antibiotic Persistence – Or Where Big Pharma Went Wrong, available at: http://masterinvestor.co.uk/equities/antibiotic-persistence-big-pharma-went-wrong
ii Florence Nightingale' Deep Mind, http://masterinvestor.co.uk/equities/florence-nightingales-deep-mind
iii See: Top 25 pharma companies by global sales at http://www.pmlive.com/top_pharma_list/global_revenues
iv Figure from Centers for Disease Control and Prevention (CDC). See: https://www.cdc.gov/vhf/ebola/outbreaks/2014-west-africa
v New Scientist, 07 May 2016, page 6.
vi Daily Telegraph, 11 June 2016.
vii See: http://www.bbc.co.uk/news/health-36549674
viii See: FiercePharma, 11 May 2016 at: http://www.fiercepharma.com/vaccines/oxford-spinoff-vaccitech-nets-ps10m-for-flu-cancer-vaccines
ix As well as synthetic biology they are: advanced materials, agri-science, big data, energy storage, regenerative medicine, robotics and satellites. The UK government report on the subject can be downloaded at: http://www.policyexchange.org.uk/images/publications/eight%20great%20technologies.pdf
x *See:* http://www.synbicite.com/news-events/synbicite-blog/ietsynbicite-joint-workshop-and-conference-enginee
xi On 17 June 2016 NICE announced that *Orkambi* will not be funded for use in the NHS – provoking widespread criticism.
xii Huffington Post 19/02/2015: http://www.huffingtonpost.com/steve-blank/life-science-startups-ris_b_6713414.html
xiii See: http://www.upstartmagazine.co.uk/piece/londons-synthetic-biology-startups

BY ADRIAN KEMPTON-CUMBER

CHART NAVIGATOR

TAKE ME UP THE NORTH WEST PASSAGE

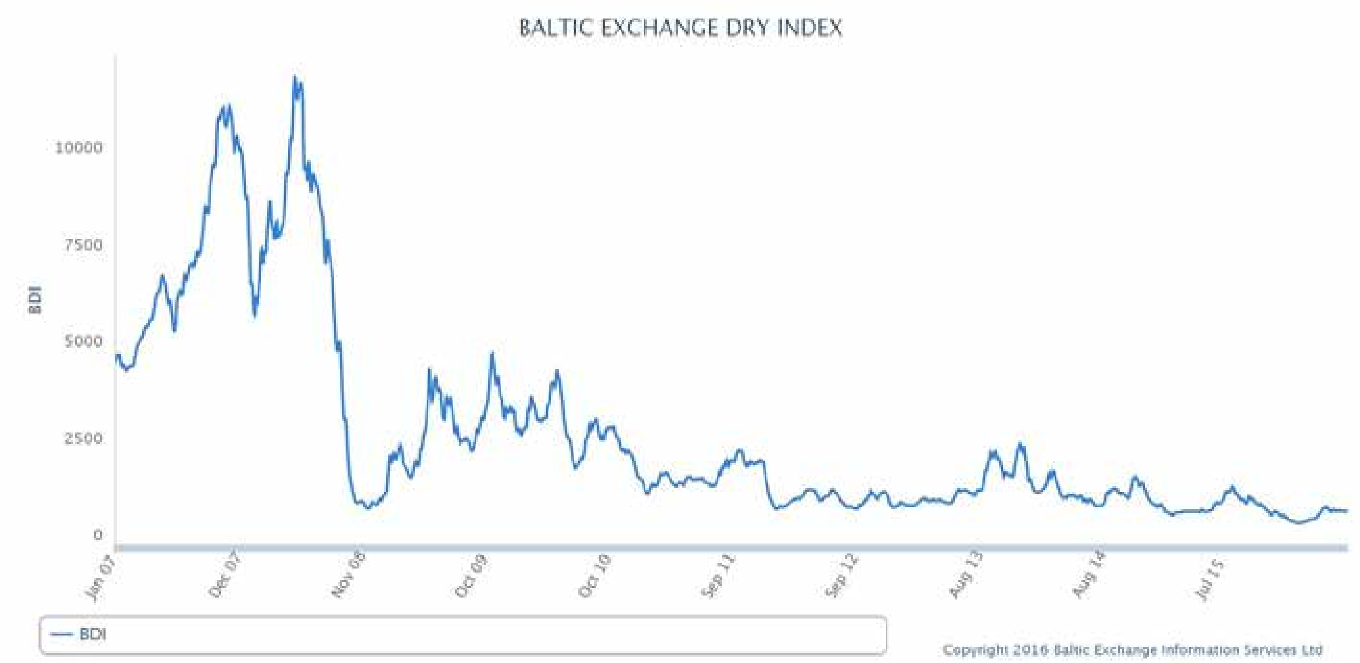
It's 100,000 years since the North Pole was ice free. The ice cap grows or shrinks on a daily basis, depending on the season, and you can watch it unfold if you want to at http://nsidc.org/arcticseaicenews, where they have a daily updated image of the extent of the ice. This year Ocean Physics Professor Peter Wadhams (Cambridge) has predicted that it will be ice free this year by extrapolating data from the National Snow and Ice Data Center. It's sort of snow and ice Technical Analysis. He's short ice. There is a vast amount of data on the site and lots of images like the one here which shows the extent of the sea ice on 21st June '16.

Daily Sea Ice Extent for: Jun 21, 2016

"THIS WOULD CHANGE THE GLOBAL BALANCE OF POWER ON A LEVEL AKIN TO PHYSICALLY MOVING COUNTRIES AROUND THE WORLD."

We'll know in mid-September if he was right, as that's the time when the ice recedes the most. And even if he's not this time around it is surely only a matter of time before it is ice free in summer. This would change the global balance of power on a level akin to physically moving countries around the world. The countries with North facing coasts in the Arctic are broadly winners: Denmark, Norway, Russia, Canada and the US. With this becoming a reality I wonder just how long Denmark will stay in the EU. They'll be as rich as Norway thanks to oil and shipping from Greenland, plus the fact that Greenland, the world's largest island – and, if it were a sovereign state, the 12th largest country in the world – would presumably become more habitable. Add to that Iceland's President Grimsson has invited the post-EU UK to participate in a 'North Atlantic Super Triangle' trading bloc, involving Norway and, critically to this story, Greenland. We could be in on the ground floor here

The first thing that would happen is that some shipping could avoid Panama and Suez and simply flit across the top of the globe. So goods could be delivered more quickly, and as the window of opportunity would be short then demand for vessels in that region would rise sharply. The Baltic Dry Index shows the change over time in the cost of shipping raw materials by sea. The index is relatively low at the moment compared to the last few years as you can see on this five year chart, which The Baltic Exchange has kindly allowed us to reproduce. The basic formula is that if the index is rising it means global economic conditions are good, and vice versa. So with a lot of sudden demand for shipping across the pole,



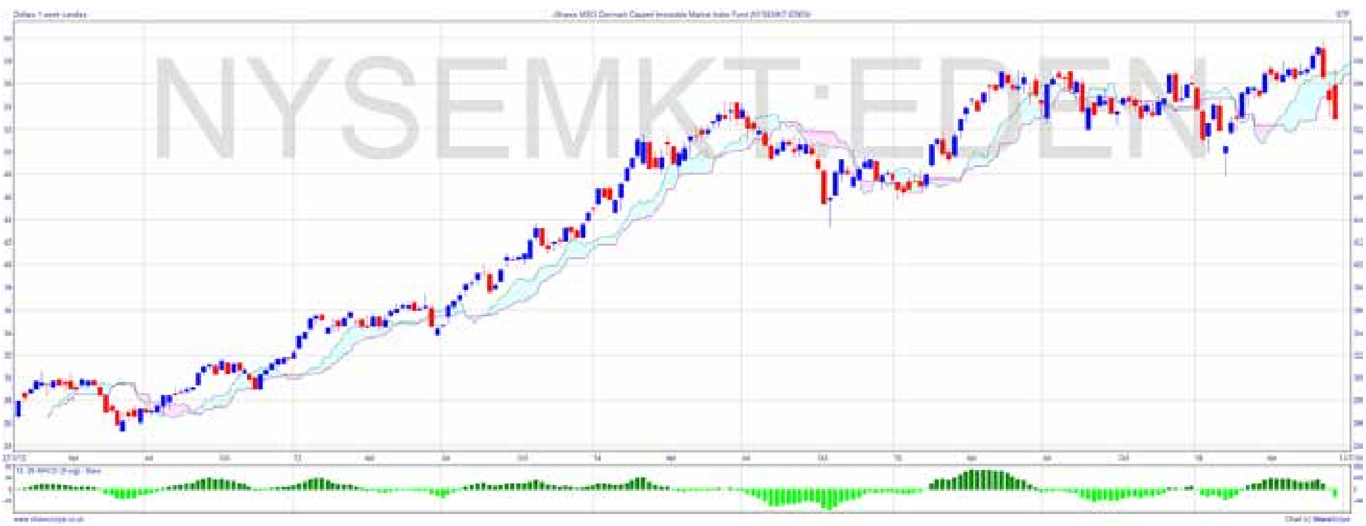
"AS PORTS – AND THE TOWNS AROUND THEM – START TO BE BUILT, THIS COULD REVIVE THE GLOBAL ECONOMY AS INFRASTRUCTURE IS PUT IN PLACE TO HANDLE THE NEW TRADE ROUTES."

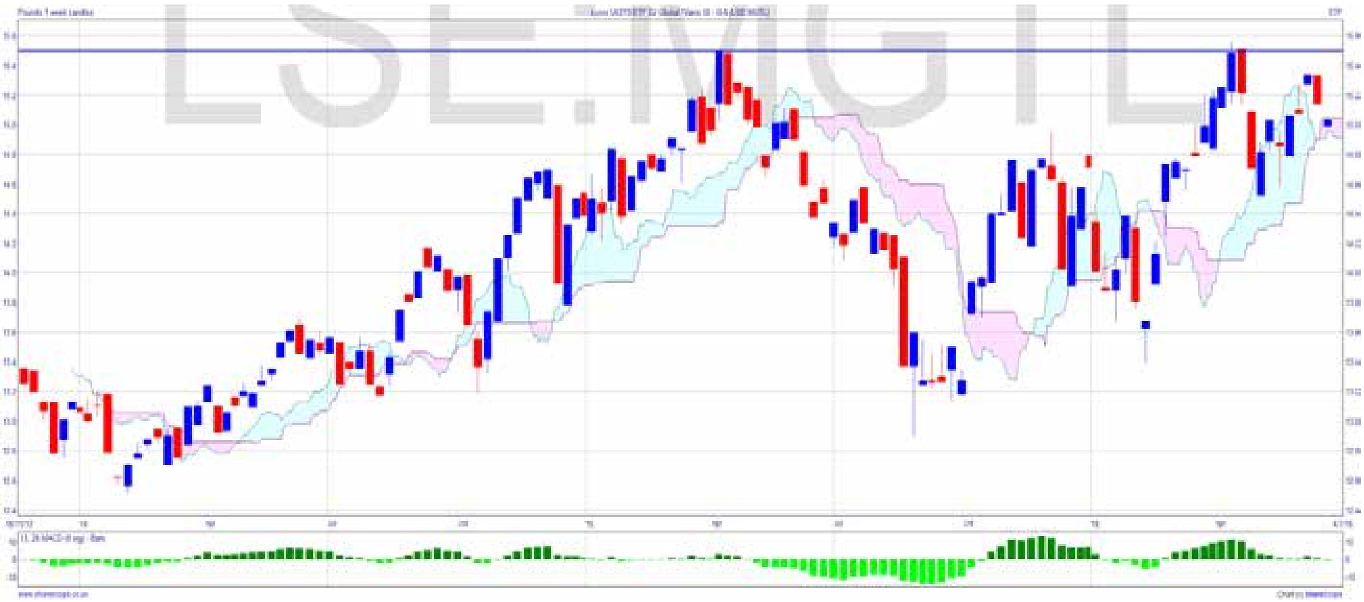
it's reasonable to assume it would rise. In the long run Panama and Suez would lose out to a fair amount of shipping as the polar route would be shorter, albeit only in the summer months. It would also be a little unpredictable, at least in the early years. But if the ice isn't thick then some ice breakers could keep shipping lanes open for regular vessels.

One of the main results would be access to the oil up there. Denmark has to be a good bet then as they would essentially become another Norway: a hugely rich oil nation with a small population. A pre-emptive investment through an ETF could be a SIPP/ISA play. There only seems to be one ETF available and it's dollar-denominated (there are a few Nordic alternatives but they won't allow you to isolate the risk to Denmark). It's called **iShares MSCI Denmark Capped Investable Market Index Fund [NYSE MKT:EDEN]**. It's been doing rather well and we could be seeing a measured move setting up here over the last two years. So there is a case to argue that's an entry point. Of course it could more or less go sideways for another two years, but it's certainly been much more resilient than the FTSE 100 over the last couple of years.

For the measured move I'm saying that the \$48 to \$58 range is a congestion area and so we might expect it to break upwards and match the move into the range – i.e. \$48-\$26. Let's call it \$20, a 30%+ potential upside. It would certainly change the global balance of power in oil if Norway and Denmark suddenly have huge reserves much closer to the developed world.

Contrastingly, a short on Egypt could be a good move too. I wrote about Egypt when I was examining the effect of the Bataclan attacks in Paris and the beach attacks in Egypt. Since then a plane has disappeared. The shooting in January was not the first such attack on tourists there. The Foreign & Commonwealth Office (FCO) advises against travelling to what looks like every tourist attraction in Egypt from Sharm el Sheikh to the Valley of the Kings. The only Egypt ETF, again a dollar-denominated New York listing, is **VanEck Vectors ETF Trust Egypt Index ETF [NYSE MKT:EGPT]**. The chart is looking weak again with a drop right





across the cloud and a failure to rally above $40. The military conflicts in the region won't be helping either. I guess everyone's gone to Iceland instead. Egypt relies heavily on tourism and that's been effectively scuppered.

Lots of sectors will benefit. Marine insurance, shipping and all raw and manufactured goods that are shipped this way since lead times will perhaps even be halved. Then as ports – and the towns around them – start to be built, this could revive the global economy as infrastructure is put in place to handle the new trade routes. In fact I'd go as far as to say this is the best thing that could happen to the world economically speaking. Economic growth is never better than the early stages of building infrastructure. So we could be looking at a generation of growth. Perhaps the long play is a global index ETF. This one's listed in London: **Lyxor UCITS ETF DJ Global Titans 50 D-£ [LSE:MGTL]**. There's not a lot to say about this chart and the strategy is a very long-term one. But in terms of entry a higher low could be an early entry to anticipate a break out above the resistance at around £15.50. It really is a very long-term play though and probably one for the SIPP.

Aside from the global index ETF there are all manner of global ETFs for everything from Water to Clean Energy and every sector you can imagine, so target whatever sector you wish. Controlling risk into very specific areas is a reality nowadays.

As a long-term framework for investment strategy this is a very broad-based set of long-term opportunities with a scaffold for shorter-term moves. So either the polar ice cap melts in summer soon or we have another world war. Global warming may yet do us some good.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BY ROBBIE BURNS

ROBBIE BURNS' TRADING DIARY

A BIG EGO IS A BIG PROBLEM

There are a lot of reasons people fail to become Master Investors. The usual suspects are fear and greed. But there is something that isn't discussed much – ego.

If you're one of the (probably) few women reading this (most traders are men), then pat yourself on the back – women suffer a lot less from this. A big ego is a major problem for traders and it stops them in particular from selling losers.

Selling a loser is very bad for the ego and many just can't cut losses.

It's all fine and dandy to have an ego in other aspects of life. After all, most of the people who get to the top positions in their field have big egos. That drives them to succeed. But it's not much good in trading. That big ego stops you from taking losses. Makes you trade too much. Makes you do all sorts of silly things.

Here's a trader I met who had been brought low by his ego. (Except for his self-esteem, which was still flying as high.)

Harry came to a seminar of mine. Short of ripping off his shirt and zip-lining into his chair from a helicopter hovering outside the seminar room, he did everything possible to convey his status as an 'alpha male'.

He actually asked a lot of questions but it soon became clear he wasn't listening to much that I was talking about.

Hunched over an alpha male laptop, he was probably 'trading' while I was talking. He was, frankly, Mr Ego.

> **"SELLING A LOSER IS VERY BAD FOR THE EGO AND MANY JUST CAN'T CUT LOSSES."**

Everyone could tell he felt himself superior to the rest of the room – and superior to me – and I was supposed to be the teacher! He was just there to confirm what he was doing was right (and what I was doing was wrong).

The funny thing was, he was convinced he was right on everything... but he had lost a lot of money.

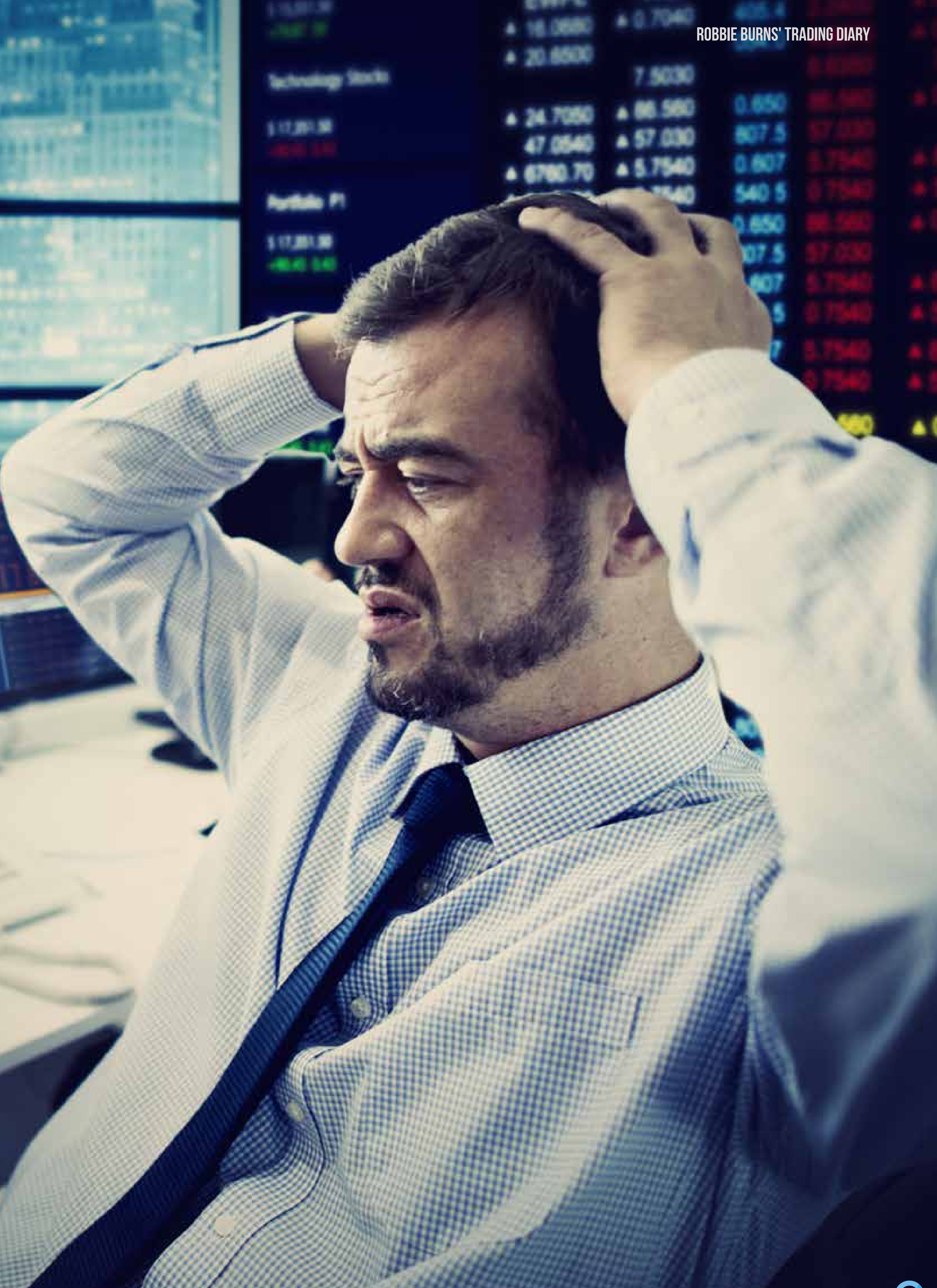
It was no surprise. I talked about a company on the day and why I thought I might buy it. I discussed my research.

Harry piped up to say my research was wrong, as were my figures. I gently pointed out that my figures were right, taken directly from the company's report.

He had got his from a website that hadn't updated to the latest figures. That's because he hadn't listened to the bit where I explained where to get the figures from.

If you let your ego sabotage your trading, like Harry did, don't be surprised when you run into problems. If he can't remove that emotion from his trading he hasn't got a chance of succeeding in the stock market.

Our ego is bound with up our pride and "achieving pride" is one of the



"intangible motives" that psychologist Daniel Kahneman of Princeton University says really drives financial decision making rather than money.

I don't want a desire to feel proud to affect my trading so I try not to brag to anyone when I have made a lot. But I have done it to the wife – and what's funny is I know when I am doing it. It's an alarm bell – every time I have bragged, it was time to bank profits.

If you are to become a Master Investor the ego has to go. If you have got one, it won't be easy. Self-awareness doesn't come readily to someone with an ego.

I know, I know: "Who the hell is this Robbie Burns to tell me I have an ego? Where does he get off suggesting I might be blind to my weaknesses?

I could crush his head in one of my hands while putting on a successful Forex day-trade with my other and that's not even mentioning where I'd put my knee."

Also, maybe, just maybe, you have an ego.

Seriously, if something or someone is telling you that you might just have an ego... try and consider that possibility. I have an ego. I don't deny it.

But when it comes to trading I ensure that it doesn't surface. I look at cold hard facts and if I get something wrong I admit it right away and cut the position.

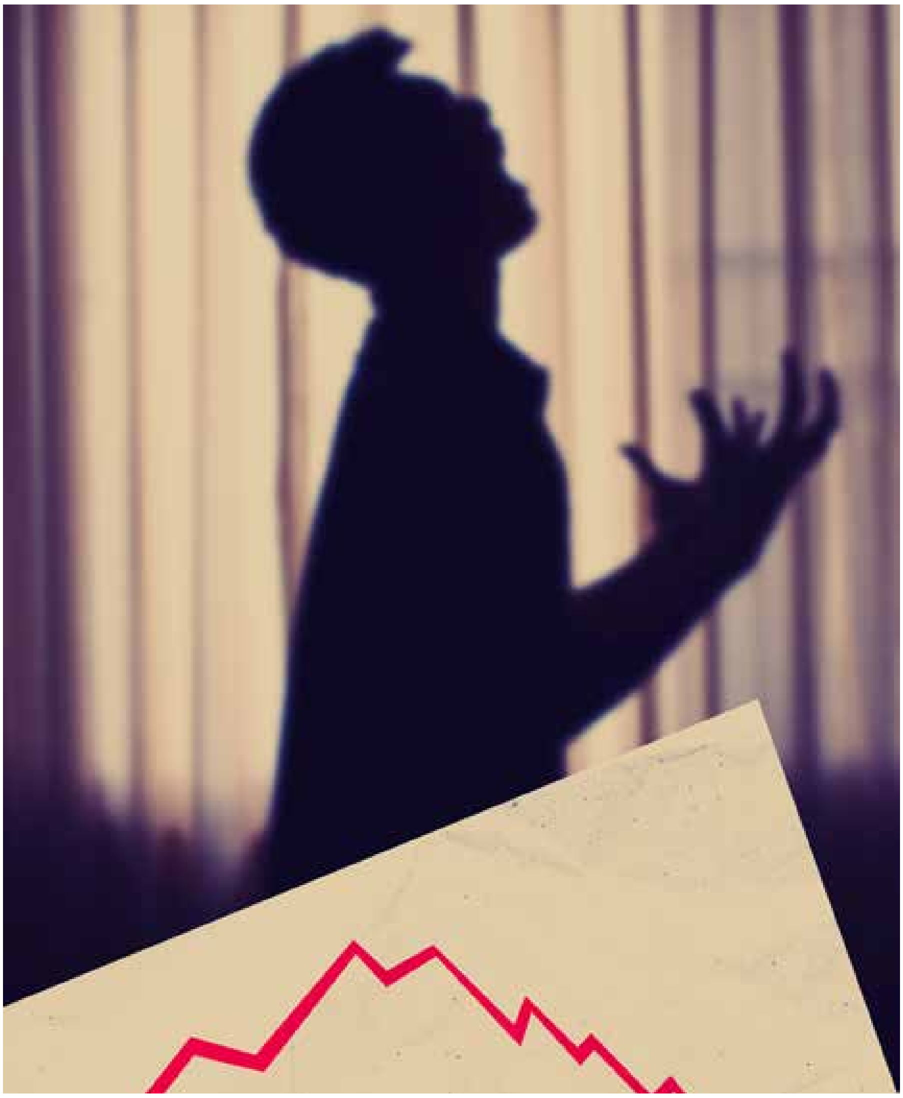
Take a good hard look at yourself: do you think trading rules are for other people?

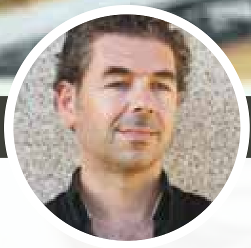
Or you're simply a cut above others intellectually? Other people are a bit dim and you're the shining star? Nothing can go wrong for you?

Cut the ego to make money. How to cut it is the hard bit. Perhaps try to become more self-aware. Realise when you made a mistake. Don't worry about cutting a loss: it isn't a mistake. It's a mistake to keep the share that's going down.

Consider sometimes you will get things wrong, you really are only human.

"TAKE A GOOD HARD LOOK AT YOURSELF: DO YOU THINK TRADING RULES ARE FOR OTHER PEOPLE?"





BY FILIPE R. COSTA

THE MACRO INVESTOR

THE DEATH OF BONDS

Unlimited Intervention

"The Federal Reserve Bank buys government bonds without one penny..."

– Congressman Wright Patman, Congressional Record, Sept 30, 1941

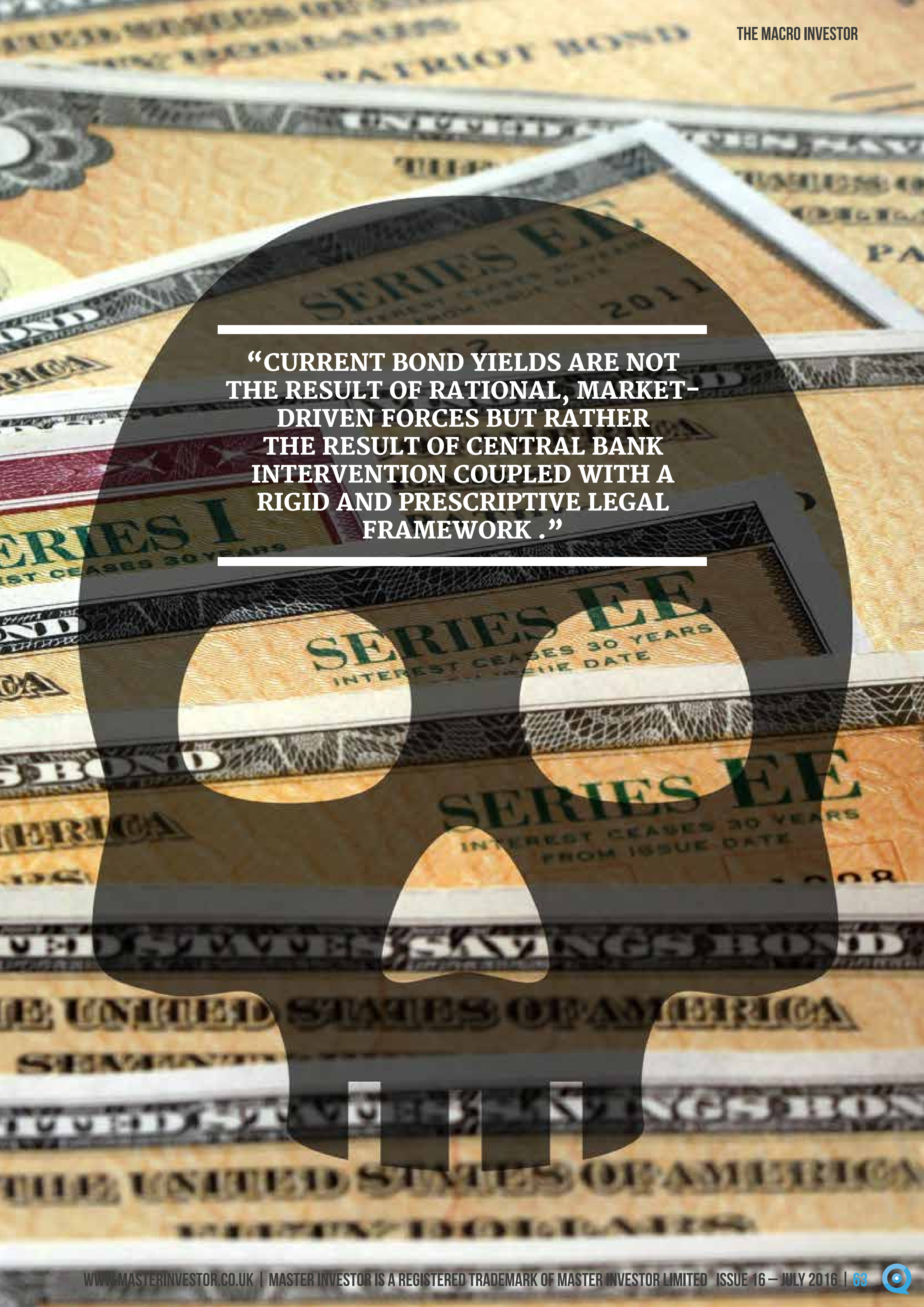
Over the last few years, investors have been trying to front run central banks by purchasing bonds, in anticipation of huge price increases as the result of the heavy demand that stems from central banks as they unfold large-scale asset purchase programmes to boost inflation levels. It all started in the US, where Ben Bernanke spent trillions of dollars purchasing government bonds and mortgage-backed securities in an attempt to reduce bond yields and thereby spur businesses and individuals to borrow, invest and spend more. But as the global economy is more interconnected than ever before, the same policy was followed the world over, which pushed global yields down and bond prices up. Even Japan, which was already running a decades-long expansionary policy, decided to become even bolder in its action.

Those who purchased European bonds ahead of the ECB over the last few years have certainly experienced massive capital gains, as yields have been pushed down by the intervention of the central bank. But at a point when yields are under water for maturities up to 10 years, there is a growing concern that we may be reaching the lower bound. We know there is a point at which people would prefer to keep the money under the mattress – we don't know exactly where that point lies, but we do know we're approaching it.

Central banks have taken centre stage over the last eight years and have exceeded governments in terms of market intervention. Current bond yields are not the result of rational, market-driven forces but rather the result of central bank intervention coupled with a rigid and prescriptive legal framework that forces some institutions to purchase assets at irrational prices. Purchasing bonds at these irrational prices is certainly not the best option, but while bonds are way overvalued, the current price level hardly represents a short selling opportunity. This irrational exuberance is not going to end soon, as inflation is still dormant, and central banks will push harder for it by increasing their current rescue programmes and using new tools. In my view, investors looking for safe havens should skip bonds at this point, while those looking for a shorting opportunity should be wary given the prospects of further interest rate cuts and asset purchase programmes.

Three Groups of Bond Investors

There are three main groups of bond investors: legally-constrained institutional investors, speculators, and risk-averse investors. The interaction between them helps explain



"CURRENT BOND YIELDS ARE NOT THE RESULT OF RATIONAL, MARKET-DRIVEN FORCES BUT RATHER THE RESULT OF CENTRAL BANK INTERVENTION COUPLED WITH A RIGID AND PRESCRIPTIVE LEGAL FRAMEWORK ."

why yields may remain at irrational levels for a long period of time and identify the boundaries for price action.

As the name suggests, legally-constrained institutional investors are large institutions that, one way or another, need to purchase safe assets due to legal constraints or statutory imposition. In general, these institutional investors only purchase the safer assets, usually government bonds and highly rated corporate bonds. Central banks, for example, hold government bonds as foreign reserves, without any care for yields or prices. The central bank of Saudi Arabia is one of the top purchasers of US Treasury Bonds, as it needs these assets to maintain the peg of the riyal to the dollar. Because the main objective is not to make a return on bond holdings, a central bank is usually insensitive to bond prices (or yields). Central banks also keep bonds on their books as the result of their open market operations. The ECB requires banks to pledge collateral to lend them money. This collateral is often composed of government bonds. Additionally, central banks sometimes purchase large quantities of government and corporate bonds, which they keep on their balance sheets until maturity. Again, the central bank is relatively insensitive to prices (and yields), as its demand is not driven by market forces.

But the central bank isn't the only institutional investor demanding bonds for legal or statutory reasons. As I mentioned above, banks need bonds to pledge as collateral for the loans they take from the central bank (and from the money market). They are also required by BASEL rules to carry safe bonds on their balance sheets. Insurance companies and pension funds also purchase safe bonds in order to match their liabilities. No matter how irrational the price of a bond is, these institutions have no other option than to purchase the 'safer' assets.

The second group of bond investors is composed of those who purchase bonds because they think there will be a greater fool purchasing from them at a later date and at an even higher price. Rationally, there is no reason to purchase a bond at a negative yield, because you are paying for the privilege of lending. By keeping the money under the mattress you get a higher return. But because of group one, group two may opt to purchase the irrationally priced bonds, as there is a greater fool that will purchase the bonds from them at an even higher price. This group just attempts to front-run central banks.

The third group is made up of anxious, risk-averse investors, who tend to purchase only the safest assets. Most government bonds are seen as safe assets in the sense that credit events are unlikely. People often ignore inflation and taxes and end up demanding assets that seem safe because all cash

"NO MATTER HOW IRRATIONAL THE PRICE OF A BOND IS, THESE INSTITUTIONS HAVE NO OTHER OPTION THAN TO PURCHASE THE 'SAFER' ASSETS."

flows are usually paid by the issuer, but which lose purchasing power over time due to the low yields not covering inflation and taxes. The existence of group three is one of the reasons why central banks have been failing to deliver on inflation levels.

No matter how low yields are, there will always be a group of investors that only wish to hold cash and government bonds. That being true, lower yields just prompt this group to increase its savings rate as it desperately attempts to maintain its future level of savings.

Massive Losses on the Horizon

The above reasoning helps us to understand why there is a bubble in the bond market and why it won't burst right now. Long-term investors saving for a pension should keep their money away from this market, but it may not be the best time to short bonds, because central banks won't stop before boosting inflation to at least 2%, meaning that, in the short term, we may see bond yields become more deeply negative. With the US delaying the next hike and revising the path of hikes to be softer than previously anticipated, I expect Europe and Japan to further expand their asset purchases and eventually cut interest rates. With so many bazookas trying to hit the target, sooner or later, inflation may just end up rising. If that happens, bond investors would experience significant losses.

Concerned with the decreasing returns they're getting from fixed income, many investors are turning to longer-maturity bonds. The demand for longer-maturity government bonds is increasing and some governments are now issuing 30-year, 50-year and even 100-year bonds. The longer the maturity, the higher the yield offered. But investors should realise that the higher yield is a compensation for the higher risk incurred. The loss that can derive from a small change in interest rates increases with distance to maturity. Longer-dated bonds are exposed to a significant interest rate risk. At a point in time when yields are at their lowest ever, investors should avoid investing in these longer-maturity bonds as a way of recovering the lost yield because they will most likely end up losing purchasing power over time.

Table 1 - Impact of a Change in Yields on Bond Prices

	10-Year	20-Year	50-Year
Current Yield	0.422%	1.034%	1.586%
Coupon Rate	2.0%	2.0%	2.0%
Coupon Payment	Semi-Annual	Semi-Annual	Semi-Annual
Face Value	€ 1,000.00	€ 1,000.00	€ 1,000.00
Current Price	**1077.99**	**1091.55**	**1085.17**
Scenario 1: After 5 Years, Bond Yields Increase by 1%			
New Yield	1.422%	2.034%	2.586%
New Price	1014.15	997.65	900.51
Price Change	**-5.92%**	**-8.60%**	**-17.02%**
Scenario 2: After 5 Years, Bond Yields Increase by 2%			
New Yield	2.422%	3.034%	3.586%
New Price	989.82	931.10	756.51
Price Change	**-8.18%**	**-14.70%**	**-30.29%**

Source: Own Calculations

Table 1 shows the impact of a rise in yields on bond prices. The base case considers three bonds, with different maturities, all paying coupons semi-annually at the rate of 2% per year. The yields are 0.422%, 1.034% and 1.586% for the 10-year, 20-year and 50-year bonds, respectively. These yields are approximately those currently on offer on French government debt.

An investor planning to keep the bond until the maturity date (or for a long period of time) is willing to accept, at the very least, a return that maintains purchasing power over time. If interest rates rise, the investor loses money, no matter whether he decides to keep the bonds or to sell them. If opting for the first option, he would keep the yield on the bond, while the market is offering something more. This opportunity cost is similar to a loss. If opting for the second, he would have to accept selling

"THE SHORTER-MATURITY BONDS OFFER RIDICULOUSLY LOW YIELDS BUT THE LONGER-MATURITY BONDS ARE HEAVILY EXPOSED TO INTEREST RATE RISK."

the bond at a discount. One way or another, a loss is incurred.

In the example depicted in Table 1, if after five years the yield rises by 1%, the price of the bond will decrease by 5.9%, 8.6%, or 17.0% depending on the bond maturity being 10-year, 20-year or 50-year respectively. If the increase in yields is 2%, the respective declines in price are 8.2%, 14.7% and 30.3%.

While this situation may appear unlikely, allow me to point out here that the main goal of the ECB (as well as for most central banks around the world) is to keep the inflation rate around 2%. The central bank will do anything to boost inflation to that level. While it may fail to deliver on its intents over a period of 2-3 years, it is more likely to achieve it over a longer period. The shorter-maturity bonds offer ridiculously low yields but the longer-maturity bonds are heavily exposed to interest rate risk. In the example depicted in Table 1, the 50-year bond suffers a loss of 30% when yields rise by 2% after five years. Even if the increase in yields occurs only after 10 years (not reported in the table), the loss would then be equal to 28.5%.

Because of the elevated risk that comes with longer-term bonds, I would avoid them, particularly at a point when central banks are playing in the opposite direction. While austerity has been the main fiscal policy driver for the last seven years, the situation may change in the near future if monetary policy continues to fail at delivering the expected results. We have already heard some central banks mention the concept of 'helicopter money' as a new tool and we will hear about boosting fiscal policy too. In my view, the risks of overshooting inflation targets are currently higher than the risks of a deflationary spiral.

There is an additional argument playing out against bonds. While bonds are usually said to be safer assets than equities because returns are less volatile, the real risk measure for a long-term investor isn't volatility of returns but rather the deviation of returns from the investor's objectives. Someone saving for a pension is looking to achieve a positive return after inflation and taxes are accounted for, after 20, 25 or 30 years. So, when evaluating the best distribution of funds between equities and fixed income, what an investor wants is to maximise the odds of hitting his target return. In this sense, the real risk of investing in bonds is the odds of equities outperforming them.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According to thorough research presented by David Dreman in his book "Contrarian Investment Strategies: The Psychological Edge", in the US market during the period 1946-2010 equities have on average significantly outperformed bonds and treasury bills over almost any time interval. For a one-year interval, for example, equities outperformed bonds 65% of the time. As the time interval is enlarged, the odds of equities beating bonds and treasury bills increase. In a 15-year interval or greater, stocks always beat bonds.

Final Remarks

The fixed income market has traditionally underperformed equities over almost any time interval. With bond yields currently at their lowest level ever and historical data greatly favouring equities over fixed income, it's hard to find any value from investing in fixed income at this point. Those needing to save for a pension would be better off investing in equities or real assets. At least that way they're protected from any surge in inflation.

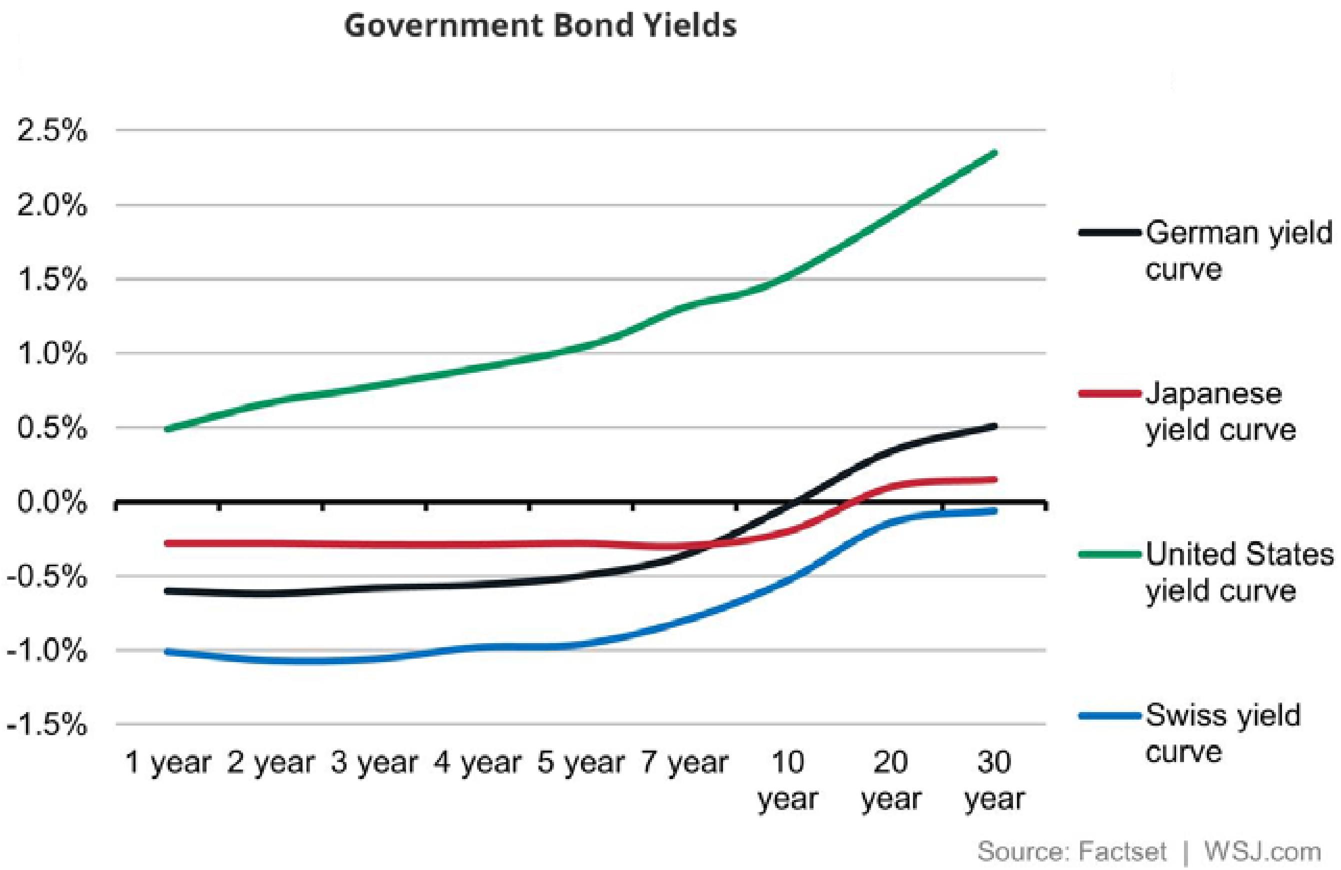
Although the world is now preoccupied with the deflation threat, average prices have historically drifted higher over time. With all major central banks around the world colluding to boost prices, investors should avoid relying on the assets that suffer the most with accelerating inflation. Nevertheless, I don't favour shorting bonds either, because I believe central banks will cut interest rates further and will continue to drive yields down in the short- to medium-term.

Compounded Returns After Inflation and Taxes

1946–2010

Holding Portfolio for…	Returns: Stocks	Returns: Bonds	Returns: T-Bills	Percent of Times Stocks Beat: Bonds	Percent of Times Stocks Beat: T-Bills
1 year	**4.4%**	−2.0%	−2.2%	65%	71%
2 years	**8.9%**	−4.0%	−4.4%	77%	77%
3 years	**13.7%**	−5.9%	−6.5%	78%	81%
4 years	**18.7%**	−7.8%	−8.6%	81%	82%
5 years	**23.8%**	−9.7%	−10.6%	80%	79%
10 years	**53.4%**	−18.5%	−20.2%	91%	88%
15 years	**90.0%**	−26.4%	−28.6%	100%	98%
20 years	**135.3%**	−33.5%	−36.2%	100%	100%
25 years	**191.4%**	−40.0%	−43.0%	100%	100%
30 years	**260.9%**	−45.8%	−49.1%	100%	100%

Source: © David Dreman, 2011. Data Source: Ibbotson® SBBI® Classic Yearbook 2011.



BY SAMUEL RAE

FORENSIC FOREX

WHERE NEXT FOR STERLING?

On June 23, the UK voted to leave the EU. After years of campaigning and debates that transcended party politics, the UK is setting out alone. What this means for all involved remains to be seen. There are a few short-term implications, however, that we can bring in to play from an operational trading perspective.

Those that have followed the Forensic Forex column here at Master Investor during the last few months will be well aware of how I use a combination of underlying fundamentals and naked price action to go at the markets. For those that haven't, however, here's a quick introduction. Essentially, I identify key levels on the daily charts in the major pairs – primarily the Aussie, cable and EUR/USD, but sometimes the USD/JPY and the GBP/JPY. As price approaches these levels, I look for a confirmatory signal (generally the closing of a candlestick above or below the levels in question, or even better, a pin bar in line with my directional bias. When these signals arrive, I enter towards a predetermined target (also dictated by key levels) and set my risk accordingly. I don't touch a trade once it has opened; I just let it play out to either a stop loss or a target hit.

That's the price action side of things. I use fundamentals to dictate my aggression. Specifically, I form a bias (bullish or bearish) for each currency, translate this to a pair, and enter towards a slightly more aggressive target if price breaks in line with my bias than I would if it was against my bias. This bias side of things is what I generally look at as part of Forensic Forex. The referendum has given us a chance to focus on sterling specifically, so here goes.

Let's start with the cable (GBP/USD). For me, as with the rest of the financial sphere, this one's a no brainer. In currency trading, and also from a wider market perspective, the US dollar is a risk off asset. That is, when shocks happen, and sentiment shifts to negative, capital will flow into the dollar as it provides a certain level of security over many other assets. Yes, its value decays through inflationary pressure, but near term (as is often the case with macro shocks) this decay is well worth bearing as a cost to offset risk.

So we've got a macro shock that translates to risk off sentiment and a flight to safe haven assets. That's the dollar side of the pair sorted – bullish. Concurrently, we've also got a genuine concern that the UK will lose its competitive edge in global markets, and this will lead to an exodus of many of the large institutions, financial and otherwise, that underpin the nation's economy. This concern

"I'M LOOKING TO BE AGGRESSIVE TO THE DOWNSIDE ONCE MORE IN THE CABLE FOR AS LONG AS THIS SENTIMENT HOLDS."

has translated to some serious sterling bearishness, and I'm more than happy to hop on the bandwagon. Price broke through a number of key levels post referendum, with entry points at 1.4, 1.38 and 1.36 offering nice quick turnaround positions, and I'm looking to be aggressive to the downside once more in the cable for as long as this sentiment holds. This doesn't mean I won't enter long (chances are we will see some bounces as speculative shorts unwind) but I will keep my targets tight on these counter trend trades.

"CHANCES ARE WE WILL SEE SOME COUNTER-TREND OPPORTUNITIES ON STANCE UNWINDING, BUT I EXPECT THE MAJORITY OF MY POSITIONS TO BE RIDING OUT STERLING WEAKNESS ACROSS THE NEXT QUARTER."

Moving on, let's look at the GBP/JPY. This one is equally simple, but for slightly different reasons. The Japanese economy has struggled for what seems like an eternity, but Shinzo Abe's policies are finally bearing fruit; and alongside some pretty aggressive trade stimulus activity, the nation is starting to see some growth. The ageing population (and in turn, the weight this puts on the government's social security bill) is still an issue, but pressure is easing. Over the last six months or so, this has translated to some strength in the Yen – strength that came despite the Japanese efforts to keep the currency weak (to stimulate export demand). This drifting strength has given me a semi-bullish bias in the Yen this year, with the strength of the corresponding currency generally providing an underscore for my directional aggression. In this instance, sterling is the corresponding currency, and there's little need to reiterate my stance on this one. A quick look at the daily chart reveals an almost identical response to the referendum in the GBP/JPY, and I am looking for entry points around 136 and 132 going forward.

All said, general markets are going to be looking in the same direction near term, and this gives us an opportunity to piggy back on sentiment. As mentioned, chances are we will see some counter-trend opportunities on stance unwinding, but I expect the majority of my positions to be riding out sterling weakness across the next quarter.

BY JOHN CORNFORD

THE SORRY TALE OF STANLEY GIBBONS

Into this Vale of Tears it is Flowers (we are told) that have been sent to soothe our troubled breasts, although we are not so often told that flowers soon wilt and die.

I was reminded of this when glimpsing another of those share spikes. Thought dead, up suddenly in late May flashed **Flying Brands (LON:FBDU)** to top the leaderboards three days in a row. It is a very small cash shell and only doubled from a £1 million market cap to £2 million. So no big deal – unless the one the market hopes for comes along.

I'm not interested in that, but I remembered that in the distant past I was the first analyst to write about Flying Flowers (as it then was) when it floated in 1993. I was enthusiastic because, based in VAT-free Jersey and selling by post standardised bunches to those too time-strapped to select flowers for their Mrs and Mums on high and holy days, it was a strong generator of cash – so much so that the shares rose from their début around 80p, to about 580p in 1998 where its market cap was around £150 million and pre-tax profits £5 million. Even the mighty Pru had a stake.

But then, when I had moved on to other things, came a profits warning. FF had by then splurged out all its cash – and more – into a motley collection of businesses, terming itself a 'multi-brand home shopping company', with a 'collectables' division comprising the jewel that it thought it had in its crown, stamp dealer Stanley Gibbons for whom it had paid £13.5 million in June that year.

Only to go immediately wrong the next year and requiring a £7.7 million write-down, which proved to be only the start. One splurge had been for garden centre and theme park Blooms of Bressingham, and another for garden tools supplier Clarke & Spiers – both having to be sold in 1999 at a £4.6 million loss, followed in 2000 by Bellbourne Flowers at another £3 million loss. On top of which, FF had spent £13 million on a call centre and on IT to integrate everything.

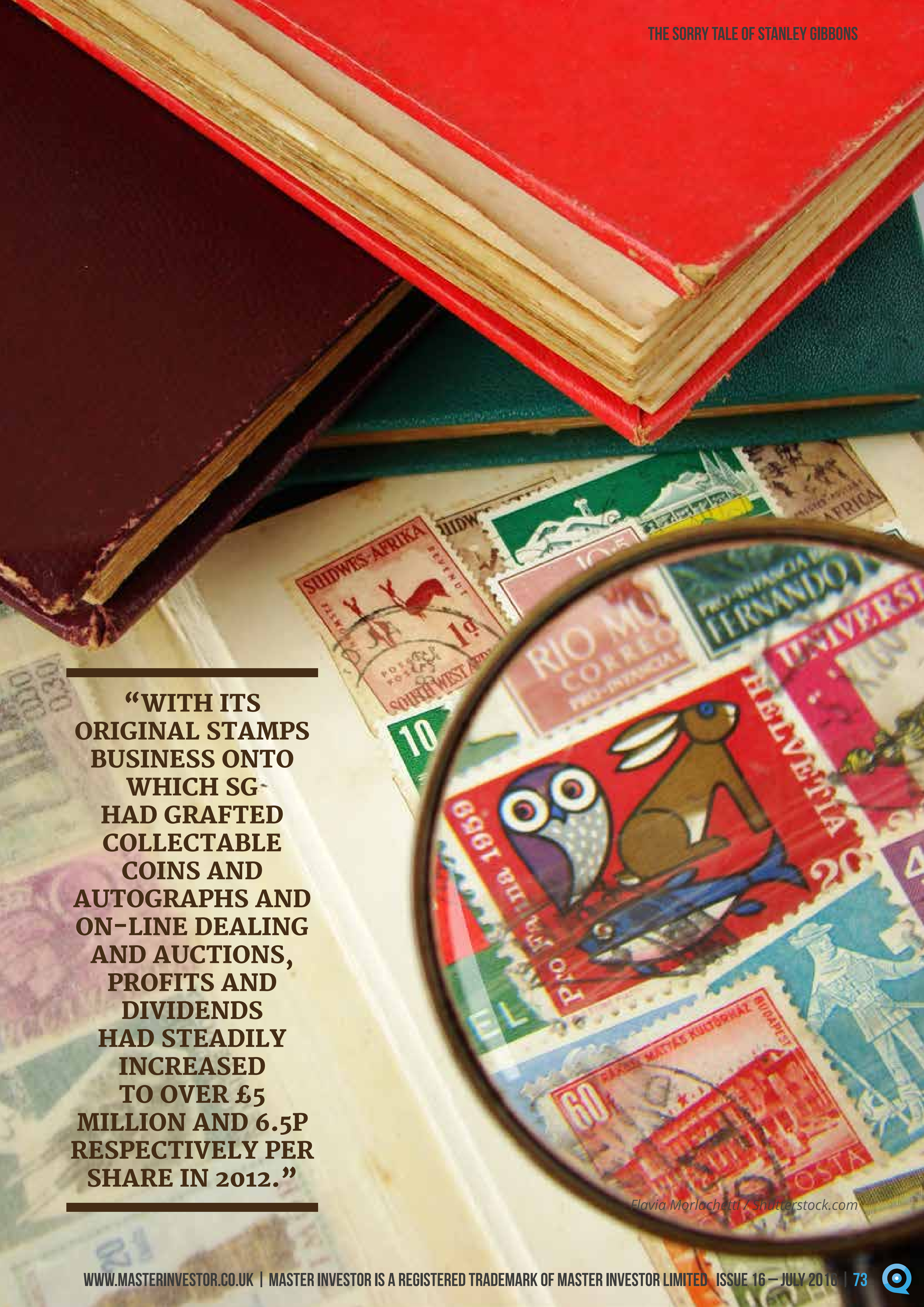
But losing and spending £28 million at a pop didn't deter the management. Recognising that it 'didn't fit in', **Stanley Gibbons (LON:SGI)** was de-merged in September 2000 as Communities.com (this was still the dot.com boom – it regained its Stanley Gibbons name in 2002) enabling the continuing and renamed Flying Brands to talk of the 'great opportunity' to take advantage of the changing retail environment and its "exciting prospects for e-commerce".

FF shareholders meanwhile had received one Communities.com (later Stanley Gibbons) share for every three in Flying Flowers, so off again they each flew – quite high for quite a time. Flying Brands flapped strongly for the next six years, having once again built a collection of 'gift' and gardening supplies around the old Flying Flowers core, seeing its shares rise from its 100p de-merger price to 300p in 2006. Until, again, some sort of curse struck.

This time FB had built on what it supposed was expertise in direct mail, customer databases, greetings cards, garden related activities like plug plants, birdseed and – oddly – music and film DVDs. But from then on, despite the usual management-speak ("many challenges but exciting plans for investment and development"), all sorts of 'one-off' problems surfaced so that, eventually, everything had to be sold in 2009 to pay off debt incurred to buy one particularly disastrous internet operation. Thus we have today's cash shell, which in 2013 had net assets of £1.7 million, against £19 million at FB's 2007 peak.

So much for Flying Brands. But Stanley Gibbons had meanwhile flown even higher and for longer, reaching 300p in 2008 against its 22p de-merger price and, after a sharp retrace to below 90p in January 2009, went on to a brief 350p peak in early 2014 when (unrecognised of course at the time) real problems were taken on board – to emerge only a year or so later.

Which was a pity, because with its original stamps business onto which



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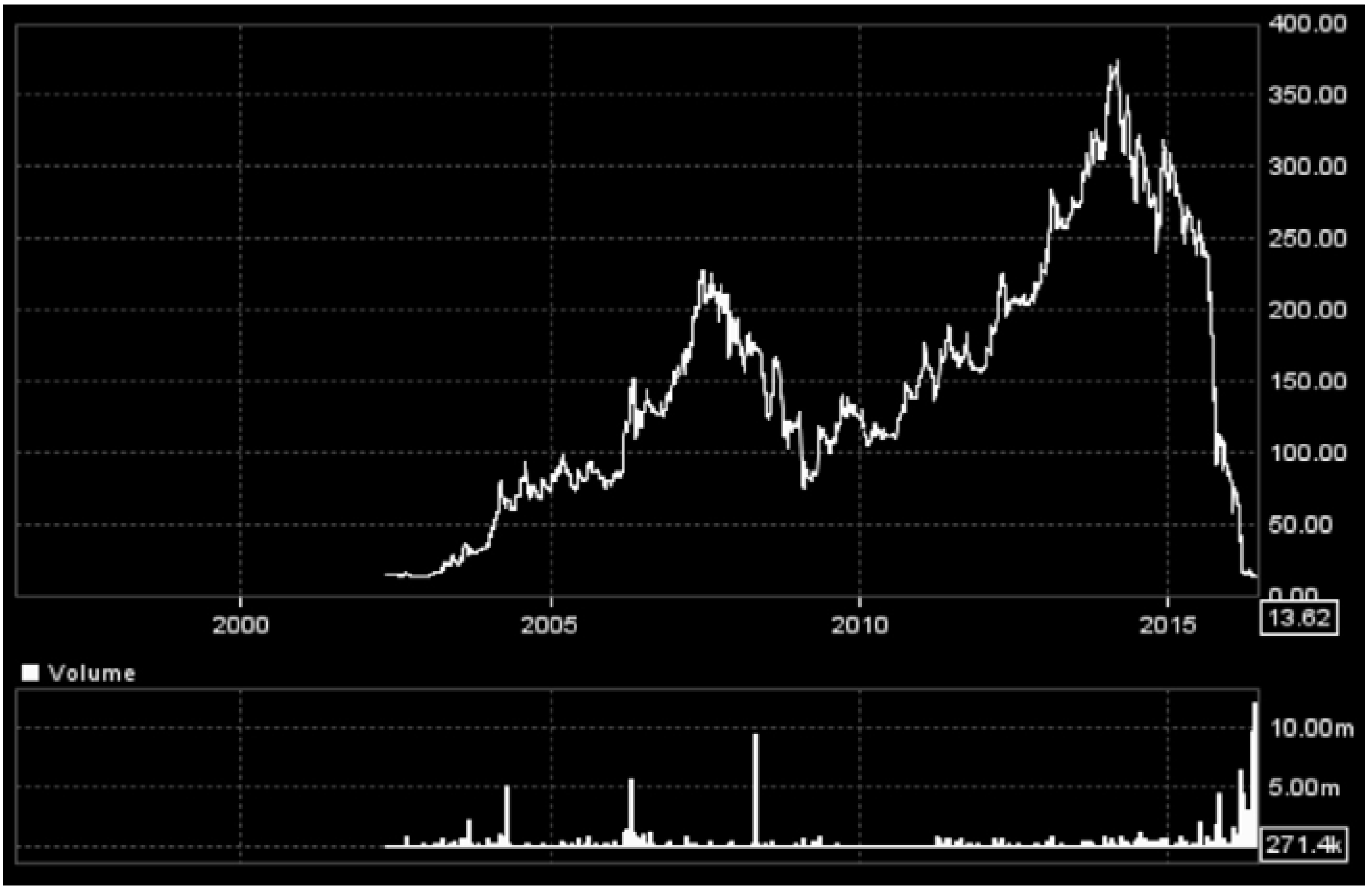
"WITH ITS ORIGINAL STAMPS BUSINESS ONTO WHICH SG HAD GRAFTED COLLECTABLE COINS AND AUTOGRAPHS AND ON-LINE DEALING AND AUCTIONS, PROFITS AND DIVIDENDS HAD STEADILY INCREASED TO OVER £5 MILLION AND 6.5P RESPECTIVELY PER SHARE IN 2012."



SG had grafted collectable coins and autographs and online dealing and auctions, profits and dividends had steadily increased (except for a brief setback in 2008 when the global crisis damaged collectors' spending) to over £5 million and 6.5p respectively per share in 2012.

If they managed to get out in 2006 and 2014 respectively, shareholders in each company would have done extremely well.

But the curse kept striking. What curse was that? Was it IT and web development? Or was it just 'ambition' and 'opportunity' exceeding ability to cope? Whatever it was, early in 2012 SG's chairman believed the company was "at the brink of realisation of the benefits of prior year efforts in building a strong base", so it was hardly surprising that in October 2012 £6 million was raised at 195p from shareholders to buy and develop US-based online stamps and collectibles trading platform BidStart, to "provide a base from which to leverage the Stanley Gibbons brand in the low value/high volume segment of the collectibles market".

And a year later followed a much larger £40 million cash raise (at 295p, increasing shares in issue by 60%) towards the £45.3 million (including £24 million goodwill) acquisition of Noble Group, with its market leading Baldwins rare coins dealership. Again, the chairman's rationale (in so many words) was "while continuing to grow the core stamp dealing and investment business, we want to move into new collectible verticals so as to migrate our business from dealer to intermediary through a focus on auctions – including the necessary digital platforms."

"THE COSTS OF INTEGRATION AND DIVERSION OF THE MANAGEMENT TO CHANGE THE GROUP FROM 'A BUSINESS BASED ON PHILATELY TO A BROADER BASED COLLECTIBLES GROUP WITH SIGNIFICANT ON-LINE DISTRIBUTION POTENTIAL' WERE PROVING TO BE ONEROUS."

By then SG was operating "an international sales and auction business focussed on a diversified range of collectibles with complementary brands in stamp dealing and auctioneering;

coin dealing; antiquarian books and art auctioneering; and dealing in autographs and memorabilia" which could "provide an excellent platform to grow market share across activities; to cross-sell its products into a wider pool of potential customers; and de-emphasise the importance of any one asset class."

And so, moving up into more rarefied markets, SG in November 2014, raised a £10 million bank loan towards the £9.5 million purchase of antique dealer and auctioneer Mallett & Co.

Only for it all to go horribly wrong. In November 2015, with the shares still over 100p, SG announced "the trading performance of the Group in the past twelve months has failed to achieve what were, in retrospect, premature and over-optimistic expectations from the investments of the past two years."

In fact the costs of integration and diversion of the management to change the group from "a business based on philately to a broader based collectibles group with significant online distribution potential" were proving to be onerous.

"The Group has continued to experience lower revenues throughout the business, with sales of rare collectibles to high net worth clients being at a lower level than expected and trading being particularly difficult in the interiors division. Additionally, the integration of recent acquisitions has still not achieved the level of cost savings that is required and there has been continued investment in the online platform. As a result of these factors, the Board now believes that for the year to 31 March 2016 the Group will report an adjusted loss before tax of between £1.0 million and £2.0 million."

"EXISTING ORDINARY SHAREHOLDERS NEVER COULD HAVE MAINTAINED THEIR FULL SHARE OF THE COMPANY."

On top of that it had run up borrowings of £19.3 million compared with an £8.7 million net cash position two years before.

Even then it seems the full scale of the disaster had still to sink in. In mid January when the shares were still above 60p (having fallen 25% in two weeks) the Board could still announce that while considering a fund-raise to reinforce its working capital and repay overdrafts, it would not be by way of equity because of the dilution it would cause for shareholders.

But, unfortunately, needs must when the devil drives. They had lost control. On 23 February when the shares were still above 50p the Board, having considered the various alternatives, was now "confident that an equity raise is the most expedient and efficient method by which to raise the capital necessary. Accordingly, the Group is in the process of raising approximately £10 million of new equity." Not surprisingly, its broker for those acquisitions, Peel Hunt, felt it necessary to step down in place of a new broker to raise the necessary funds.

But even then the message had still not quite sunk in, because the shares stayed above 40p for the next few weeks until, on 11 March, SG had to admit that the raise would be for £13 million at 10p per share. And the attempt to soothe existing shareholders by promising no dilution if they fully participated proved to be weasel words. To do so they would have to not only take up their 8 for 10 entitlement under an open offer but also (this was only made clear in the small print) they would have to take up another 140% in new placing shares – of which only 26% could be 'clawed back' to fulfil them.

So, existing ordinary shareholders never could have maintained their full share of the company. And even if they could, for every share for which they had already paid (anything historically between 40 and 350p) they would have had to stump up another 29p to keep it.

Was that worth it? Will SG be able to get back onto a track to justify that effectively 29p they needed to pay, or is it all really the mess that the current 13p is implying?

The company has been promising to repair the damage, taking onto its Board Clive Whiley of Evolution Capital to conduct a root and branch review and to recommend whatever measures, disposals, or new funding options might be appropriate.

And SG's old, key institutional shareholders Henderson and Fidelity have been happy to stump up enough to keep their respective 29.5% and 10% stakes.

So maybe they know better than the rest of us that something worthwhile will remain. The brands that SG has been getting together even if mangled must, surely, still be worth a good deal (a bit like Hornby, and not much bigger). But how much damage might have been done – quite apart from the deterioration in Mallett's and parts of the high value stamp and other collectables markets that the company has admitted to?

Unfortunately, because shares in issue now are seven times greater than when last the old core of Stanley Gibbons stamps was making its peak profits in 2012 before the acquisitions splurge, investors can forget completely that 350p share price peak. Then, SG was valued on a near 20x PER and 3x net assets, so that, even back on that old track, with no other disposal losses or costs meanwhile, and on the same rating, the price on the expanded shares would be no more than 50p – which at a more appropriate 1/3 the 2012 rating produces the current share price.

Apart from that guide I don't think any analyst could assess what value there might really be left. Much delving into the obscure and erratic world market for esoteric, collectables, antiques, coins, stamps, furniture etc. and their equally obscure high net worth customers, would be needed.

But who knows? In the depths, the curse of Communities.com – SG's original dot-com trendy name, in the dot-com year of infamy – might be obscuring some treasure to restore a bit to shareholders. After all, the market cap now is only around half the price SG paid just over two years ago for Noble Group's mainly coin dealing business (except that 60% was goodwill, which might or might not have to be written off).

So could there be some sort of happy ending? The management's expansion and web hubris has done a lot of damage for the existing long-term shareholders, because on 177.1 million shares now, compared with 25.3 million before that first foray into BidStart in late 2012, whatever is rescued will be worth only 14% of the share price it would have merited then.

So the answer seems to be *"not likely"*. But some lessons might be valuable:

1) Beware the power of 'web integration' to disintegrate what it touches.

2) Always read the Chairman's reviews for every (not just the latest) year, and compare with the outcome.

3) Note that 'Caveat Emptor' doesn't seem a concept familiar to management promising the 'synergies and growth' that their ambitions have put their way. They might promise 'growth', but it often turns out to be in their salary and issued shares. Much less often is it in the share price.

4) Cross-check the board and management names revolving through these various company doors over the last 20 years!

"SG'S OLD, KEY INSTITUTIONAL SHAREHOLDERS HENDERSON AND FIDELITY HAVE BEEN HAPPY TO STUMP UP ENOUGH TO KEEP THEIR RESPECTIVE 29.5% AND 10% STAKES."

BY CAROLINE DREWETT

MILLENNIALS & MONEY

CROWD FUNDING IS IT WORTH THE EFFORT?

"IN 2016, THE CROWDFUNDING INDUSTRY IS ON TRACK TO ACCOUNT FOR MORE FUNDING THAN VENTURE CAPITAL."

Business is on the move. There's no doubt about it. From hotdesking, to the Social Stock Exchange, to increasing social awareness and accountability, the future of entrepreneurial business for Millennials seemingly lies in business driven by communal social initiatives. With collaboration on the web providing an opportunity for exponential growth, starting a business has never been so exciting. No longer does it necessitate a one-man-band startup hidden behind a laptop with seemingly no way to make it out of your home office. Now, the power of the masses is at your fingertips, where collective ideas, resources and strategies can be readily tapped into by the budding entrepreneur.

There are, of course, still many challenges and big decisions to consider before starting out, but one of the fastest growing ways for startups to get a boost is crowdfunding. Everywhere you look, there are exciting crowdfunding opportunities for the well informed and the forward thinking. Crowdfunding was recently catapulted from relative obscurity into the mainstream when Facebook bought Oculus VR, a successfully crowdfunded tech product, for $2bn, which according to Zuckerberg 'is just the start' of a 3D visual platform revolution. So the successfully crowdfunded project can bare enormous fruit. According to Forbes, 2014 saw $16 billion crowdfunded, with that figure estimated to grow to over $34 billion in 2015. In 2016, the crowdfunding industry is on track to account for more funding than venture capital. So what exactly is crowfunding, and is it all as it's cracked up to be?

Crowdfunding is an innovative way to virtually collaborate on a project's funding or even purchase equity in a startup. It has great appeal to those inspired by the ingenuity of the startup community but frustrated by financial barriers. Crowdfunding can help early stage companies establish a network of investors while securing capital, whether it's through acting as matchmaker between startups and investors via a trading platform, or acting as an online community for peer-to-peer or social lending. Essentially, investors are able to discover, fund and support businesses that they believe in, and strong companies are able to seize an opportunity to grow, develop and succeed.

There are essentially three main types of crowdfunding: equity (giving part of the long-term value of a company), reward (incentivising funders with special rewards), and debt (donating to a business or project in exchange for a financial return and/or interest at a future date). The idea of crowdfunding is not new, with well-known sites such as Kickstarter in the US initially becoming popular by allowing individuals the opportunity to promote their project in exchange for rewards; but we are certainly in a new phase of this alternative finance movement as the power of the crowd – something that has great appeal to socially conscious and communally committed Millennials – takes on a new level. After all, it is the input of individuals in the crowd that triggers the crowdfunding process and influences the ultimate value of the offerings or outcomes of the process. From Colony88, a creative startup supporter in Hong Kong; to Crowdrise, a fundraising site for charitable causes; to Crowdcube, one of the stars of the UK scene: this new wave of funding ranges from individuals becoming shareholders contributing to the development and growth of the offering, to those playing a donor role oriented towards social projects.

For Millennials looking to engage in this entrepreneurial people power, there are clearly benefits. Crowdfunding offers businesses the chance to test the market and see how popular something is going to be before a large-scale operation is set up, and any glitches can be ironed out early on. Given that individuals act as agents, selecting and promoting the projects in which they believe, the process gives a great indication of the lie of the land and the market. There is an organic spontaneity throughout. As the ball gets moving, crowdfunding creates hype as social-media-proficient Millennials come on board and disseminate information about projects they support in their online communities, and so share the product even before it's launched. The pressures of getting traditional investors on board can be tough, and this often presents huge stresses and strategic conflicts. Here, you're not tied to one investor, or in fact any investors in the true sense. Crowdfunding is merely people buying your product on various different levels; and those who pay more receive more acknowledgment.

Gil C / Shutterstock.com

So crowdfunding undoubtedly presents startups with an interesting and creative option, but with so much out there, it's clearly also important to be mindful of a few things. Choose your crowdfunding site carefully and be sure to check out what fees are involved. It all depends on your product or 'offering'. In some cases traditional investors may suit your business best. They offer their expertise and advice to start-ups, who, in some cases, can be young, inexperienced and in need of guidance. These investors then have a vested interest in the company, so if it loses its way, they can assist and get it back on track, as they want to protect their investment. Crowdfunding doesn't offer any 'real' investment or risk from others – with many startups offering products as low as £5-10 for basic investment.

But cautions aside, it is difficult to ignore the pull of such a powerful communal economy. Large compa-

"CHOOSE YOUR CROWDFUNDING SITE CAREFULLY AND BE SURE TO CHECK OUT WHAT FEES ARE INVOLVED."

"WHAT'S APPEALING TO OUR GENERATION IS THAT CROWDFUNDING DOESN'T HAVE TO BE SOLELY ABOUT MAKING MONEY SIMPLY FOR PROFIT'S SAKE. IT CAN ALSO BE RAISED FOR ALTRUISTIC PURPOSES."

nies (even listed ones) are also using crowdfunding for smaller side projects as a means to test the market. Marvell's vice president Peter Hoddie raised a $52,000 campaign to attract 500 backers to test its new Kimona Create software and hardware tool kit. It speaks volumes if the everyday person is willing to pay $599 to a company which last year reported profits of $3.4 billion. Hoddie believes it to be much more valuable than a survey or focus group, and if people are willing to vote with their feet in such a positive way, it must signal accuracy in the product's future saleability.

Perhaps the most exciting aspect of crowdfunding, though, is that is has opened up the world of business and has changed the goal posts in the process. There is an array of exciting alternatives out there, and many crowdfunding websites are not targeting the likes of Marvell, but the individual start-up – the Millennial. For example, Peerbackers, is consistently recognised as one of the top crowdfunding websites in the industry, focusing on funding entrepreneurs and innovators; and Endurance Lending Network provides a platform that connects small businesses looking for up to $500,000 of debt capital. From businesses to the individual, there are options. Millennials struggling to get a foot in the housing market will be especially keen to hear about Fundrise. It's real estate, but not as we know it. For those who can't afford a property of their own, Fundrise offers a company in which anyone can buy shares in order to own part of a property. These 'shareholders' earn from both rent and capital gains, and it gives them the same opportunities that owning their own home would, but on a much smaller scale for those who can't afford to buy on their own. In a time when buying a property is becoming less and less attainable, this is an opportunity for everyone to get on the ladder, albeit by investing in one piece of the ladder at a time.

What's appealing to our generation is that crowdfunding doesn't have to be solely about making money simply for profit's sake. It can also be raised for altruistic purposes. DonorsChoose has raised $225 million for more than 400,000 classroom projects – from buying classroom dictionaries to funding field trips. The academic crowdfunding site Experiment assists in the much needed area of research funding. Here, scientists approve every project before they go live on the site, which allows researchers and scientists to propose their projects directly to the people who care about their field. Rather than gaining anything physical, campaigns share progress with donors as thanks for their monetary support. RocketHub too gained traction in the sciences with its annual SciFund Challenge, an online effort to fund science projects. On a similar level, Unbound provides an alternative to the frustrations of the publishing industry, where authors pitch an idea and potential readers pledge money to fund its writing. It is both a funding platform and a publisher; the site splits a book's net profit 50:50 with the author.

There are, of course, many out-of-the-ordinary crowdfunding opportunities worthy of consideration. With environmental factors never far from the thoughts of many Millennials, Spacehive is a funding platform for communal projects and public spaces. The site offers a list of projects, from new parks to playgrounds, towards which people can pledge money. Like Kickstarter and many others, money is only taken once the total funding target has been reached. And for all those Millennials with one eye on the future, Project Get Old is a programme led by Pfizer, in partnership with Indiegogo, based on the idea that age doesn't have to dictate health. Pfizer's goal is to showcase and garner support for as many projects as possible that improve quality of life as we age.

So crowdfunding, if maximised, can offer something for everyone. Whether you have a charity project or a business idea, crowdfunding can be used to help turn your entrepreneurialism into reality. Crowdfunding, or collaborative funding via the web, is one of the standouts for growth in our evolving collaborative economy. Its potential for exponential growth is exciting, but so too is the communal power of the crowd. Crowdfunding provides an opportunity to be part of a great idea, and as the tag line of crowdfunder.co.uk highlights, 'Behind every project is a great story'. It is this personal touch, this social awareness, this engagement with the community that drives so many new ideas from Millennials. In crowdfunding, there is the potential for all this and more.

JUNE 2016

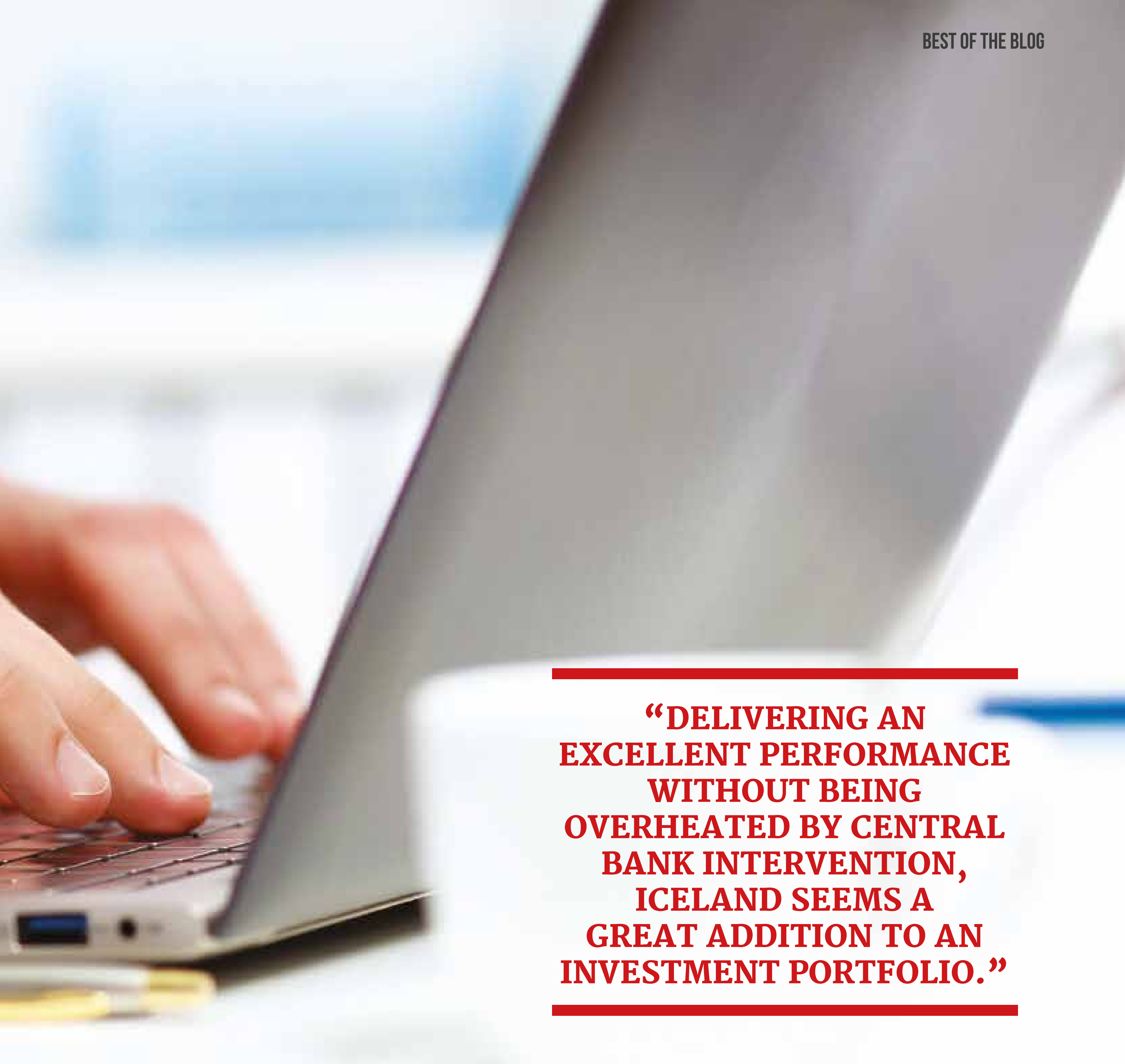
BEST OF THE BLOG

Why Iceland is Making a Mockery of the Eurozone

The financial crisis of 2007-2009 should be renamed the financial crisis of 2007-(?) when it comes to the Eurozone. Eight years after the peak of the crisis, the region is still drowning in debt, plagued by deflation, hobbled by a weak banking sector (headed by a big, fat central bank), and submerged in weak economic growth. While the Eurozone implodes, there is a small northern country, heavily criticised for its unorthodox way of dealing with a bankrupt banking sector, which seems to have overcome its crisis in just two years and is now flying high.

While many in the UK and the Netherlands have good reason to distrust and complain against Iceland due to the Icesave case, the truth is that the country is a case study from which the Eurozone and the IMF should learn in order to avoid future mistakes when dealing with financial crises. Delivering an excellent performance without being overheated by central bank intervention, Iceland seems a great addition to an investment portfolio. The main Iceland equity indexes have been performing well and still have huge potential for the next few years as this small economy recovers at a must faster rate than any other country in Europe.

When central banks from major economies are unconstrained in the



"DELIVERING AN EXCELLENT PERFORMANCE WITHOUT BEING OVERHEATED BY CENTRAL BANK INTERVENTION, ICELAND SEEMS A GREAT ADDITION TO AN INVESTMENT PORTFOLIO."

base money they are able to create, the best solution for smaller economies is not always to allow a free market to work. After all, quantitative easing and negative interest rates are certainly not the result of free market interactions, but rather of a planned distortion where central banks play a major role. When that happens, money flows tend to accelerate and increase in scale, inflating smaller economies all over the world until the point where it creates a financial crisis.

Unlike the rest of the world, when Iceland faced a bankrupt banking system, it decided the best way to deal with it would be to allow banks to go bust while jailing their executives. In the rest of Europe, policymakers adopted a different approach, as they preferred to pay huge benefits to the rotten bankers to get rid of them, while nationalising the debts they created. This of course solved the 2008 banking crisis, but at the expense of creating a bigger 2011 sovereign crisis, as peripheral Europe was by then unable to deal with the huge government imbalances created by the public bailouts.

By Filipe R. Costa

Click here to read the full article

The Pitfalls of Open-Ended Property Funds

Investors with long memories may have been spooked by the recent activity in the Investment Association's property sector. A number of fund providers, including Aberdeen, Henderson, M&G and Standard Life Investments, have switched from their normal offer price to the lower bid or mid price. This has reduced the value of these holdings by as much as 5% or 6%.

The affected funds have all been hit by a wave of client redemptions as investors look to exit their positions ahead of the EU referendum. A vote in favour of the Leave campaign on June 23rd-could have significant negative connotations for the sector and many people are uncomfortable leaving themselves exposed to the risk.

"PROPERTY FUNDS HAVE DELIVERED STRONG RETURNS IN RECENT YEARS AND EVEN OVER THE LAST 12 MONTHS THEY HAVE PRODUCED AN AVERAGE GAIN OF 6.4%, WHICH MAKES IT ONE OF THE BEST PERFORMING SECTORS OF THE MARKET."

Property funds have delivered strong returns in recent years and even over the last 12 months they have produced an average gain of 6.4%, which makes it one of the best performing sectors of the market. The problem is that the slowdown in the economy and risk of Brexit have prompted significant client withdrawals.

This wouldn't be an issue for most asset classes, but funds that invest in actual bricks and mortar are incredibly illiquid. The managers get round this by maintaining significant cash balances of typically 10% to 15% that are sufficient for normal market conditions, so the switch in pricing suggests that they are getting short and need to raise additional liquidity.

Each property fund calculates a daily bid and offer price that reflects how much it would receive per share if all the assets were sold and how much new shares would cost to buy given the value of the underlying portfolio. The difference between them – the spread – is typically 5% or 6%. This is largely due to the costs of buying and selling the various properties and is much higher than for most other funds.

Under the normal pricing arrangement when client inflows exceed the outflows, the dealing prices are based on the higher offer price. This ensures that buyers contribute to the transaction costs incurred when the fund invests their money in new properties.

By Nick Sudbury

Click here to read the full article

Where Big Pharma Went Wrong

What is your favourite apocalypse? Global warming precipitating cataclysmic sea-level rise? Thermonuclear war caused by hackers violating the Pentagon? Fundamentalists with dirty bombs? A global pandemic of bird flu? President Donald? Brexit? Or: what about antibiotic resistance?

I've just listened to a BBC R4 programme[i] on the subject of the increasing immunity of super-bugs. According to the best medical minds, unless we can tackle this threat we are looking into the abyss. We're already at 700,000 preventable deaths per year globally as a result of antibiotic resistance, and the recent O'Neill Report[ii] suggests that this will rise to 10 million people by 2050. That's more people than die of cancer every year right now. Recently it was announced in the US that a patient was suffering from a form of e-coli which was entirely resistant to *all* available antibiotics.

The problem arises because antibiotics have been used too freely, not least in intensive agribusiness, and the bugs have been allowed to evolve faster than new medicines have become available.

I don't want to worry you but antibiotic resistance is looming at precisely the time that all of the big pharmaceutical players are in retreat. What I mean by that is that they are scaling back investment in R&D around new blockbuster drugs in favour of what used to be called *proprietary remedies.* And the science and economics behind this has been little reported.

Back in February 2011, the US giant **Pfizer (NYSE:PFE and LON:PFZ)** announced the closure of its research facility in Sandwich, Kent – the very stable that created the blockbuster *Viagra*. In the event, total closure was averted.

"ANTIBIOTIC RESISTANCE IS LOOMING AT PRECISELY THE TIME THAT ALL OF THE BIG PHARMACEUTICAL PLAYERS ARE IN RETREAT."

This was part of a change of strategy. The company wanted to trim $3 billion from its US$9 billion research budget and to expand into non-prescription medicines such as *multivitamins*. (Funny how our skinny forebears managed without *multivitamins* – or supplements of any kind, for that matter.)

At about the same time, **GlaxoSmithKline (LON:GSK)** announced a reduction in the proportion of sales reinvested in R&D from prescription medicines. It then closed its depression research unit in Harlow, Essex, with the loss of 380 jobs, after concluding there was insufficient prospect of producing a new blockbuster drug.

By Victor Hill

Click here to read the full article

Is It Time to Add Tesco to Your Shopping Basket?

Staring hard at the Tesco share price charts does not make the equity look any more attractive in terms of absolute and relative share price momentum. Over the last year, Tesco shares have dropped 30 per cent whereas the FTSE100 Index has fallen by only 10 per cent.

Over a six month perspective, Tesco shares did better than the FTSE 100 (up 4.8 per cent in contrast to the FTSE 100's rise of only 2.4 per cent) but in recent months the weakness of performance has chipped in again with dear old Tesco, underperforming the market – as measured by the FTSE 100 index – by over 7 per cent.

Tesco was in decline for most of last year and it looked as though it had broken out of that downtrend early this year. Sadly, that breakout was as short lived as a dragonfly! The share price is now heading down again. There seems no obvious support in sight, particularly following the company's last announcement.

The only useful observation, in relation to a year's chart, is that it was profitable, from a trading point of view, to pick up the shares after they had underperformed the market by 30 per cent or more and to sell them again after periods when the shares are shown to have performed in line with the index.

Such a chart 'buy' signal flashed last October, so could it possibly be true now given that the shares have once again underperformed the FTSE 100 by 30 per cent again? However, that has happened only once and there is no great supporting evidence yet of it wishing to do so again, just at the moment. The main observed thrust of the share price's momentum, still appears to be southerly in direction. Something for watching, I think!

By Robert Sutherland-Smith

Click here to read the full article

BY RICHARD GILL, CFA

READ TO SUCCEED

THE LAWS OF WEALTH

PSYCHOLOGY AND THE SECRET TO INVESTING SUCCESS

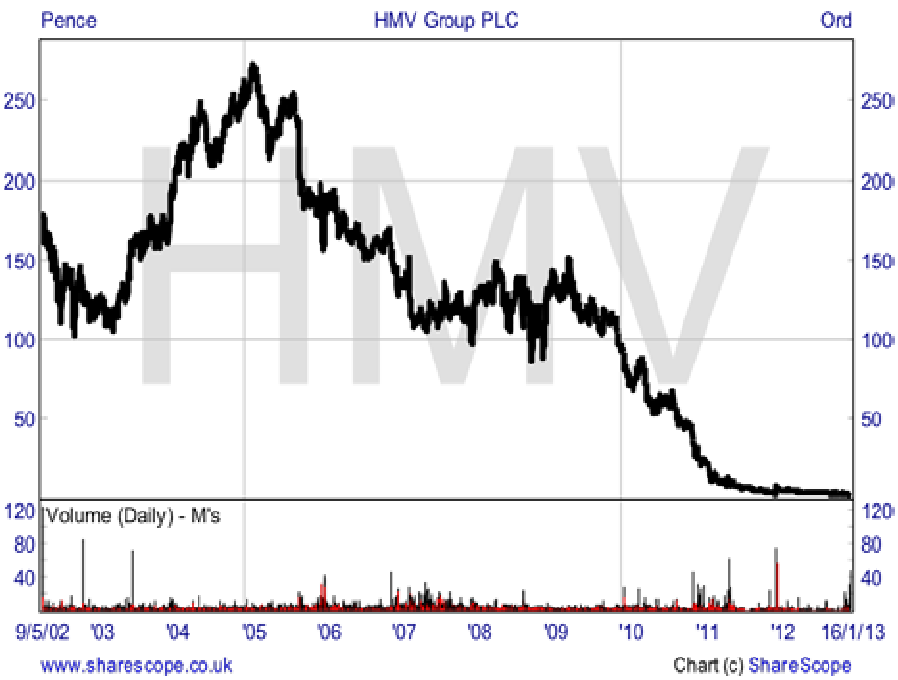
BY DR DANIEL CROSBY

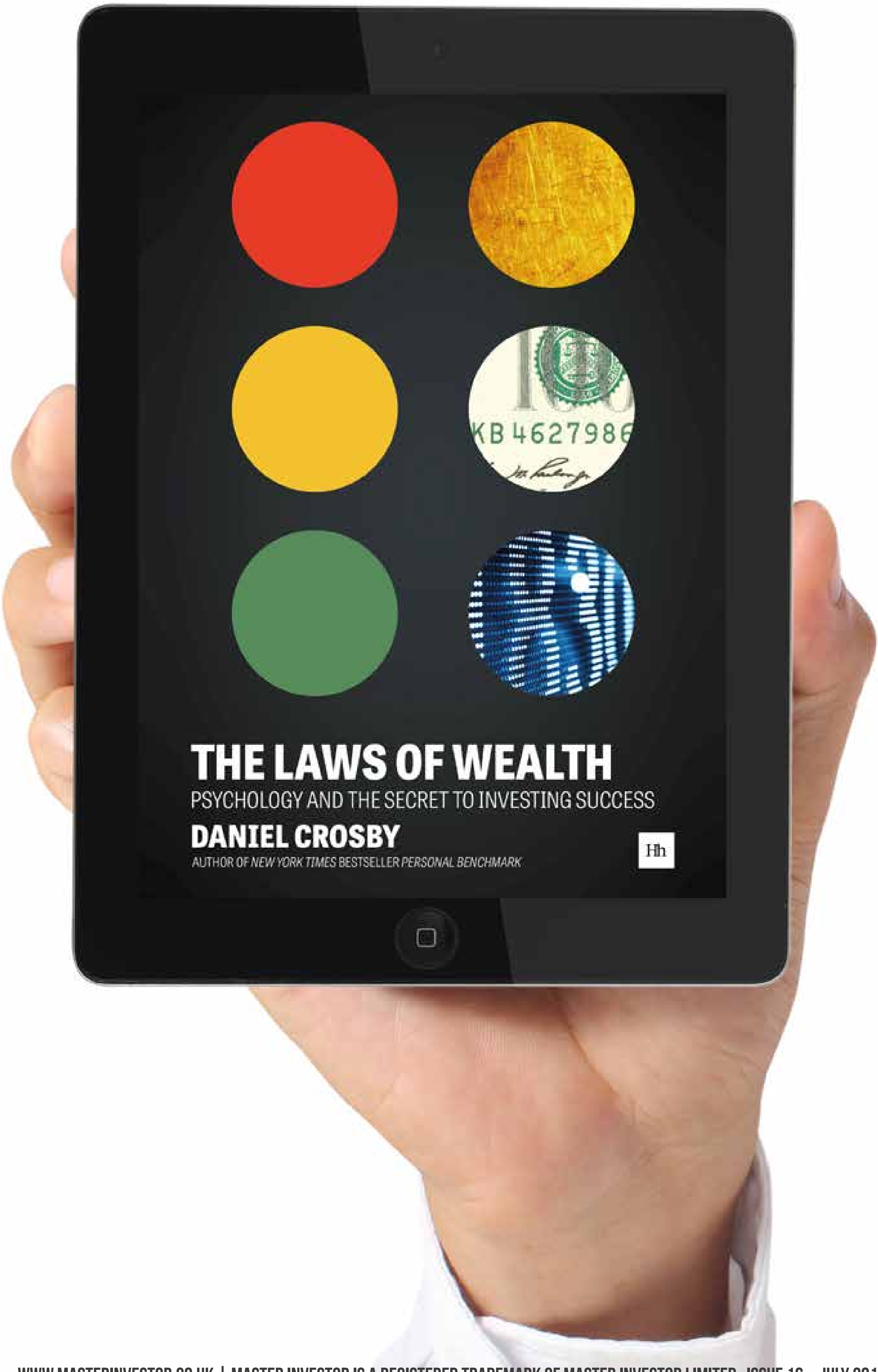
Behavioural finance, in my view, is one of the most interesting and thought provoking areas of economics. Instead of focussing on the ways humans, or "Homo economicus", *should* behave in relation to their decisions, as traditional economic theory does, behavioural finance attempts to explain exactly *why* we as investors decide to make the choices we do. Choices which often don't seem to make any sense.

For example, the emotionless, disciplined investor assumed under traditional theories would analyse a stock rationally and objectively, not letting emotions sway their investment decisions. But in the real world a whole range of biases and feelings can affect how we look at our investments and what decisions are made.

"IN THE REAL WORLD A WHOLE RANGE OF BIASES AND FEELINGS CAN AFFECT HOW WE LOOK AT OUR INVESTMENTS."

To give one example, ***confirmation bias*** is an affliction whereby investors only focus on factors which meet their pre-conceived positive beliefs and whereby negative factors are played down. But downplaying the negative aspects could be incredibly damaging to wealth. Take HMV in the early 2000s for example. Many investors were focussing on the company's strong market position and ignoring the ever growing rise of internet based music distribution. And we all know what happened to HMV. If you don't, here is a chart.

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THE LAWS OF WEALTH
PSYCHOLOGY AND THE SECRET TO INVESTING SUCCESS
DANIEL CROSBY
AUTHOR OF NEW YORK TIMES BESTSELLER PERSONAL BENCHMARK
Hh

No matter how emotionless or regimented investors may be, these so called behavioural biases are still likely to affect their decisions at one time or another – after all, we are all human and not robots. In fact, an estimated 117 such biases have been identified by proponents of behavioural finance as being likely to sway decision making for the worse. These range from the well known overconfidence bias to the more exotic Semmelweis reflex.

Unfortunately, the discipline as a whole has been more concerned with identifying these biases rather than coming up with a practical solution to avoiding them – a bit like a doctor diagnosing a condition and not offering any treatment. It is in *The Laws of Wealth* that author Dr Daniel Crosby, attempts to take the discipline a step further, by analysing the theory behind investment psychology and then suggesting ways to become a better investor.

Crosby himself is an asset manager and founder of Nocturne Capital, has a PhD in clinical psychology and is a leading behavioural finance expert who uses his expertise in designing financial products and in security selection. He is also a prolific writer having authored books, newspaper columns and many blogs.

Mad world

Setting the scene, Crosby begins the book by explaining that humans must invest in risky assets in order to survive and prosper over the long term. Given that inflation eats into wealth over time, no one will have a decent pension pot if they only invest in low risk government bonds and bank deposits. However, due to the way our brains are hard-wired we are ill equipped to invest in risky assets. This is because the world of investment often operates in contrast to everyday life.

For example, in investment, asset returns can often be predicted more accurately over the long term than in the short term. In contrast, you are probably more likely to know what you will be doing at this time tomorrow than in five years. And while in life the consensus view of how good a film is might be accurate, in investing the consensus view is often wrong – investment outflows being their highest at the bottom of the market being one example. So in a world which often makes little sense, clear rules must be applied if investors are to thrive.

Don't be silly

Part One of the book moves onto Crosby's key Laws of Wealth, ten rules of behavioural self management which must be digested and acted upon if investors want to increase wealth over their lives. The first rule, "You Control What Matters Most", reflects one of the main points of Crosby's overall work, being that investors can be their own worst enemy. He surmises that bad behaviour, or in other words, emotional responses to market conditions, can result in investors underperforming the market by up to 4.3% per annum. The next nine rules will help you to learn good behaviour and to close that bad behaviour gap.

"EMOTIONS ARE THE ENEMY OF GOOD INVESTMENT DECISIONS."

What follows is some pretty good advice, including hiring a financial advisor specialising in managing behaviour, buying shares in bear markets and diversifying across a range of asset classes. All are explained in an entertaining manner but also backed up by theory and real life examples. In conclusion to each law Crosby provides a useful "What now?" summary section, which covers what to think, ask and do when faced with each situation.

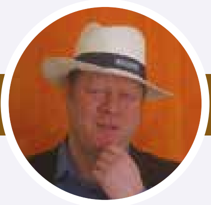
My own particular favourite law is number four – "If You're Excited, It's a Bad Idea". In other words, investors should not let powerful emotions influence their decision making. While they have a huge part to play in life, Crosby suggests, *"Emotions are the enemy of good investment decisions".* We have all seen spurious marketing communications along the lines of *"this stock will soar by 1,000%"* and *"live the life you've always wanted by investing in ostrich farms"* and so on. The problem is that much of the investment world is controlled by marketers (not analysts) who are paid to put you into a state of excitement so that you will buy their products. After reading this chapter hopefully you will think twice before parting with your cash. In that vein, the author provides some useful tips on how to manage emotions, including exercising vigorously and limiting intake of alcohol – two things many of my investment chums will not be pleased about!

Part Two then goes on to introduce Crosby's Rules Based Investing approach, a set of factors which if successfully implemented will help to mitigate risk, exploit mispricing, protect from disaster and increase returns. He summarises his approach well with the following, *"Exceptional investing over a lifetime cannot be predicated on luck. It must be grounded in a systematic approach that is applied in good times and bad and is never abandoned just because what is popular in the moment may not conform to longer-term best practices."* This part will teach you those practices.

Conclusion

Crosby has two hopes for The Laws of Wealth. Firstly that it will make you better off financially and secondly that it will leave you with a richer awareness of self. While the first aspect may well come in time I have certainly become a lot more aware of my own behavioural biases by reading this book and intend to do something about them by applying the techniques described.

Overall, this is a highly readable book, well researched by an expert in his field and full of practical advice on how you can improve your long-term finances. Those who dislike equations and investment formulas will be pleased to see that the book is maths light, with any numbers presented in easy to read tables and charts. Interspersed with anecdotes and stories it is also an entertaining read. The Laws of Wealth will appeal to a broad range of investors including private individuals who are managing their own portfolio, financial advisors who want to provide exceptional service to their clients and fund managers looking for an edge in the markets.



BY ADRIAN KEMPTON-CUMBER

THE FINAL WORD

SOLDIERS OF FORTUNE

I was on an organised walk discovering the trees in my then local park in Ealing a few years back. I mean learning what sort of trees they were, not just locating them. Anyway, the park ranger was telling me that they also do walks with infant-school children and they have to make them wear hi-vis gilets for health and safety. They're in a suburban park! Madness. I thought back to when I was growing up and there were almost no 'traffic calmers' – 'sleeping policemen' we used to call them. Now they're everywhere. It occurred to me what has changed. In those days Darwinian natural selection was allowed to play out. But now we need all nature's losers who would have been run over in the normal course of events to work in Call Centres.

"WE ARE LIKE SNIPERS, PERHAPS TAKING A LONG TIME TO SET THE SHOT UP AND THEN SOMETIMES NOT EVEN TAKING IT AT ALL IF CONDITIONS CHANGE. THE ANALOGY IS PERFECT."

Well there is no concept of health and safety in trading. You pays your money and you takes your chance. There is consequently no place for sentimentality in trading. We have to literally take advantage of people and take their money off them. You can't really sentimentalise that as a concept!

Luckily we have lots of things working in our favour as private investors. Firstly we can be agile. What I mean by that is that fund managers, in particular pension fund managers, have their hands tied to a greater extent. They must trade only the markets they are managing funds in, and they must keep largely invested. Even in a SIPP we have the option to move into a cash fund, thus effectively being out of the market in cash when we want to be. As a result, pension funds tend to be well behind the curve when it comes to disposing of stock in a downturn. Effectively it means they are keeping the price artificially high while we sell out, and when they do finally make a decision, assuming the price has continued to fall, they will have underwritten our gains. We're taking money out of people's pension funds – another good reason to manage your own pension, incidentally.

While we're on the subject of pension funds, if you work here in the UK you're obviously subject to the vagaries of the UK economy. From a risk perspective the very last thing you want to do then is expose yourself to even more of that risk that you've already taken on, living and working here, by investing in the same economy. Arguably your whole portfolio should be in overseas investments as a diversification. Currency hedging is so cheap and easy nowadays that it's really unclipped our wings for global investing.

As with all finite resources and commodities, if you've got them someone else hasn't. If you have a job then you've robbed someone else of that opportunity. We have to be detached

and emotionless when it comes to trading. Just like a soldier in fact. We have to dehumanise the markets, which shouldn't be too hard since they are only really theoretical in their existence. We are soldiers of fortune. It's a daily battle out there to take money off other people. Even if you buy so-called 'ethical' investments based on the stock market, it's still someone else's money you're gunning for. We are like snipers, perhaps taking a long time to set the shot up and then sometimes not even taking it at all if conditions change. The analogy is perfect.

You can't rely on governments (and never could) to look after you. It's a jungle out there and you have to look after yourself. Society is a sum that doesn't add up. The world is not a fair place and it's up to you to make sure it's unfair for someone else and not for you. That's the reality in which we live. Buy things from people who are desperate to sell for whatever reason, and sell to people who are greedy and have already missed the boat. We have to be in (and out) early, and anticipate trends.

When it comes to tax, the average person has cognitive dissonance. That is to say their beliefs about it directly conflict in a paradoxical sense. They have to bend some of their beliefs out of shape to agree with others. This is usually a function of having 'received opinions', instead of their own. Most people are running around with a motley set of opinions they got from a variety of other people, and about which they themselves have given no serious thought. It's a cop-out – an abdication of civic intellectual responsibility. Needless to say, their opinions conflict and cannot be defended in an argument. This is a by-product of not teaching critical thinking as part of the standard curriculum.

It's amazing how people decry company executives earning big fat bonuses, approved by their board and shareholders incidentally, whilst having no problem with footballers and film actors earning far, far more but without employing tens of thousands. They complain about Starbucks not paying Corporation Tax in the UK whilst ignoring the fact they have paid billions in the US. Meanwhile, they have no problem with the Church paying no tax at all, in spite of the fact that it's a cash business selling a product that would fail Sales Legislation and Trading Standards; and if the largest denominations sold up and gave it all away they could end global poverty tomorrow, having stockpiled trillions of dollars globally over the centuries. I'm not sure what they're waiting for, as I thought that was their gig. Cognitive dissonance indeed.

Tax planning became essential when Wilson's Labour government in 1974 raised the top rate of tax to 98%. In certain circumstances it was possible to attract a further 5% on top, so for some there was a marginal tax rate of 103%. When people complain about tax havens: blame Wilson and Labour. But that doesn't affect the man in the street you might say. No, not exactly. But if you've ever bought duty frees when you're on holiday, then we have established you too don't like paying your taxes and rely on international tax planning solutions, too. Now we're merely haggling over the amount. There is nothing shameful about legally avoiding paying tax. Want to pay more tax? Then earn more money. Making your investments tax efficient is going to add a small percentage to every profit you make. And don't forget Einstein considered compounding the Eighth Wonder of the World. Keeping a lid on costs, especially tax, can have a massive impact over time.

It's going to get more dog eat dog than ever out there over the coming generation. Graduates, and in particular unskilled workers, will be almost literally fighting over jobs as the job pool shrinks. It'll be much more like the Wild West, and our job is to do what government consistently fails to do: safeguard our own interests. The reason they don't is that it is inevitably at the expense of others, which is why they keep changing it to maximise votes.

The important thing is to get it right though. I correctly called the Leave win on 17th June in my blog piece Something for the Weekend – Looks Like a Win for Brexit, and the fall in **Cable (GBPUSD)**, which I started writing about in January as a short below $1.40 (Is it time to short cable?) and in a few more articles subsequently. In other words it was going to fall anyway and Brexit just happened – or appeared – to be the catalyst. Much money is to be made when going against the prevailing school of thought. John Paulson holds the record for the biggest trade win in history when he shorted subprime. Confident in the face of ridicule, even many of his own hedge fund investors cashed out and left the fund because he was such a maverick. Some people are idiots. But it's a good thing we can take their money now, too. We should be more like him.

It's about being right. It's about winning and not losing, and there is nothing to be embarrassed about in winning and making (lots of) money. There's been a 'politically defect' view that money is dirty and one should be ashamed for making it. Not at all. One should be ashamed for not making it and failing to provide those who depend on one with security. Don't underestimate the almost always ridiculous times we live in, when apparently people don't even understand a simple referendum question and want to re-sit the exam. The world is full of idiots waiting for us to relieve them of their money.

"MUCH MONEY IS TO BE MADE WHEN GOING AGAINST THE PREVAILING SCHOOL OF THOUGHT."

I remember teachers that used to say "it's more important to take part than to win". What an awful thing to teach children. We might as well tell them X-Factor is a viable career path.

So what's a good opportunity that's one you'd not want to tell your friends about, but could be a goody? **Monsanto (NYSE:MON)**. One of two things happens now: either the island created some upward momentum – and remember, the fall of the candle is in tandem with the market move down on Brexit – or it's an island reversal, which is one of the most reliable of chart patterns. It's less likely to be a reversal, I would say, as the US markets will be much more attractive now that Europe and the UK are home to uncertainty. The price is still above the cloud there, and OK, the MACD is a bit toppy so it might flounder a bit. But what a great controversial company to throw some cash at if you can find a suitable entry point. Put another way, to continue the theme of the article, get it in your sights, and if the conditions are right, and you can, take the shot. And if you don't like what Monsanto does, so much the better. Why not use the profits for activism against them?

We are soldiers of Fortune.

MARKETS IN FOCUS

JUNE 2016

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
Bovespa	5.2	17.7	
FTSE 100	4.4	4.2	
Russian Trading System	2.5	23.4	
Dow Jones	0.8	2.9	
S&P 500	0.1	2.7	
Hang Seng	-0.1	-5.1	
NASDAQ 100	-2.3	-3.8	
S&P/ASX 200	-2.7	-1.2	
Euronext 100	-4.3	-6.6	
DAX Xetra	-5.7	-9.9	
CAC 40	-6.0	-8.6	
Nikkei 225	-9.6	-18.2	
IBEX 35	-9.6	-14.5	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Natural Gas	28.6	24.8	
Coffee	19.8	15.8	
Silver	17.7	36.4	
Sugar (No. 11)	16.4	32.1	
Iron Ore	12.3	25.0	
Palladium	9.3	6.7	
Gold	8.6	24.9	
Soybean	7.0	33.7	
Platinum	4.9	15.2	
Copper	4.6	3.3	
Crude oil (Brent)	0.5	33.8	
Crude oil (Light Sweet)	-1.0	30.7	
Cocoa	-3.0	-7.8	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
EUR/GBP	8.3	13.0	
AUD/USD	2.9	2.2	
EUR/USD	-0.3	2.2	
USD/CAD	-0.9	-6.3	
USD/CHF	-1.7	-2.5	
EUR/CHF	-2.0	-0.4	
USD/JPY	-6.8	-14.2	
EUR/JPY	-7.1	-12.3	
GBP/USD	-8.0	-9.5	
GBP/AUD	-10.6	-11.2	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Jul 14	Aug 04
ECB	0.00%	Jul 21	Sep 08
FED	0.50%	Jul 27	Sep 21
BOJ	-0.10%	Jul 29	Sep 21
SNB	-0.75%	Sep 15	Dec 15
BOC	0.50%	Jul 13	Sep 07
RBA	1.75%	Jul 05	Aug 02
RBNZ	2.25%	Aug 11	Sep 22
BOS	-0.50%	Jul 05	Sep 06
BON	0.50%	Sep 22	Oct 27

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Fresnillo PLC	62.9	132.2	
Acacia Mining PLC	47.7	150.6	
Indivior PLC	46.1	33.7	
Randgold Resources Ltd	45.0	103.0	
Centamin PLC	36.9	104.8	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Circassia Pharma PLC	-62.2	-68.2	
Aldermore Group PLC	-45.0	-48.6	
Shawbrook Group PLC	-42.2	-51.3	
Crest Nicholson Hold Ltd	-39.5	-36.1	
Essentra PLC	-38.2	-38.0	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Industrial Metals	23.6	87.3	
Oil & Gas Producers	23.2	32.5	
Mining	20.6	44.2	
Tech Hardware & Equip	13.2	7.9	
Tobacco	13.0	23.4	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Real Estate Inv & Serv	-14.1	-23.4	
General Retailers	-13.5	-19.9	
Real Estate Inv Trusts	-10.6	-13.9	
Life Insurance	-10.2	-18.8	
Financial Services	-9.3	-13.6