ISSUE 12 – MARCH 2016
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MAGAZINE

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THE RISE OF THE MACHINES

HOW TO INVEST IN THE AGE OF THE ROBOT

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BEAR MARKETS

ARE THEY AN INVESTOR'S BEST FRIEND?

EUROPEAN BANKS

WHY DEUTSCHE BANK'S WOES COULD BE THE TIP OF THE ICEBERG

ALAN STEEL

ASSET MANAGEMENT GURU TALKS PENSIONS, INVESTMENTS AND TAX

DIVIDEND TAX

HOW MIGHT THE UPCOMING CHANGES AFFECT YOU?

WELCOME

Dear Reader,

One of the difficulties of being a magazine publisher is to manage the balancing act of reporting about exciting subjects well ahead of time (to give you valuable intelligence), while also delivering content that ties in with the biggest themes of current news (to give you up-to-date information about trending subjects that affect your investments).

In all modesty, I dare claim that we managed to do both with our contributions to the Brexit debate.

This magazine and its contributors started analysing the subject well ahead of time. For example, Jim Mellon ("Mellon on the Markets") flagged the risk of a weakening Pound as early as August 2015. This gave our readers an edge in the market, and enabled quick-thinking investors and traders to turn a tidy profit by engaging in short-selling.

We remain on the pulse of the subject, by regularly featuring articles that look at the EU referendum from the perspective of an investor. The mainstream media is now (finally!) doing a brilliant job of reporting about all the other aspects of what will undoubtedly be the single biggest political decision in the lifetime of British voters. Our team, in turn, will continue to focus on the investment-related aspects of the debate.

In our research, we regularly speak to sources that may be seen as left field, but which enable us to look at a subject from all angles. Just last week, Jim briefed a group of Latin American ambassadors about the Brexit subject. I was lucky enough to attend with him, and from the audience's questions I learned about the very different viewpoints and concerns of this particular group.

Our magazine (and website) has a diverse, highly competent group of contributors. They all have outstanding achievements to their name and provide in-depth analysis of subjects that affect your investments, your savings and your future.

None of this would be possible without the ongoing feedback and encouragement we receive from our readers. For any and all comment you have, please do not hesitate to shoot us an email (info@masterinvestor.co.uk). Every single reader email is read and replied to.

Best regards,

Swen Lorenz,
Editor, Master Investor

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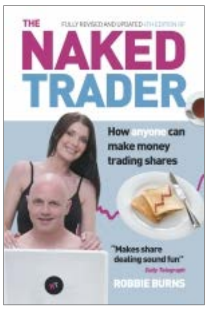

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ALL OTHER TOPICS

BY SWEN LORENZ

AROUND THE WORLD IN A DOZEN PROPERTIES (PART 12)

INDIAN ELEPHANTS CAN GALLOP

Mention real estate investments to anyone, and they instinctively think of office buildings, residential property, and maybe land. However, infrastructure is also part of the real estate equation. Think toll roads and warehouses! One little-known London-listed investment fund offers an opportunity to invest into infrastructure properties in India. As our editor, Swen Lorenz, explains, now might be the perfect time to look at this rather bombed-out share.

India has long stood in the shadow of China, despite the fact that its population of 1.3 billion people doesn't lag far behind China's 1.4 billion. However, it was widely perceived to be the less dynamic and more backward of the two mega-markets. In terms of the level of overall development, yearly growth rate, and approach to dealing with problems such as corruption, India often came a poor second. More recently, though, this perception has started to shift in India's favour.

The country's President, Pranab Mukherjee, recently described his country as a new "haven of stability" in a turbulent global economy. This may still be a bit of an exaggeration; but it's true that India has made considerable advances in repealing obsolete laws, simplifying procedures for approvals, and putting in place a non-adversarial tax regime to attract investment. As a consequence, India has jumped 12 places in the ease of doing business rankings of the World Bank, while foreign investment inflow has risen 39% in recent times.

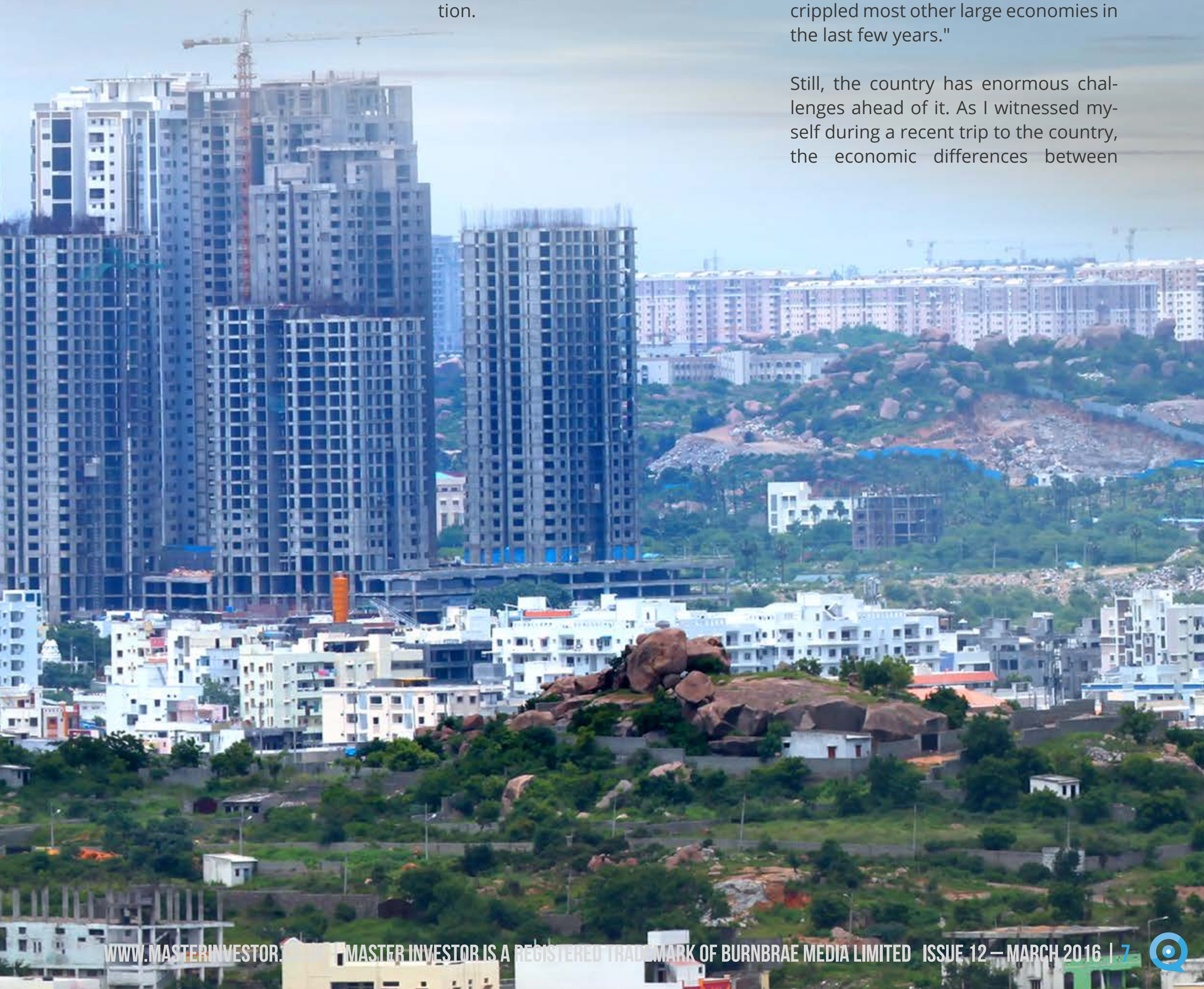
The latest figures released by the Indian authorities put economic growth in the emerging powerhouse at 7.5% in 2015, the highest in the world, and up from 6.9% the year before. Growth in China is heading in the opposite direction – predicted to be only 6.3% in 2016 – while the US will expand by a mere 2.6%. Let's not even mention the economies of Continental Europe or the inherent risks of the Chinese banking sector.

After several disappointing years, the Indian elephant has once again begun to dance. India's economy is now the 10th or 11th biggest in the world, and if forecasts are to be believed, it will reach third, after the US and China, in less than 15 years. One of its key features is, of course, its young population.

Among the two most powerful drivers of economic growth in India are urbanisation and aspiration. India's population is hugely ambitious, eager for education, and strong on household savings. It has also quite simply had its share of luck recently. For example, the heavy use of untaxed money in property transactions has led to much of the property market functioning with off-the-books transactions. Think Rupees in suitcases, or to be more precise, suitcases full of Rupees! This kept India from suffering the kind of mortgage-financing related banking issues that plagued other countries in the aftermath of the financial crisis.

In what is quite an extraordinary statement by a public official, Kaushik Basu, the chief economist of the World Bank and former chief economic adviser to the Indian government, said that "the nation's tradition of petty corruption and untaxed money helped India avoid the worst of the banking crisis that has crippled most other large economies in the last few years."

Still, the country has enormous challenges ahead of it. As I witnessed myself during a recent trip to the country, the economic differences between



some parts of the country are absolutely staggering. Spending time in New Delhi, you'd think of India as a country that has largely arrived at a developed-nation standard. But after a two-hour drive to the south, you find yourself in the kind of Indian towns and villages where raw sewage flows in front of the shops on main streets. That's before you have even ventured into the parts of the country that are truly under-developed. More than 20,000 Indian villages are still not even connected to the electricity grid. The enormity of the country and the sheer scale of its challenges are difficult to fathom.

It's clear that infrastructure investments are needed – and that's where AIM-listed **Infrastructure India PLC (IIP)** aims to carve out its niche. Having floated in 2008, the closed-ended investment fund is based on the Isle of Man for tax purposes, and focuses entirely on infrastructure properties in India.

The biggest investment of IIP is a 99.99% stake in a company developing warehousing capacity and associated logistics services. Founded in 1972, the company sets up rail-linked warehousing hubs and aims to sign up solid, long-term, blue-chip customers. In a country where most cargo is still transported by truck, the portfolio of land investments with rail sidings and statutory approvals is a veritable asset indeed. What's more, all of the company's locations, once set up, lend themselves to gradual expansion over time. This business has high barriers to entry and IIP did well in making this particular area its core investment.

It also owns 26% of a toll road, a 125km four lane expressway connecting the towns of Lebad and Jaora. This road is a vital connection from north to south, and provides crucial links to National Highway 8 from eastern Rajasthan to the industrial city of Indore as well as a link to National Highway 3 which connects to the major cities of Mumbai to Agra. The company has a 25 year concession and it can increase prices by up to 7% per year.

Further assets include two hydro electric plants and a wind farm. As per September 2015, the company controlled assets worth £330 million, and it has been managed by a highly experienced team in India and Britain. In theory, at least, it should make for a winning formula. However, this hasn't been the case for shareholders thus far. Since peaking at 90p in 2011, the share price has lost 80% of its value and is currently trading at just 18p. What's more, the share price is trading significantly below the 48p net asset value the company reported as per September 2015.

What happened?

Several factors conspired against IIP, which is why anyone who bought into the company in the past has yet to see any returns. Delays to projects occurred, the Indian Rupee has been in a downwards trend for three years, and emerging-market assets are currently being viewed with suspicion by investors. One project requires additional funding, which is currently under negotiation but not yet secured. Add a lack of market liquidity for the AIM listed share to the mix, and it becomes apparent why the share prices has taken such a hammering. The market has taken the stance that IIP's assets should be valued at a discount because of the inherent risks and challenges.

That, in turn, may just be a lucky opportunity for new investors. The Rupee has devalued further since September 2015, and the next company report is likely to show a further decrease in net asset value simply because of the weak currency. However, with its current hefty discount to net asset value, this development seems more than priced into the share already. At a share price of 18p, the market seems to be anticipating a worst-case scenario.

"THE SHARE PRICE IS TRADING SIGNIFICANTLY BELOW THE 48P NET ASSET VALUE THE COMPANY REPORTED AS PER SEPTEMBER 2015."

Between January 2015 and August 2015, the share price nearly doubled from 12p to 22p. It has retreated back to 18p since then, which makes for an interesting buying opportunity for those who want to bet on the long-term future of the country. More cautious investors will want to wait for the outstanding additional financing for one of the hydro power projects. Those with an appetite for buying when the market is at its point of maximum pessimism may consider buying an initial stake now. India isn't for the faint-hearted, but with quality assets bought on the cheap, it could make for significant capital gains in the long run.

BY JAMES FAULKNER

AN INTERVIEW WITH ALAN STEEL OF ALAN STEEL ASSET MANAGEMENT

Alan Steel rose to prominence in the financial sector after being the first person to put pen to paper to accuse Equitable Life of rampant mis-selling. A true champion of the ordinary saver/investor, Alan founded Alan Steel Asset Management in 1975, and now has £900 million under management. I caught up with him to talk pensions, investment and tax planning, and to get a glimpse of what promises to be a must-see performance at this year's Master Investor Show in April.

James Faulkner: Great to have you here today, Alan. If you'd like to kick off by introducing yourself to our readers and giving us a bit of a rundown on Alan Steel Asset Management, that would be great.

Alan Steel: *After giving up on trying to become an actuary in 1973 (thanks to having a personality and a sense of humour, not to mention an ability to communicate with people – I discovered you can't have any of these attributes as an actuary), I wanted to give folks advice on money, so I became an IFA and joined a specialist business in the Scottish borders.*

I had trained up on With Profits etc. from a technical viewpoint, and by that time I had a background in systems, pensions, investment and the like. The tax system in the UK was going through radical changes, inflation was raising its ugly head, and interest rates were beginning to increase sharply – not a good environment for straitjacket With Profits plans. Looking back it was the right decision for me. I stayed with the IFA business for two years and then set up my own business in my home town of Linlithgow. Having started in early summer 1975, we now we have 42 skilled staff – of whom ten are fully qualified advisers – about 7,500 square feet of office space (only in Linlithgow), and around £900m under management.

> **"THERE'S NO DOUBT THAT INVESTORS, BIG AND SMALL, MAKE TOO MANY DECISIONS BASED ON EMOTION. FEAR = SELL, GREED = BUY... REPEAT UNTIL BROKE."**

JF: I think you won't mind my saying that you've been around a fair while. With reference to the current downturn, you said you'd 'seen it all before'. How are you advising clients in the current environment? Is it a case of 'keep calm and carry on'? Or should we batten down the hatches?

AS: *I often introduce myself at presentations by saying "I stand before you the man who has survived at least ten 'Ends of the World'". In certain surroundings, when you are hit on the head by a brick it's a bolt from the blue. When it happens again in similar surroundings it could just be a coincidence. But when it happens the third time there's definitely a trend going on.*

Having always been curious (as former girlfriends will attest), and being someone who was always convinced folks like Anthony Bolton, Warren Buffett, and more recently Neil Woodford weren't consistently successful through luck, and being blessed with a brilliant memory (long-term, that is), as every bear market and bull market swapped sides over the years a trend became fairly clear. But you won't spot it by running with the herd/crowd.

During the dot.com bubble in 2000 I'd convinced myself demographics held the key, and clearly something else was going on. I dedicated my time to studying as far back as 500 years, believe it or not, reading everything I could get my hands on, and sourcing and comparing various apparently successful analytical services. The best independent service I've found is that of Ned Davis Research in the US. We find their research extremely useful and build our asset allocations for various client groupings around their macro insights.

In addition, there's no doubt that investors, big and small, make too many decisions based on emotion. Fear = sell, greed

"THOSE WHO WELCOMED PENSIONS FREEDOM HAVE NO IDEA OF THE DAMAGE IT WILL DO TO MOST SAVERS WHO HAVE LITTLE COMPREHENSION OF HOW COMPLEX SUCCESSIVE CHANCELLORS SINCE 1987 HAVE RENDERED THIS MOST VALUABLE OF RETIREMENT SAVINGS VEHICLES."

= buy... repeat until broke. You just have to look at the US Dollar figures over the last 25 years to see that being contrarian isn't easy given how our brains are wired. So for over 12 years now we've communicated twice weekly with our clients, to make them aware of what's going on behind the hysterical headlines. We have learned that even our younger clients should have a defence as well as an attack, just like all successful teams. We've had just one panic recently out of 2,000 plus.

JF: These days getting the investment decisions right is only half the picture. We recently spoke about the importance of tax shields, such as a SIPP, to building long-term wealth. Is tax planning just for the wealthy or should we all pay a lot more attention to WHERE and HOW we invest?

AS: *Funny that! A few years back I had a Marketing Director who suggested we only focus on new clients who had £1 million plus. I pointed out that over 80% of our clients had come to us with far less, and the only reason they were, on average, investment millionaires was because of our work with them over the years. Sadly there's not enough knowledge or perspective around. Back in the 1970s my mother thought that if you took your money out of the building society you lost it. She paid no attention to tax or income yields or the effect of inflation eroding the value of her hard earned savings.*

Nowadays you can't get away from money/stockmarket/economic worries. BBC Noise at Ten and CNN (aka Constantly Negative News) are only a small part; 24-hour Business channels, Internet sites, blogs, Twitter etc. all spell out gloom most the time. And then suddenly the complete reverse, as in the case of "the new paradigm" in the late 1990s just before the collapse, or 2006/7 in property, just before the great recession.

So tax planning is important – of course it is – like ISAs for holding dividend-income paying investments; pension plans (not SIPPs, which the vast bulk of investors don't need with their extra fees and hidden commission facilities); making use of Capital Gains Tax exemptions to create tax free income; using Offshore Bonds to save taxes on Trusts etc. But a tax wrapper is only as good as what's inside it. I wish I had a pound for every time someone's come to us over the years saying "don't give me any pension plans – they're useless." It's what's inside that makes the difference! And now a properly written pension plan can be the best tax plan against Income Tax, Capital Gains Tax and Inheritance Tax.

JF: We all know governments like to fiddle with the tax rules. Despite how annoying that may be, many have welcomed Mr Osborne's overhaul of the pension system, along with the significant increase to ISA allowances and the new 'NISA' ISA rules that allow transfers between cash and stocks and shares ISAs, amongst other things. Is this all that it's cracked up to be? Or are we simply about to find that he giveth with one hand and taketh away with the other – possibly through the scrapping of higher rate tax relief on pensions in the upcoming March budget?

AS: *Those who welcomed Pensions Freedom have no idea of the damage it will do to most savers who have little comprehension of how complex successive Chancellors since 1987 have rendered this most valuable of retirement savings vehicles. Almost 600 changes since then,*

315 between 2000 and 2006, when Brown introduced... wait for it... "pensions simplification"! How many changes since? About 200! Now we have eight different Lifetime Allowance regimes, with more to come after 5th April. Add to that all the variations of Personal Pensions, Section 32s, plans with guaranteed annuity rates you can only dream about today being swapped for "freedom", plans that allow up to 100% tax free cash hidden in small print being dumped by savers ignorant of what they had. Frankly it's a dog's dinner.

"PEOPLE WHO SAY THEY WON'T PAY FOR FINANCIAL ADVICE DO PAY. THEY PAY FOR THEIR SMALL MINDEDNESS BY REACHING RETIREMENT WITH TOO LITTLE SAVINGS."

Some people say these Chancellors know not what they do. Well that's not good enough. It's all so complicated you're a mug if you don't ask around where to find knowledgeable, experienced, honest IFAs to be your partner in ensuring you take the right paths through this savings and fiscal mess. High rate tax relief in my mind should have disappeared years ago. Those who cared about their retirement would still have invested, obtaining a 25% uplift on every £1 invested, and the rest would be in no worse position... and still would have ignored the opportunity. The new ISA transfer on death opportunity is good news. How long before it's history though? Same goes for some of the new "freedoms". But in the meantime surely it makes sense to put the best foundations in place – both in tax structures and investments.

JF: With Tully's tax guide now said to run into 14,000+ pages, there's no wonder that most people think they're navigating a mine field when it comes to financial planning. But what would you say to those people who have some money to invest but wouldn't consider themselves to be 'wealthy' enough to pay for financial advice? Perhaps you'd also like to mention something about the new rules for IFAs following the Retail Distribution Review, which has altered the way that IFAs are remunerated?

AS: *People who say they won't pay for financial advice do pay. They pay for their small mindedness by reaching retirement with too little savings. They keep it in deposits. They buy 'cheap' index trackers that have underdelivered for the best part of 20 years.*

Haven't these folks noticed that all the best sportsmen and women employ coaches? The likes of Andy Murray, Rory McIlroy, rugby and football teams compete for the best coaches. That's what an experienced and knowledgeable IFA is – a coach. And in law he/she is the Agent of the Client. In other words they are there to put the client first.

Now let's talk charges. Before RDR, financial products carried charges – upfront ones and/or repeat charges called trail. For years now, as far as IFAs are concerned, these charges were transparent and had to be disclosed BEFORE a product was sold/recommended. Upfront commission was voluntary, not obligatory. Many IFAs chose to heavily discount or charge a fee, and accept trail, which was then typically rebated from the fund manager's normal annual management fee.

The FSA/FCA, our toothless (and some would say useless) regulator, decided this wasn't in the best interests of savers, despite research to the contrary. Their view was that costs would be driven lower. What's happened is that many advisers (mostly bank employees or self employed salespersons) have gone, and the bulk of IFAs have increased their repeat income (now called Adviser charge instead of Trail) to 1% p.a. or higher with initial charges and switch charges, too (we haven't increased –now 0.6% and no switch charges). I cannot for the world of me understand why folks don't approach people like us who make no charge at all for a meeting and a report. Mind you, over 80% of our new enquirers come via word of mouth from existing clients, many of whom have been clients for over 30 years.

JF: Being a Yorkshireman, it's really great to talk to someone in the industry who calls it as it is and doesn't pull any punches. I'm sure readers will be glad to hear that you're going to be presenting on the Main Stage at this Year's Master Investor Show in Islington on Saturday 23rd April. Is there any chance you could give us a sneak peek of what you'll be talking about on the day?

AS: *My plan is to use the template of my "Economic Tricks: The Ibiza Mix" presentation originally presented in Barcelona in Oct 2002, when, believe it or not, the world was coming to an end and Chicken Lickens ruled the headlines. I'm going to share what I've learned over the last 43 years, in simple analogies or ways for attendees to use probability to assess what they should be investing in, for how long, and why.*

I'll share the three-word Latin motto from the 17th century that may change their lives as it did mine. Then there's the magic number of the universe to help them assess the usefulness of their investment strategy; why broccoli and chocolate are useful comparisons; what we can learn about bricks and deserted islands; why cycles are important; and how to gauge sentiment as a contrarian indicator. There will be some music to lift the spirits, along with the occasional surprise and a few laughs, I hope, along the way. There might even be room for Groucho Marx's advice.

JF: It sounds like Jim is going to have a tough act to follow, Alan. Thanks for taking the time to speak with Master Investor, and I look forward to catching up with you at the show!

AS: *HaHaHa! I wish! Mind you, I found Ibiza years before he did. Thanks for your kind words.*

BY JIM MELLON

MELLON ON THE MARKETS

My birthday lunch in Brussels last month was a jolly affair, with 21 people attending, including the editor of Master Investor. After the lunch, and after its effects had worn off, I turned to contemplation. No, I haven't suddenly gone all "mindful", but February 17th has always seemed a good day for internal reflection. And some of that reflection of course has to be about the past year's mistakes, some personal and some investment related.

My main error in the past year, from an investment point of view, has been to underestimate the general stupidity of governments and their central banks. Today, one third of the world's developed economies have negative interest rates on their government bonds. Japan, Sweden, Switzerland, Germany and others all get paid by investors (possibly not the right word for this pack of morons) to hold their bonds.

The idiots who buy such bonds are playing a greater fool theory, which ALWAYS ends in tears. No doubt, the governments that issue these types of negative yielding bonds think they are being clever; after all, what is not to like about receiving interest rather than paying it?

What is not to like about the idea that by forcing investors and banks to acquire riskier assets, they are somehow or other kick-starting their faltering economies into life? In addition, these negative interest rates have the general effect of making the currency of the underlying issuer less attractive, with capital flight to higher yielding bonds elsewhere, and a welcome fillip to the export sector of the issuing nation.

"MY MAIN ERROR IN THE PAST YEAR, FROM AN INVESTMENT POINT OF VIEW, HAS BEEN TO UNDERESTIMATE THE GENERAL STUPIDITY OF GOVERNMENTS AND THEIR CENTRAL BANKS."

The idea runs further. With negative interest rates, and a declining currency, incipient or actual deflation in the issuing country gets exported elsewhere, and the (vain) hope is that inflation begins to pick up domestically. Fat chance.

What these fools don't realise (and Janet Yellen does, albeit belatedly) is that by engineering a "false" rate of interest, either very low, or below zero, three things happen.

One is that the domestic savings industry gets destroyed. How can pension funds, insurance companies and wealth managers generate any sort of return when they are crowded into trades where a negative return is GUARANTEED? In countries such as Germany or Switzerland, this destruction is becoming evident, and the consequences are dire. If people prefer to hold cash, or not to go into savings plans, the flow of capital required to build factories, replace machinery and undertake research and development dries up. That is why the capital stock of countries such as Germany and Japan is ageing at the same rate as the population – i.e. fast. That means that


FEDERAL RESERVE
1936

productivity growth – which is almost zero – will continue to decline, and the consequences are horrible.

In addition, the assault on savers means that pensions provision (and can any of us live on state pensions?), at a time of demographic urgency in most developed nations, will become less and less adequate. Make no mistake, the United Kingdom is in no better position than Germany and Japan, despite the fact that we still have marginally positive interest rates. Our less-than-Iron Chancellor is attacking pension savings with gusto, beggaring the future for short-term political gain. He won't be around (hopefully) to see the effects of his "raids" on pensions, but all of us will suffer as a result. He is an arch tinkerer without a clear vision for long-term growth, and I hate to say it, certainly not a "conservative" chancellor.

Of course, some will argue that negative interest rates are having some effect on spurring alternative investments, which might spur economic growth. My analysis of this is the opposite: rather, it seems to be encouraging speculation in gold (the cost of holding gold is less than the cost of holding cash in many cases), and in financial engineering by companies (e.g. share buybacks), as well as in unproductive property.

Knut Wicksell, of whom I will be speaking at the Master Investor Show in April, suggested that a "normal" interest rate should be one at slightly below the return on new capital investments by corporations, encouraging companies to borrow at an appropriate rate to fund productive investments.

A negative interest rate suggests a dysfunctional economy, one in which large corporations reap a windfall from the lower cost of debt, but smaller, entrepreneurial companies are frozen out of the market for debt. Zombie companies, which in a normal economy would be put out of business, are sustained by low debt servicing costs on their existing debts, leading to a tremendous and injurious misallocation of capital.


GongTo/Shutterstock.com

The second reason that negative interest rates are so bad for us is that banks – already hit by fines, the requirement for more capital, and challenges from a largely unregulated internet based fintech sector – can't make money. If they can't make money, they can't lend money, and that leads to further deterioration of the economic outlook.

And the third reason that negative interest rates are *so, so bad* is that savers, some dependent on income from interest, end up taking risks that they shouldn't, leading in some cases (many cases in future) to penury and dependence on the (impoverished) state.

All of this means that we are governed by idiots, that the funds that buy these negative interest bonds are managed by morons, and that most central bankers should be pilloried and removed from office.

Will this change? Well, if it doesn't, the long-term effect is likely to be economic catastrophe. This is why I feel that Mrs Yellen, who now "gets it", will continue to increase rates this year, albeit at a gentle rate, and that we can expect a rise in US rates before the end of the year.

As I have written before, this is likely to lead to a DECLINE in the US dollar, as normally (and perversely) happens when US rates rise. So I would generally be a BUYER of the Euro (despite its mounting problems), and possibly a buyer of the pound. I am neutral on the Japanese Yen and on commodity currencies.

As long as these beggar-thy-neighbour policies persist, however, and people talk about the abolition of cash, gold will benefit, and I suspect, as I wrote last time, that gold and silver remain great buys.

Stock markets remain range bound, with lots of day trading potential, but little longer term upside, except in the case of Japan, and now, just possibly, the beaten up emerging markets. I have been playing the in and out game, but I am able to do so because I monitor the markets closely, and have an able team helping me.

For those poor people dependent on pension fund managers who buy negative interest rate bonds, or insurers who are forced into sub-prime assets – God help them.

Happy Hunting!

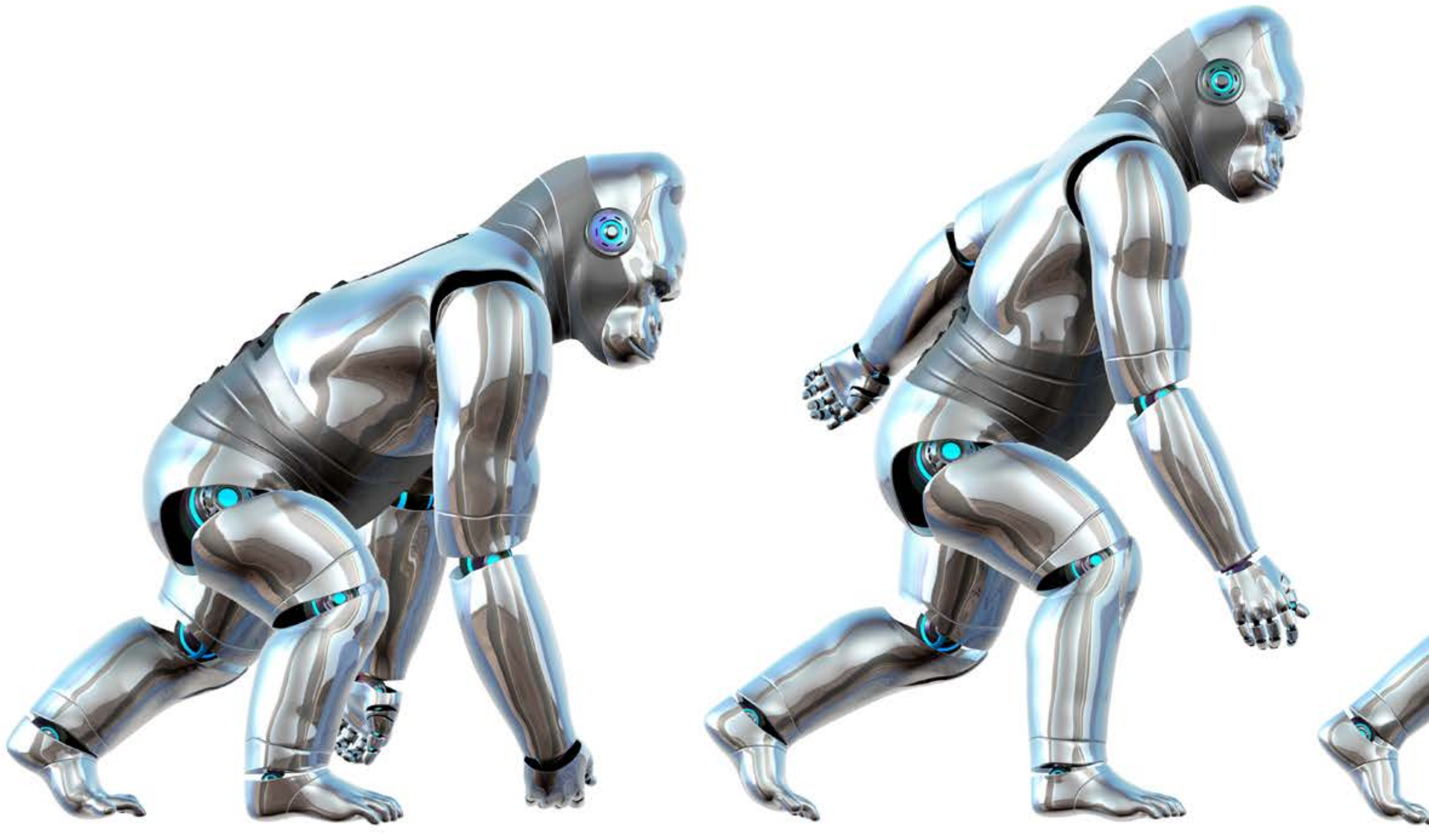
Jim Mellon

Click here to follow Jim's trades on Twitter

BY AL CHALABI

HOW TO INVEST IN THE RISE OF THE MACHINES

Seldom does a day go by without a new article in the media on robots, and in particular how they are going to steal our jobs. Some of these articles target a specific sector that will be disrupted by automation, such as driverless cars or robot factory workers. Pretty much all the articles adopt an alarmist tone, citing various studies that predict mass unemployment in the years ahead.



To add to the scaremongering, some highly respected figures from the scientific and business community, including Professor Stephen Hawking and Elon Musk have recently voiced their concerns about artificial intelligence being the greatest threat to humanity – far more sinister than robots just stealing our jobs.

How seriously should we heed the call of these warnings and is there anything we can or should do about them? Will they prove to be unwarranted, just like all the doomsday warnings about the Millennium bug (AKA Y2K) at the turn of the century?

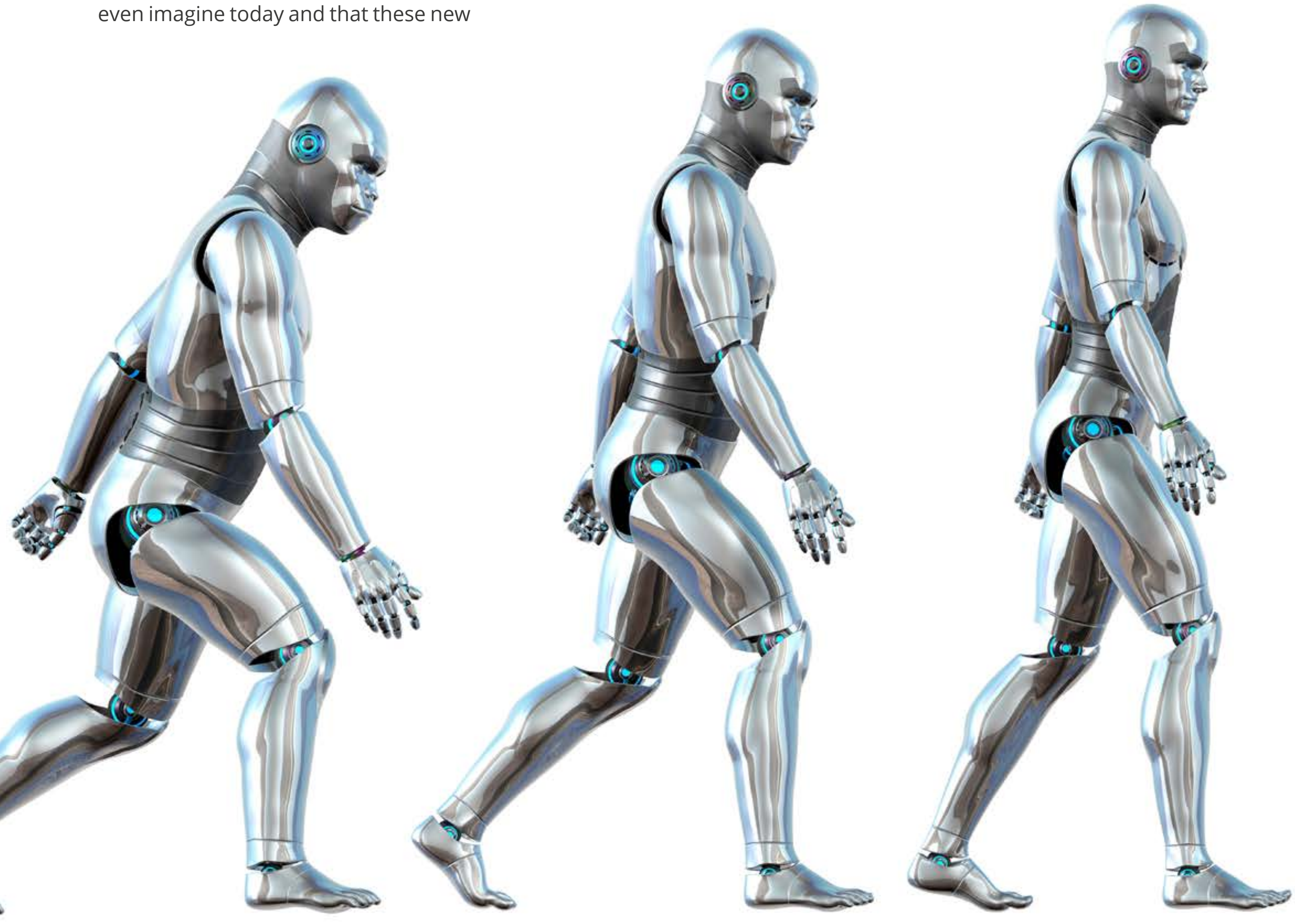
The threat of mass unemployment

A common argument against the threat of widespread unemployment due to robots and automation is that the process of displacing workers will take place over many years, buying us time to react and adapt before most humans lose their jobs. Another retort is that this era of automation will spawn new industries that we cannot even imagine today and that these new industries will create millions of human jobs to offset the ones lost to automation. For example, how many young students in the 1980s were advised to pursue careers in website development or search engine algorithms or even social media? There was no way of foreseeing these roles a decade before they emerged.

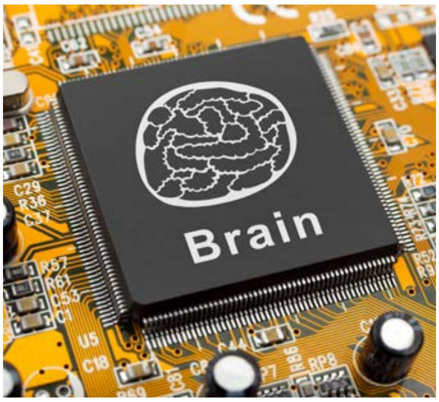
"EVEN THE MOST OPTIMISTIC SCENARIO CONCEDES THAT MANY JOBS, EVEN THOSE OF SKILLED PROFESSIONALS, WILL EVENTUALLY BE AUTOMATED AND REPLACED BY ROBOTS."

But even the most optimistic scenario concedes that many jobs, even those of skilled professionals, will eventually be automated and replaced by robots in a similar way to the many manual jobs that were displaced as a consequence of the industrial revolution some 250 years ago. In fact, James Watt's steam engine and the subsequent industrial revolution was the single most significant event in human history in terms of its impact on the global population and social development. Nothing that occurred prior to this event comes anywhere close. This is because for the first time, it allowed humans to utilise mechanical power many times that of our own limited muscle strength, giving us an exponential rise in productivity.

Just as the industrial revolution replaced manual workers with more productive machines, today's revolution is replacing human brains with computer programs. Our limited brain power will slowly lose out to unlimited computer



processing power. This will impact the global population and social development far more than the industrial revolution ever did. Its impact on jobs will be far-reaching, but will there be new human jobs available to replace those lost?



To answer this question, let's take a look at two relatively new companies that have emerged over the past decade or so: Google and Facebook. Undeniably they have become global behemoths in the blink of an eye on a corporate timescale and they have indeed created new jobs that didn't exist only a generation ago. But how many employees do these companies have? Google is reported to have a staff of around 60,000 and Facebook around 12,500. These are impressive numbers until you consider the market capitalisation of these companies – Google's is $490 billion and Facebook's is $300 billion (give or take market fluctuations). If we take the ratio of market capitalisation to headcount as a crude measure of productivity, we find that Google's is approximately $8.2 million per employee and Facebook's is $24 million per employee. For privately held companies such as Snapchat and Uber, this ratio is even higher.

When we calculate this ratio for more traditional companies such as McDonald's, it is only around $63,000 per employee, and for Walmart it is $93,000 per employee. These are orders of magnitude less than the modern tech giants. Even an old tech giant like IBM has a ratio of approximately $347,000 per employee, still only a fraction of Google and Facebook's.

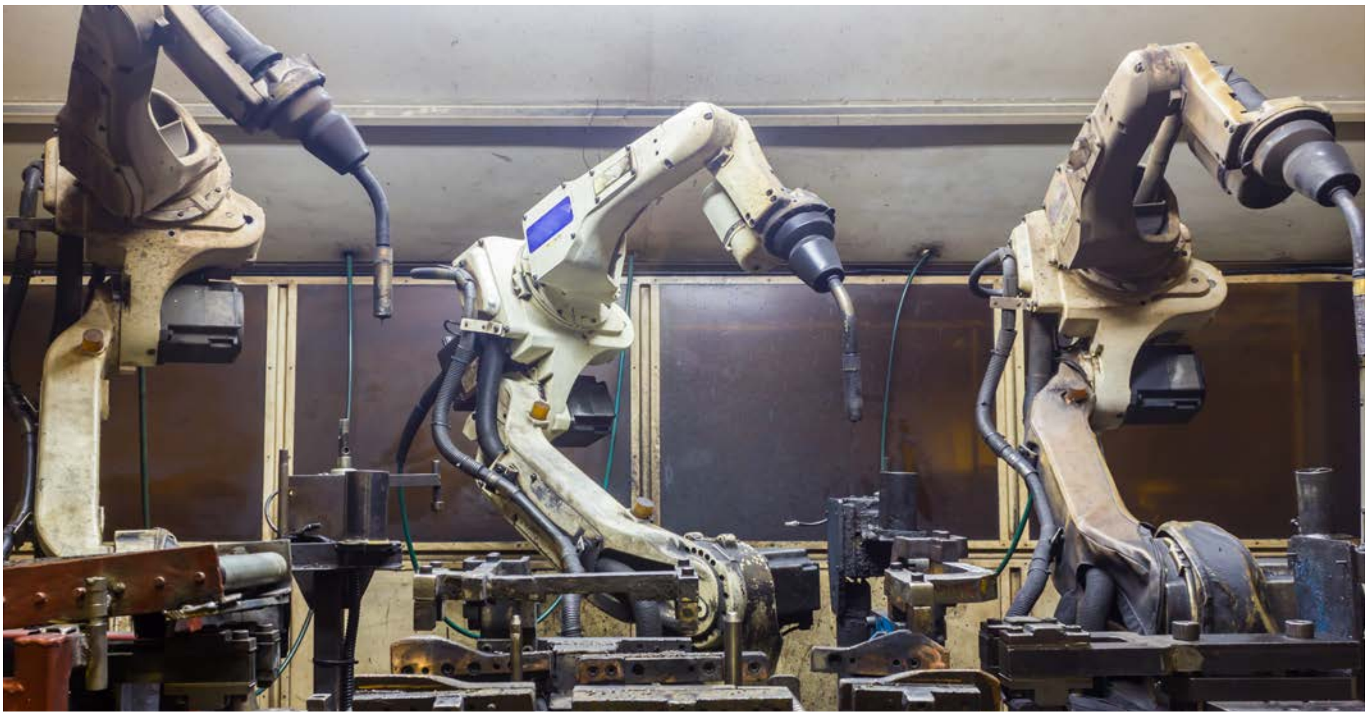
Although by no means conclusive, it would be reasonable to infer that new tech companies being born out of the computer revolution tend to be staff 'light' and don't require as many employees to deliver high profits to shareholders when compared to the more traditional ones. Unfortunately, it is these traditional companies that are probably going to be among the first to replace their staff with robots and automation. McDonald's employs 1.7 million people and Walmart employs 2.2 million!

This comparison between the new and the old corporation is an indicator of what is and will continue to happen across all sectors over the coming decades, which clearly does not bode well for society as a whole. Already, the rich-poor divide has never been greater in human history with the richest 2% of the population having as much wealth as the poorest 55%. Worse still, the richest 85 people are wealthier than the poorest three billion. This income inequality will be further amplified as more robots and computers enter the work force. Poverty ultimately leads to social instability, even in the developed world, so everyone will be affected, even the rich. What can be done to avert a future breakdown in society where mass unemployment abounds?

Is there a solution?

Of all the economic models, a capitalist-derived system based on private ownership, production and profit has been the most effective at building national wealth and improving the quality of life of citizens. But what happens as we approach an era in which production is automated? The owners of production (the rich) will reap all the prof-

> "IN A POST-WORK ERA, OUR CURRENT ECONOMIC SYSTEM WOULD NEED AN OVERHAUL."



> "NEW JOBS WILL EMERGE THAT DO NOT EXIST IN ANY FORM TODAY. LUCKILY, THE TRANSITION TO A TOTALLY AUTOMATED WORLD WILL TAKE MANY DECADES, GIVING US TIME TO ADJUST AND ADAPT TO SOME OF THESE CHANGES."

its, leaving everyone else out of the loop, and the rich-poor gap will continue to widen until some rift or breaking point in society occurs. Adopting a wait-and-see approach is probably not the wisest course of action, although policymakers often react like deer staring at the headlights of an oncoming vehicle when faced with global dilemmas, with climate change being a good example. So what can be done to avert this scenario?

In a post-work era, our current economic system would need an overhaul. Without human workers, governments would suffer huge revenue shortfalls as money collected from payroll tax, income tax and VAT diminishes over time. To offset against this, governments could impose a tax on companies that use robots based on how many units they have or how productive they are. Countries could compete for companies to establish production facilities in a similar way that they do today with corporation tax rates.

But even if governments were able to introduce such new taxes to offset against those previously collected, what should they do about the mass of unemployed and poverty-stricken workers?

One radical idea is to introduce a guaranteed monthly income to all citizens. This would at least ensure that each person is able to afford food and basic accommodation regardless of their plight. Obviously the existing welfare system would need major reform as part of this change. People would then be free to pursue any career or higher learning ambitions they may have. Any income earned through employment, investment or business enterprise would be retained by the individual and taxed at the appropriate rates.

Proponents of this approach believe that it would encourage entrepreneurial activity and innovation as people tend to take more business risk, safe in the knowledge of having a guaranteed basic income.

How today's jobs will change in the future

As more people find themselves replaced by machines in the coming decades, it may be possible for agile, skilled human workers to adapt their roles, working alongside robots. For example, let's take the role of a surgeon: as the number of types of procedures performed by robots increases, the surgeon's role would require less cutting and more supervising and troubleshooting, ensuring that everything is working smoothly with his team of surgical robots. Over time, a surgeon's role will continue to migrate up the difficulty scale, performing the more unusual procedures that robots are still not capable or certified to do.

Take also the role of drivers. It is estimated that 10% of today's jobs in the US are driving-related. It is likely that this percentage is similar in the UK. Although over the next couple of decades these jobs will be replaced by driverless vehicles, new job roles in this sector will almost certainly emerge. It is hard to envisage today what these roles might be, but they may involve working in a centralised network monitoring centre to troubleshoot traffic accidents or vehicle malfunctions – a sort of hybrid between a call centre and an air traffic control centre. There may also be remote human override centres run by vehicle manufacturers to handle anomalies that are beyond the capability of the vehicle's decision-making algorithm.

Of course, given a long enough time horizon, pretty much all of today's jobs will be automated or performed by robots, but as a consequence of this, new jobs will emerge that do not exist in any form today. Luckily, the transition to a totally automated world will take many decades, giving us time to adjust and adapt to some of these changes.

Threat to humanity

How seriously should we take the perceived threat of artificial intelligence to humanity in which a "Terminator" movie-style apocalypse wages war on us humans? The key to whether this could become a reality hinges on whether computers will be able to develop self-awareness, or consciousness, at some point in the future. Given that we still can't define scientifically what self-awareness actually is, it would be rather challenging to write an algorithm for it. However, the human brain comprises 86 billion neurons each with hundreds of thousands of synapses. As large as these numbers are, they are finite and eventually with enough computer processing power, it will be possible to replicate the human brain in some form. However, I don't believe we will reach this milestone until at least mid-century. By that time, we humans will likely be augmented with certain types of organic-based brain implants or 'upgrades', such as the ability to speak different languages, or the ability to excel at certain sports or disciplines.

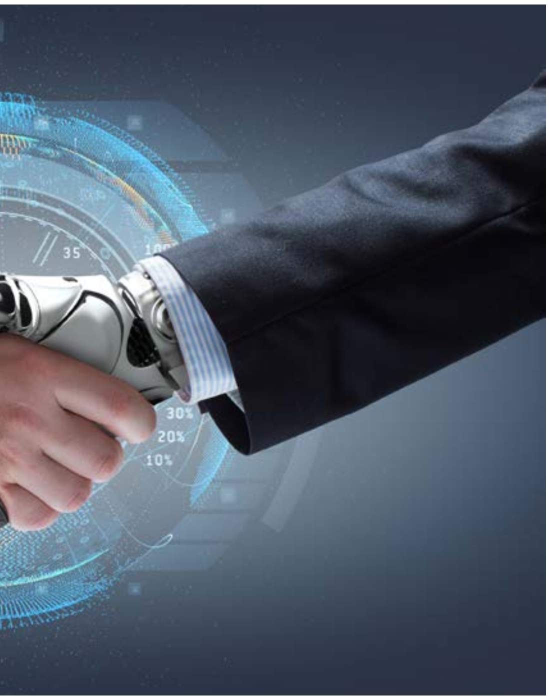
So for the next 35 years or so, we only have to worry about robots stealing our jobs rather than taking over the world. And by the time computers develop self-awareness, I'd like to think that we will have achieved it in a manner that is compatible with humanity coexisting alongside.

The investment opportunities

The use of automation to replace human workers is an irreversible trend and no one can future-proof their job. For those well into their working lives, the chances are that you will manage to get to retirement before you are replaced by robots. For those starting out in the work place, be aware of the coming changes and try to find a way to adapt your role to still be relevant. At the same time it would be wise to include in your investment portfolio some equity in companies that are leading the charge in the robot revolution. Given how fast this industry is moving, it would not be surprising if some of the big players in automation in 10 years' time have not even been incorporated yet. However, we can invest in today's industry leaders as they will likely remain in a strong position in the coming years.

The current macro-economic uncertainty does not serve as an ideal backdrop for investing in equities, so it may be wise to build positions in these companies gradually to smooth out any market volatility say, over a four- to six-month time period. I'm going to suggest a number of companies, all very well-established and each specialising in a certain area of automation, such as industrial, medical and military. These companies have large R&D budgets to

"IT WOULD BE WISE TO INCLUDE IN YOUR INVESTMENT PORTFOLIO SOME EQUITY IN COMPANIES THAT ARE LEADING THE CHARGE IN THE ROBOT REVOLUTION."



> **"INTUITIVE IS IDEALLY POSITIONED TO TRANSITION TOWARDS BECOMING A MAKER OF AUTOMATED SURGICAL SYSTEMS WITHIN THE NEXT DECADE."**

further their technology, as well as the cash to acquire other companies that may develop superior or complementary technology to their own.

First up is **Fanuc Corporation (TYO:6954)**, listed on the Tokyo Stock Exchange. This is a solid company that is well-positioned to capitalise on the growing trend in factory automation. It has taken a beating in the recent market wobbles and is now around 25% cheaper than it was a year ago. With a dividend yield of 4.5% and a PE ratio of 18, this is a must have stock in any robotics portfolio.

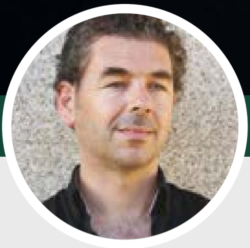
In the medical field, there is NASDAQ-listed **Intuitive Surgical (NASDAQ:ISRG)**, the maker of the market-leading da Vinci Surgical System, a high-precision surgical apparatus that provides minimally invasive surgical procedures. The system comprises a number of mechanical probes controlled by a surgeon through a console with a high definition screen. Intuitive Surgical was the first company to be granted FDA approval for general laparoscopic surgery back in 2000. Today it is in use across 64 countries, with the US being its largest market covering all 50 states. The company is currently on its fourth generation system called the da Vinci Xi, offering surgeons more precision and control.

With a $20 billion market capitalisation and an extensive track record in minimally invasive surgery, Intuitive is ideally positioned to transition towards becoming a maker of automated surgical systems within the next decade. Its access to capital will also allow Intuitive to make strategic acquisitions should it spot a technology that could boost its own system's capability.

The US military spends $600 billion on defence annually and the top three beneficiaries of this enormous government spending in 2015 were **Lockheed Martin (NYSE:LMT)**, **Boeing (NYSE:BA)** and **BAE Systems (LON:BA)**. Big US government contracts provide solid revenue and involve development in leading edge technologies, which often have lucrative private sector applications across a number of areas from space exploration to drones to augmented reality.

NASDAQ-listed **iRobot Corporation (NASDAQ:IRBT)** has a range of products for the home and the workplace. Its leading product, the Roomba (a robotic vacuum cleaner) has sold over 14 million units worldwide. The company is generating steady top line growth and has been profitable for a number of years. It is currently trading in the $30 range, which is roughly in the middle of its five-year high and low range. The company recently announced its 2015 revenues, which were $616.8 million. Net income for the year was also up to $44.1 million. It is a mass-market play in relatively simple and affordable labour-saving robots, so in this respect the company should see steady growth provided that it continues to innovate and enhance its products. Its home robots account for 85% of its revenues, which is evenly split between domestic (US) and international sales.

Finally, it would be remiss of me not to mention **Alphabet (NASDAQ:GOOG),** formerly Google. With so many fingers in so many pies, it could already be considered a diversified robotics and automation portfolio in itself, with other businesses thrown in. It is already a leader in driverless cars, artificial intelligence (Deep Mind acquisition) and robots (Boston Dynamics acquisition). Alphabet is well-positioned for the present and the future.



BY FILIPE R. COSTA

ECONOMICS CORNER

WILL AUTOMATION UNLEASH MASSIVE UNEMPLOYMENT?

A new era

Technology is now an integral part of our lives. We use computers at the office to help expedite our tasks; we use tablets and smartphones to stay tuned when out of the office; we withdraw money from ATM machines; we validate travel tickets through machines; and we drive cars that were mostly made by robots. The automation of tasks is not a new process. In reality it started with the Industrial Revolution in the 19th century, where machines replaced artisans. But the process is gathering pace and we are all being replaced by a new intelligent machine that threatens to make us all obsolete. While the computerisation of the economy will expand the output capacity of the global economy, it will also create several risks for the labour market. According to two Oxford researchers – Carl Frey and Michael Osborne – 47 per cent of US workers have a high probability of seeing their current tasks automated over the next 20 years. That being true, massive displacement is expected in the labour market, which may lead to income redistribution issues and eventually depress the economy. A question then arises: *will the coming robot-era unleash massive unemployment?*

Digging into the data

In 1750, artisanal skills were heavily in demand in England. By then, the best tools available were human hands. But with the Industrial Revolution that took place during the 19th century, artisanal work was replaced by factory work, where the use of machines and labour specialisation led to mass production. During the 1980s most repetitive jobs that were created in the Industrial Revolution era were then replaced by machines. While requiring a high initial investment, machines do not get bored of performing repetitive tasks, don't need a lunchtime break and can work without interruption during the weekend. As a result, productivity rose, freeing up resources for other activities.

Thirty years later, scientists expect machines to eventually outperform humans in almost any task, not just those repetitive tasks that don't involve human dexterity. Intelligent machines are proliferating and they're being equipped with ever more refined systems. Companies like Microsoft, IBM, Google (Alphabet), and Facebook, have already invested billions in developing artificial intelligence projects. Today's companies have a tenth of the number of employees similar companies had in the 1960s for each unit of market value or sales they command. Companies inside the technology sector are able to generate millions of dollars in sales per employee, mostly due to the use of computer systems.

LABOUR PRODUCTIVITY IN SELECTED COMPANIES

Company	Market Capitalisation (in Billion USD)	Sales (in Billion USD)	Nr. Of Employees	Market Capitalization per Employee (in Million USD)	Sales per Employee (in Million USD)	Sector
Alphabet	487.6	75.0	61814	7.9	6.5	Technology
Yahoo	27.7	4.9	12500	2.2	5.7	Technology
Facebook	299.4	17.9	12691	23.6	16.7	Technology
Linkedin	14.7	3.0	9372	1.6	4.9	Technology
Netflix	40.6	6.8	3900	10.4	6.0	Services
Ebay	24.4	8.6	11600	2.1	2.8	Services
Twitter	11.9	2.0	4200	2.8	6.0	Technology
Alcoa	11.2	23.7	59000	0.2	0.5	Basic Materials
Goldman Sachs	64.4	34.2	36900	1.7	1.9	Financial
Coca-Cola	189.1	45.2	129200	1.5	4.2	Consumer Goods
Exxon Mobil	341.4	296.4	75300	4.5	1.2	Basic Materials

Source: Morningstar

As an example, Facebook generates \$16.7 million (£11.7 million) in sales per employee, Alphabet generates \$6.5 million (£4.5 million), and Yahoo \$5.7 million (£4.0 million). Companies in other sectors are less reliant on computerisation and therefore generate a much lower level of sales per employee, as in the case of Alcoa.

"TODAY'S COMPANIES HAVE A TENTH OF THE NUMBER OF EMPLOYEES SIMILAR COMPANIES HAD IN THE 1960s FOR EACH UNIT OF MARKET VALUE OR SALES THEY COMMAND."

But while computerisation seems to work well inside the technology sector, it is expected that intelligent machines will also spread to other sectors over the not-too-distant future. Tesla Motors, for example, has a large artificial intelligence programme aimed at developing self-driving cars. These cars can cut accidents by 90% or more while erasing the need for a driver. Scientists believe self-driving cars will take to the roads in the next 25 years. When that happens, they will put the 10% of US jobs that involve driving a vehicle at stake. This pattern is alarming, as it may lead to a massive dislocation in the jobs market.

The arguments for replacing humans by machines are compelling. Humans are prone to error, expensive, and inconsistent. Machines, on the other hand, require an upfront investment but can complete tasks endlessly with little maintenance and in a homogeneous way. With the industry now growing, robots will become widely available, cheaper and more capable, and will take on more jobs in place of humans.


Dong liu/Shutterstock.com

The use of industrial robots is expanding at a huge rate. In 2013, there were 1.2 million robots around the world. In 2014 the number had grown to 1.5 million, and in 2017 their number is expected to increase to 1.9 million. Japan leads the world with 307,000 robots, followed by North America with 237,400, then China (182,300), South Korea (175,600) and Germany (175,200). They're heavily used in the auto industry, for example. But even companies like Amazon are now studying ways of automating tasks inside a warehouse, where a robot with the ability to select items and move them around can help reduce a staff of 50,000 to just a few hundred.

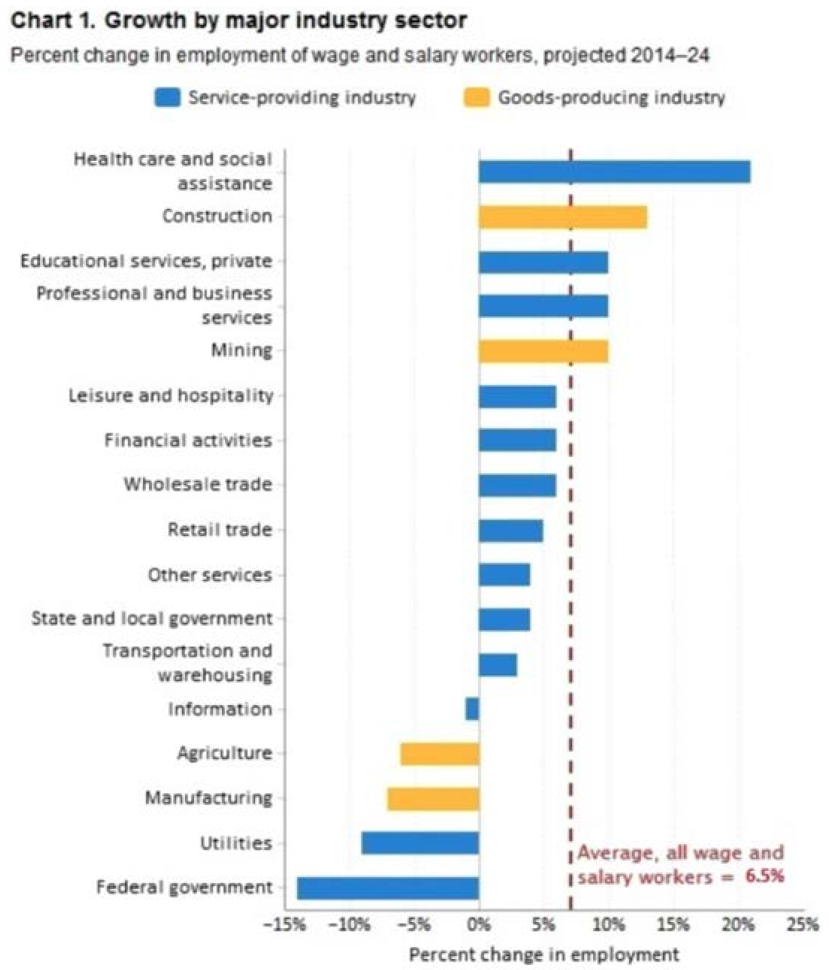
Automation has also arrived to financial markets. Most financial instruments are available for electronic trading, which allows us to purchase almost anything with just a few clicks and in just a few seconds. There is also the advent of high frequency trading that performs automatic trading based on computer algorithms. Another example of automation comes from the treatment given by Associated Press to corporate profits reports. They used to assign journalists the task of collecting data from Zacks Investment Research and rewriting information to publish around 300 profit reports per quarter. They now use the technology provided by Automated Insights, which automates the process by generating short stories of around 150 to 300 words as soon as the information arrives on the Zacks database. They now provide 4,400 reports per quarter, allowing journalists to dedicate their efforts to different tasks like analysing and discussing on the numbers reported.

There's no doubt automation has arrived in almost every sector of our economy. But it has failed to steal many office jobs up to now. These jobs require complex interactions that are not easily codified. A computer can be trained to beat Kasparov at chess, but it is much more difficult to train a computer with the human senses that are integral to office tasks. But as technology develops, robots will no doubt become better equipped to replace humans here as well.

Not all jobs are created equal

The US Bureau of Labour and Statistics (BLS) usually publishes a report with employment projections based on current and expected trends in the jobs market. According to their latest projections for the period 2014-2022, 15.6 million new positions will be created in the period, representing growth of 0.5% per year in the labour force. Healthcare occupations and related industries are expected to experience the fastest employment growth and to add the most jobs. These industries are expected to grow mainly due to the effects of an ageing population. The positive trend in healthcare and social assistance is confirmed in many academic studies that see job positions in occupations related to this industry expanding over the next few years. However, manufacturing, agriculture, utilities and federal government will all be impacted negatively.

While useful to understand important trends, the BLS report falls short of taking account of the full impact stemming from the automation of the economy. With that in mind, a study conducted by Carl Frey and Michael Osborne (2013) better identifies the particular trends expected in occupations. The Oxford researchers examine



Source: U.S. Bureau of Labor Statistics

"TELEMARKETERS, CARGO AGENTS, TAX PREPARERS, DATA ENTRY SPECIALISTS AND LIBRARY TECHNICIANS ARE A FEW EXAMPLES OF OCCUPATIONS WITH A 99 PERCENT PROBABILITY OF AUTOMATION."

the impact of automation in 702 occupations to estimate the probability of automation in each case.

Frey and Osborne's model predicts that most workers in transportation and logistics occupations, as well as the bulk of office and administrative support workers and labour in production occupations, are at risk. Telemarketers, cargo agents, tax preparers, data entry specialists and library technicians are a few examples of occupations with a 99 percent probability of automation. The researchers claim that many services occupations, where most employment growth has been occurring in the US, are at stake too. At the opposite end of the sprectrum are several supervisory activities that require judgement, are highly subjective, and rely on creative and social skills. In the past, automation hit the middle classes, pushing some people without the required skills down the scale; but according to Frey and Osborne, this time those on the lowest wage brackets and with the lower skills are the ones expected to be affected the most by automation. Their occupations will be completely replaced by robots and computers. Those who have higher skills will likely keep their jobs.

Some final comments

The world is changing fast. In 20 to 25 years, we will most likely face roads filled with driverless cars and most tasks will be fulfilled by a new generation of robots and computer systems. While in the past the automation process served to replace humans in repetitive tasks, it now goes deeper, as robots are able to recognise patterns and offer a ready substitute for labour in a wide range of non-routine cognitive tasks. Advances in technology have allowed scientists to enhance senses and dexterity in robots in order to allow them to perform tasks they couldn't previously. This means that many jobs will be lost in the future.

Two important points should still be made. First of all, automation is expected to lead to a huge improvement in productivity, which will allow us to reach much higher output levels. If less time is required to complete a task, or if there is no longer any need for human intervention in that particular task, then people will move on to other tasks. In the past, when new technologies arrived, some jobs ceased to exist but others have been created. There's no reason to believe this time will be different and that jobs will be lost forever. Second, while new jobs surface and others submerge, a dislocation is likely to occur. If robotisation/computerisation occurs relatively fast, society may lag, supplying a disproportionate workforce for obsolete occupations. If that happens, then huge redistributions of income will occur and social unrest could emerge. Those working in occupations with lower wages and requiring fewer skills are more exposed to these problems. The best chance for all of us is to acquire creative and social skills, which are more difficult for a robot to replicate.

PROBABILITY OF COMPUTERISATION (FROM LEAST- TO MOST-COMPUTERISABLE)

Rank	Probability	Occupation
1	0.0028	Recreational Therapists
2	0.0030	Mechanic Supervisors
3	0.0030	Emergency Management Directors
4	0.0031	Mental Health Social Workers
5	0.0033	Audiologists
6	0.0035	Occupational Therapists
7	0.0035	Orthotists and Prosthetists
8	0.0035	Healthcare Social Workers
9	0.0036	Oral Surgeons
10	0.0036	Supervisors of Fire Fighters
11	0.0039	Dieticians and Nutricionists
12	0.0039	Lodging Managers
691	0.9900	Data Entry Keyers
692	0.9900	Library Technicians
693	0.9900	New Accounts Clerks
694	0.9900	Photographic Process Workers
695	0.9900	Tax Preparers
696	0.9900	Cargo Agents
697	0.9900	Watch Repairers
698	0.9900	Insurance Underwriters
699	0.9900	Mathematical Technicians
700	0.9900	Hand Sewers
701	0.9900	Title Examiners
702	0.9900	Telemarketers

Source: Frey & Osborne (2013)

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BY VICTOR HILL

OPPORTUNITIES IN FOCUS

EUROPEAN BANKS: PLEASE ASSEMBLE AT THE MUSTER STATION

We really do hate to interrupt your cruise. But there's a rumour that a keen-eyed crewman on the bridge has spotted an iceberg. No, it's worse than that, actually. Some of the crew are whispering that we've already hit an iceberg. But it's just a small one, apparently. Anyway, don't panic. Just keep that life jacket under your arm during the cabaret...

Many people first became aware that something was awry in the European banking sector when, on Monday, 08 February, shares in the German giant Deutsche Bank fell by nearly nine percent and then by a further five percent the following day, hitting a *thirty-year low*. Deutsche Bank perambulated its CFO who announced that bondholders should have no fear. But German Finance Minister Wolfgang Schäuble still had to go on Bloomberg to say that he had "no concerns about Deutsche Bank". That's unusual – particularly in Germany.

The sell-off took place after the unremarkable announcement that the bank would have to write down some loan exposures for the last quarter of 2015. It seems that some of these are related to the oil and commodity sectors. But that was not the proximate cause. It seems that the stock market was convulsed by fears that Deutsche Bank did not have sufficient funds to meet interest payments on hybrid instruments that it uses to bolster its capital base. The bank, which has been the subject of takeover speculation in the German press, of course paraded all the latest glossy statistics on the level of its Tier One Capital in an attempt to allay such fears.

In fact, shares in the European banking sector are having an even worse year than the Shanghai Index overall – some banks worse than others. On 15 February the STOXX Europe 600 Banks index was down by 28.26% over 52 weeks; but down by nearly 22% in the first six weeks of 2016[i]. In contrast, the STOXX USA 900 Banks Index was down by 13.22% over 52 weeks and by 15.83% year to date. Mind you, Japanese banks have fared worst of all, losing about one third of their value this year.

Deutsche Bank hit the headlines because of its symbolic prominence as the most enduring bank of Europe's largest economy – though its shares then bounced back by ten percent on Wednesday, 10 February when it announced plans to launch a bond buy-back programme. (Another very unusual move, by the way.) In fact, the entire sector has become jittery. Why?

If you believe that markets move for a reason there is always, at bottom, a reasoned explanation. It seems that Mr Market thinks that – sooner rather than later – in a world of bombed-out commodity and oil prices (itself a foretaste of the threatened *global deflation* about which

"ON 15 FEBRUARY THE STOXX EUROPE 600 BANKS INDEX WAS DOWN BY 28.26% OVER 52 WEEKS; BUT DOWN BY NEARLY 22% IN THE FIRST SIX WEEKS OF 2016."

"ACCORDING TO RECENT RESEARCH FROM OLIVER WYMAN, EUROPEAN BANKS ARE CARRYING MORE THAN €580 BILLION IN NON-PERFORMING LOANS (NPLS)."

I wrote last month) one of those big commodity and or oil majors is going to go pear-shaped. What's more, sovereign default is back in the frame. This time it's not just Greece (which is still in trouble) but oil-dependent states like Venezuela.

And when the defaults occur, lenders will take massive hits. In fact, there could be lenders which fail as a result. And when one bank fails, there is the risk of contagion, or, as economists have it, *systemic crisis*.

But is it really possible that after all we went through during the Credit Crunch of 2008 (not to mention its prequel (Northern Rock, Bear Stearns etc.) and sequel (sustained recession)), the bailouts, banking reforms, Basel III, *pro-active prudential regulation*, quantitative easing, the European Sovereign Debt Crisis, the Greek, Portuguese and Irish bailouts, debt work-outs and pious words… *that we could be back to 2008 with a banking system about to go into melt-down*? I can hear John McEnroe screaming: You cannot be serious…

Well, I'm afraid that it is *possible*, for reasons I shall explain – though not very *probable*. The real point that I want to make is that the banks' best days are behind them.

It is true that those commodity outfits are bombing. On 10 February – the day that Deutsche Bank bounced back – miners listed on the FTSE-100 endured a drubbing. Anglo American was down almost 10% at 339.20p, Antofagasta was down 8.9% at 412.90p and Glencore was down more than 7.3% at 95.28p. Their one-year charts all look like a suicide leap.

Yet unlike in 2008 the household sector is robust. Consumers, especially in the US, have more savings and less debt than eight years ago. Back in 2008, the average US household saved only 2.5% of after-tax income; today it's about 4%. Household debt as a percentage of net worth (a sort of personal sector debt to equity ratio) hit 65% during 2009, today that figure has fallen to 36.5%. The average debt service as a percentage of income has fallen to 15% today from 20% in 2009. So households are in a stronger position today than they were when the last crisis hit. That means consumer spending should remain robust for the foreseeable future, which

should continue to drive the economy. And yet the warning lights have been flashing for months on the central bankers' dashboards. But the underlying dissonance in the European banking sector has been muted by the orchestral volume of the European Central Bank's QE programme, conducted by Signor Draghi. Though, it is in Signor Draghi's home country that the banking system is in the most advanced state of decay.

According to recent research from Oliver Wyman, European banks are carrying more than €580 billion in non-performing loans (NPLs)[ii]. Italy holds the largest stock of NPLs at €161 billion or eighteen percent of the total – with SME loans making up 78% of Italy's NPLs. This compares with a level of about eight percent in Spain. And by the way, there are still issues around precisely when a loan asset is designated an NPL. This leads me to think that these numbers could be underestimates. (Indeed, researching this article, I have found that there are glaringly incompatible figures in circulation.)

Several Italian banks have already hit the crash barriers. In Q4 2015 four Italian savings banks were recapitalised, partially or wholly by means of *haircuts* for depositors. Prime Minister Matteo Renzi forced depositors to bear losses in bank restructurings. Remember that when taxpayers pay the price of rescuing a bank, that's called a *bail-out*. But when depositors are penalised in order to rescue a bank, that's called a *bail-in*.

Taxpayers, mind you, don't commit suicide as a result of bail-outs; whereas depositors who have lost their life savings due to *bail-ins* sometimes do. This has cost Signor Renzi popularity.

Despite government measures, there is very little by way of a secondary market for impaired debt in Italy. Hence the *Banca d'Italia* is calling for a bad bank – a special purpose vehicle designed to purchase and dispose of NPLs on the Irish model. Yet Prime Minister Renzi has found it politically impossible to realise this.

Under the EU Bank Recovery and Resolution Directive (BRRD, 2014) shareholders and creditors of a failing bank must be bailed-in before any state funds can be mobilised to recapitalise a bank. Shareholders and junior bondholders are hit first, followed by senior bondholders and depositors with balances of more than €100,000. The aim of the Directive was of course to move the pain of bank recapitalisation from governments to banks' investors and savers. But because many junior bondholders in Italy tend to be retail investors – who have been encouraged to enhance yield by buying bank bonds – many depositors are also bond investors, and so are doubly penalised.

In July 2015, when a small mutual bank, the Banca Romagna Cooperative (BRC), ran into trouble, the Italian government's first instinct was to use funds from the national Deposit Guarantee Insurance Fund to inject new equity. But this move was prevented by Brussels. Instead, the entire cost of the recapitalisation was borne by shareholders and junior bondholders.

Then, on November 22 last year, just before the EU directive came into effect, the Italian Bank Resolution Fund, (which is funded by the country's healthy lenders but guaranteed by the state-owned *Cassa Depositi e Prestiti*), paid €3.6 billion to restructure another four small banks: Banca Etruria, Banca Marche, Carichieti and Carife. €1.6 billion was paid to buy up a slew of NPLs and to shove them into a hastily formed toxic bank. The remaining €1.75 billion was invested in the banks' equity capital. Even so, 12,500 small investors who owned €430 million in junior debt had their investments wiped out. One elderly pensioner hanged himself[iii].

The government rushed through the hybrid rescue package before the new regulations took effect because it feared that a full *bail-in* of the four banks could have triggered a bank run throughout the country. It was forced to impose losses on some retail investors after the EU rejected an alternative scheme that would have spared them, saying it violated EU state aid rules.

"ITALY HAS THUS FAR BEEN UNABLE TO ATTRACT THE HEDGE AND PRIVATE EQUITY FUNDS SUCH AS CERBERUS AND APOLLO WHICH OBLIGED, FOR EXAMPLE, LLOYDS BANK AND ROYAL BANK OF SCOTLAND IN THE UK."

Banca Etruria, based in Arezzo, Tuscany, was the only one of the four to have been listed on the Rome bourse, so should have displayed greater transparency. The four banks were put up for sale by the Banca d' Italia in late January with Oliver Wyman as the advisor. So far, there are no takers.

In late January this year attention was focussed on Italy's oldest bank, *Banca Monte dei Paschi di Siena* (BMPS), which goes back to the age of the Medici. After it failed a so-called Asset Quality Review conducted by the ECB in late 2014 it won regulatory approval to restructure. In May 2015 it raised €3 billion in new share capital. But since then it has failed to offload much of its €42 billion in bad loans (about 31% of its total loan portfolio). The bank's share price has fallen by more than two thirds since the May 2015 share issue.

In 2012, Italian households held more than €370 billion of junior bank bonds. Hitherto, bank bonds have accounted for 40% of retail investor portfolios in Italy, but now Italian investors have woken up to the increased risks. Many

investors have declared that they were not alerted to the risks involved. Prime Minister Renzi has admitted that some of the bonds might have been mis-sold, and has set up a €100 million compensation fund. Regulators are now calling for a ban on the sale of junior bank debt to retail investors.

It is fair to say that both the popularity of Signor Renzi's government and that of the EU have been damaged. Italians are already aggrieved by the migrant crisis and by the refusal of the EU to permit the state to prop up Italy's ailing steel industry. Euro-scepticism is clearly not a British monopoly.

Italy has long maintained a network of tiny local banks which have served not only as financiers but as wealth advisers for families around the country. Despite some consolidation of the banking industry in recent decades, Italy still has about 650 lenders – probably the highest number in Europe. Anecdotally, poor governance is common. The Italian banking sector is further undermined by the inefficacy of the judicial system, which is notoriously slow and often stymies the swift settlement of bankruptcy disputes.

In the last week of January, Italy and the EU struck a deal to approve a new government guarantee scheme that will help rid the country's banks of their huge NPL piles. Investors were unimpressed, and bank shares fell. Italy has thus far been unable to attract the hedge and private equity funds such as Cerberus and Apollo which obliged, for example, Lloyds Bank and Royal Bank of Scotland in the UK when they wished to discard their dross (at a deep discount to book, of course).

Portuguese bank shares have also tumbled not least because the new left-of-centre coalition government spooked the market by imposing losses on senior bank bonds last December. And let's not even think about Greece where bank shares have fallen by 60% this year.

The new EU directive owes more to what happened in Ireland during the Credit Crunch than anywhere else. In the middle of the post-Lehman Brothers market meltdown in September 2008 the Irish government offered blanket guarantees to all bank creditors. This was partly a response to the more hesitant stance of the UK government; but it had global consequences – and Ireland paid a very high price. The entire Irish banking sector had to be bailed out to the tune of €64 billion or about one third of the country's total GDP at the time. All of this money came from the Irish government, which in turn had to be bailed out by the EU in 2010.

Another concern in the European banking sector is the rise and rise of so-called CoCo bonds which count as *Additional Tier 1 Capital*. These are bonds which can be converted into equity in a crisis, or *contingent convertible bonds*. Though they are untested, they currently offer a cheaper alternative to equity capital. The total size of the CoCo Bond market is now estimated to be close to the volume of sub-prime mortgages floating around in 2007, although in my view the comparison is not illuminating.

Then there are the ongoing fears that some European banks – Deutsche Bank included – will face more litigation and fines from regulators. This is on top of arbitrary taxes and negative interest rates (now official in countries like Switzerland and Sweden). As recently as last November Barclays was fined £72 million by the FCA for failing to minimise the risk of financial crime. That's another reason why it is becoming more difficult for ordinary citizens to open a bank account.

Another factor is that exposure to bank stocks seems to have been increasingly skewed of late to Exchange Traded Funds (ETFs). Thus you can get exposure to the banking sectors of almost any European country, or all together, by buying into these vehicles. But, because they are leveraged, they tend to be volatile.

One narrative that has been rehearsed of late is that banks simply cannot flourish in an environment of super-low rates. The idea is that the higher rates, the higher bank margins and therefore

"EUROPEAN BANKS ARE UNDER STRESS, BUT MOST COMMENTATORS WILL ARGUE THAT THEY ARE PROBABLY NOT AS DANGEROUSLY EXPOSED TO WIDESPREAD DEFAULT AS BACK IN 2008."

the higher the bottom line (*net interest income*). But this is only true is certain cases. In times of super-low rates like now banks can reduce their cost of funds to negligible levels. Just consider what returns you receive on your savings account. You will be lucky to get a half of a percent. But your bank can lend your savings out as a residential mortgage for a house-buyer at around four percent right now. So the bank is still turning three and a half percent on the deal – and for a relatively low-risk form of secured lending. If the cost of funds was twelve percent and the interest charge on mortgages fifteen and a half percent, they would be making just the same net interest income.

Yes, European banks are under stress, but most commentators will argue that they are probably not as dangerously exposed to widespread default as back in 2008. And they have been put under pressure by regulators to strengthen their capital bases. They have achieved this by, in many cases, shrinking their loan books, or by issuing new equity, or by a combination of the two. And it is true, on paper at least, with a few exceptions, that their capital ratios look robust. Most large banks now have tier one capital ratios in the low to mid-teens. RBS's Common Equity Tier 1, for example, is around 15% and, according to the Bank of England's recent stress tests, would fall to a low but not critical 6% in a crisis. RBS's core capital ratio in 2008 was just 4%.

But actually – this is still a subject of debate – the 2008 Credit Crunch was not just due to banks having inadequate capital: it was also a *liquidity crisis*. That was why regulators, not least the Financial Services Authority (FSA) in the UK, took steps to ensure that banks carried sufficient *liquidity cushions* at all times to withstand a major liquidity crisis. These measures were further elaborated in the Basel III provisions put forward by the Bank of International Settlements (BIS) based in Basel, which is a kind of club of all the major central banks. Further, the Basel III provisions were effectively made European law by the EU Capital Requirements Directive IV (CRD4, 2011) and by an attendant instrument called the Capital Requirements Regulation (CRR), otherwise known as the *single rulebook*.

So banks now have to keep adequate capital buffers against losses *and* liquidity buffers in case the credit markets seize up as they did in September 2008. The adequacy of both the capital buffers and the liquidity buffers is determined by adherence to strict ratios. In the case of liquidity, banks have to show that they have unencumbered *high quality liquid assets* – that is assets that can be converted into cash quickly – sufficient to cover all net cash outflows in the event of a hypothetical "stress scenario" (that is, a crisis). There is always, of course, an opportunity cost to additional liquidity.

Global stock markets have been falling throughout January and February not because of explicit concerns about the banking sector but because of the downturn in global economic growth, which began in China. (Mind you, China's current problems originated from its government's intervention in the banking system to crank up lending artificially). Most pro-market economists think that the stock market itself is a fairly good bellwether of where the global economy is going. And an economic downturn means an increase in corporate and personal default rates: and that means more losses for banks.

Before the Credit Crunch of 2008 the banks had enjoyed more than twenty years of faster growth than the global economy as a whole, and the share of financial services as a percentage of the total economy in both the US and the UK – and elsewhere – had risen to record levels. This crisis – if it is one – follows seven years of bank deleveraging in which the role of the financial sector has relatively declined. More rigorous prudential regulation – those capital and liquidity buffers – plus the decline of lucrative instruments (and fraudulent practices – vide the LIBOR scandal) have attenuated banks' return on equity. It is no longer the favoured sector that it once was.

Banks are also facing new competition from alternative funding sources, not least peer-to-peer lending (P2P) and crowdfunding, though even those *unicorns* at Silicon Roundabout funded by private equity and P2P debt still need banking services.

And consider this. Those all-important capital cushions are made up of either retained earnings or common equity. When the banks were raking in huge profits, they were also building up their capital buffers rapidly. In the anaemic environment of Post-Credit Crunch banking, with earnings down, their capacity to top-up those capital buffers every year is reduced. That means that many banks have had to resort to rights issues – to the tune of €250 billion for European banks over 2007-14. But reduced profit combined with more shares in circulation – that's the classic recipe for a fall in share prices.

There has been a lot of froth in the financial media in recent weeks as to whether we are back to 2008. I don't think so – this is 2016. But in some ways, while a systemic banking collapse in Europe is, in my view, unlikely, the outlook for banks is gloomy. They have become stable state companies (about which I wrote in my blog article of 15 December last year – *Investors Should Understand the Company Lifecycle*). Their prospects for growth and expansion are less favourable than for the economy as a whole. Therefore, the main motive for holding their shares is the dividend income to be obtained. Woe betides banks – like Deutsche Bank – which cancel their dividend.

On a macro level you don't have to be a pessimist or a cynic to doubt whether the new stricter bank risk management framework will make much difference in the long term. The banks are still using risk models which (without getting technical) rely on the predictive capability of past default data *assuming that it is normally distributed*. (In other words – the data conforms to the mathematics of the *Bell Curve*.) In this model, events which represent six standard deviations away from the mean simply cannot happen.

"THE VIEW IN THE CITY IS THAT THE NEW-STYLE BANKING REGULATORY REGIME IN THE UK IS AT LEAST AS GOOD AS IT IS IN THE EUROZONE."

The problem is that freak losses do happen more frequently than they *should*. The stock market crash of October 1987 was, in risk model terms, a twenty standard deviation event. That's an event which is only supposed to occur a couple of times in the history of the universe. (Not really much consolation if you lost your shirt.) Brilliant minds like those of Taleb and Mandelbrot have explored precisely *why* these risk models don't work; but my point here is simply this: *they don't work, and the experts know they don't work*. Even the most sophisticated statistical risk models cannot accommodate *Black Swan Events*. They deal with *known unknowns*; whereas most risk resides in the *unknown unknowns* quadrant of the risk universe matrix.

In the same way, a buffer of *liquid* assets may not be a buffer at all if credit markets seize up and the bid-offer spread rises to gigantic levels, as in 2008.

And, by the way, the Credit Crunch – as Taleb has written – was *not* a black swan. It was predictable. It was a big fat ugly pigeon which all intelligent people could see would, sooner or later, crap on our heads.

The view in the City is that the new-style banking regulatory regime in the UK is at least as good as it is in the Eurozone – where the Capital Requirements Directive has been universally adopted. As I write, Sir John Vickers, who previously served as Chief Economist at the Bank of England and chaired the Independent Commission on Banking (ICB) (though it is unclear whom he represents now) has proposed that banks' so-called *countercyclical buffers* (which are held additionally to Core Tier 1 Capital) should be increased from 2.5% to 3%[v]. To the layman this probably seems like medieval theology; but the point is that no one can come up with a universally accepted definition of how large bank capital buffers should be. It's more a matter of judgment than of mathematical calculation. So this tedious argument will never really go away.

But so long as risk aversion dominates the mind-set of nanny policymakers, the pressure on banks to bolster their capital will persist, and bank profitability will suffer accordingly.

Looking out on deck, I think we are about to be hit by a nasty wave. But there ain't no iceberg. *This is not a red alert. But please assemble at the muster station* – if, that is, you wish to join a jollier cruise. This one – the banking cruise – is going nowhere through choppy waters. And if I am right about the probability of global deflation setting in over the medium-term, as I argued in last month's *Master Investor Magazine* (*Deflation? It's behind you!*), then you can expect a long bout of sea-sickness too.

i https://www.stoxx.com/index-details?symbol=SX7P
ii **See:** http://www.consultancy.uk/news/3251/oliver-wyman-to-advise-on-sale-of-rescued-italian-banks
iii **See:** http://www.reuters.com/article/italy-banks-bonds-idUSL8N1490SJ20151221
iv **If any readers wish to investigate the theoretical background to this I would direct them to *The Black Swan* (Penguin, 2010 edition) by Nicholas Nassim Taleb and to *The (Mis)Behaviour of Markets* (Profile Books, first published 2004) by the late incredible genius Benoit B Mandelbrot. Note that Taleb dedicated *The Black Swan* to Mandelbrot. Mandelbrot, who developed fractal geometry, foresaw that in future better risk modelling might be achieved by the application of fractal mathematics – but we are still waiting for a breakthrough.**
v **See:** http://www.bbc.co.uk/news/business-35573225

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BY ADRIAN KEMPTON-CUMBER

TECHNICAL ANALYSIS CORNER

CARRY ON INTEREST RATES

If the Carry On franchise was still going, and they made this movie, you'd have Sid James as a Floor Manager of currency traders. Innuendo-a-mundo, like "Oh Sid, would you like to make a deposit?" "Maybe, Darlin'. Is there any penalty for withdrawal? Mwah ha ha ha." "Quick, look at the screens. One of them's gone all red and another one's shooting up all over the place!" "You've been caught with your shorts off, haven't you?" "That's not an upside-down head and shoulders – it's a cock and balls!".

For those who aren't familiar, the Carry Trade is taking advantage of disparity in interest rates in different countries. Typically Japan has been a good place to borrow from, with very low interest rates for years now. That money could then be invested into places with higher interest rates, and some very stable ones at that.

Economic theory says this shouldn't work. It should only be a temporary phenomenon, and gains should be wiped out as the 'no arbitrage equilibrium' is restored. But that hasn't been the case at all. In fact, it can be shown that over time gains of 5%-6% have been achieved without having to do anything too sophisticated. It could be argued that over longer periods the bigger price shocks could wipe out longer term profits, but they don't often happen that quickly, so it would be quite possible to correct a strategy to take account of those corrections by simply staying out of the market during periods of adverse volatility.

The problem for smaller investors is, as always, access to the market. There have been money market accounts that take advantage of overnight deposit rates but you can't get in without a six-figure sum, and even then you will have to pay charges. CFD and spread betting has done a lot to level the playing field, but making money on FX trades is not so easy as the advertising might have you believe. If you look at daily returns over any decent amount of time, then you will find that there are so few days that lie outside the main part of a normal distribution that you can't regularly make money greater than the cost of trading. But that assumes rules that one wouldn't apply to trades – i.e. being in the market from open to close. (FX markets make a nonsense of that by being 24 hour markets.)

> **"CFD AND SPREAD BETTING HAS DONE A LOT TO LEVEL THE PLAYING FIELD, BUT MAKING MONEY ON FX TRADES IS NOT SO EASY AS THE ADVERTISING MIGHT HAVE YOU BELIEVE."**


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So what we're looking for are changes brought about by changes in interest rates. There haven't been many of those in our neck of the woods since '09, but there have elsewhere. So I'm going to use the US dollar as the currency to borrow in, and the Aussie dollar as the one to make the gains on. So each time one of those rates changes I'll mark it on the chart and show the new rate, and we'll see if there was a move that we could trade accordingly.

Starting in 2009, when the Fed rates went to historic lows, we would imagine there was an opportunity here as the RBA (Reserve Bank of Australia) was at 3.25%, a quite decent differential of 3%. Australia at that time was about to boom based on commodity demand and the fact that they are a major commodity producer. Looking at the currency chart overall though, that's what it looks like: Australia is a commodity. As they lower rates from our starting point of 3.25% to 3% we see the currency appreciate from 0.7 to over 0.9. That's an absolutely massive move in terms of percentage. Even without leverage that's an amazing move of well over 25%. So far, so good, except that the rate fell. But it can take a while for funds to move so let's say that's what happened and the impetus was the Fed reducing their rate previously. Our carry trade plan seems to be working.

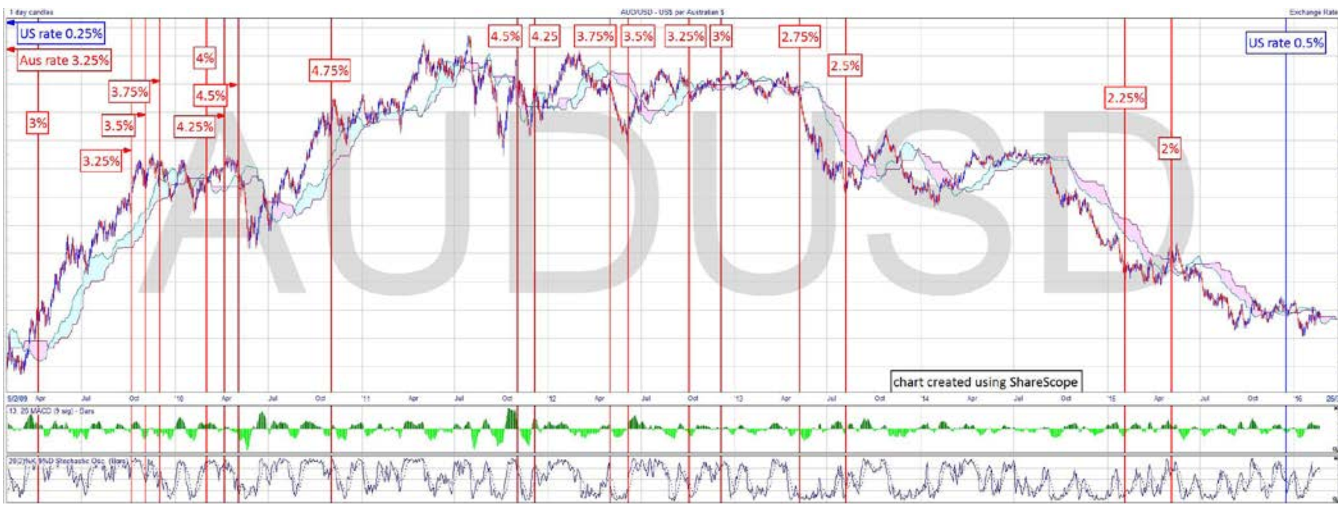
However, during the next seven months the RBA raises the rate from 3.25% to 4.5% with no discernible effect on the currency at all. That's a curious response by the market if the carry trade model is working. After all, Australia is not a banana republic, so you'd expect confidence in the currency. In fact at the time I'd say it was as close to a gold standard as we're likely to see these days: a currency, asset-backed by commodities! So all the more bizarre that with that final push to 4.5% the currency then falls off a cliff and loses over 10%. We then see a move up over the next four months of around 20%. Nice work if you can get it. And that at least more than recovers the 10% loss of May 2010, but only assuming it didn't wipe out your account.

Next, another rise to 4.75%. This broadly adds another 10% over six months. But after this we are not going to see any more gains. Basically, as the months go by and successive interest rate cuts kick in, we see exactly what we'd expect to see: the Aussie dollar weakens against the US dollar, to right back where it started, but this time the prevailing interest rate is only 2%. Now the Fed has raised the US rate it should put pressure on the Aussie dollar to fall further.

So what have we learned? Well broadly speaking we can make profits from the carry trade concept. But really it wasn't the only sign. If we'd just stuck to our normal TA methods we would have done just as well.

I've looked at the Swiss Franc versus US dollar as a sanity check. Switzerland is of course famous for inventing time, pretend neutral states, cog railways and in the patisserie department those famous rolls that I've always thought

"THE TRADITIONAL ECONOMIC MODEL THAT CLAIMS INTEREST RATES ARE SUPPOSED TO PROVIDE A PREDICTION OF EXCHANGE RATE CHANGES IS FLAWED."



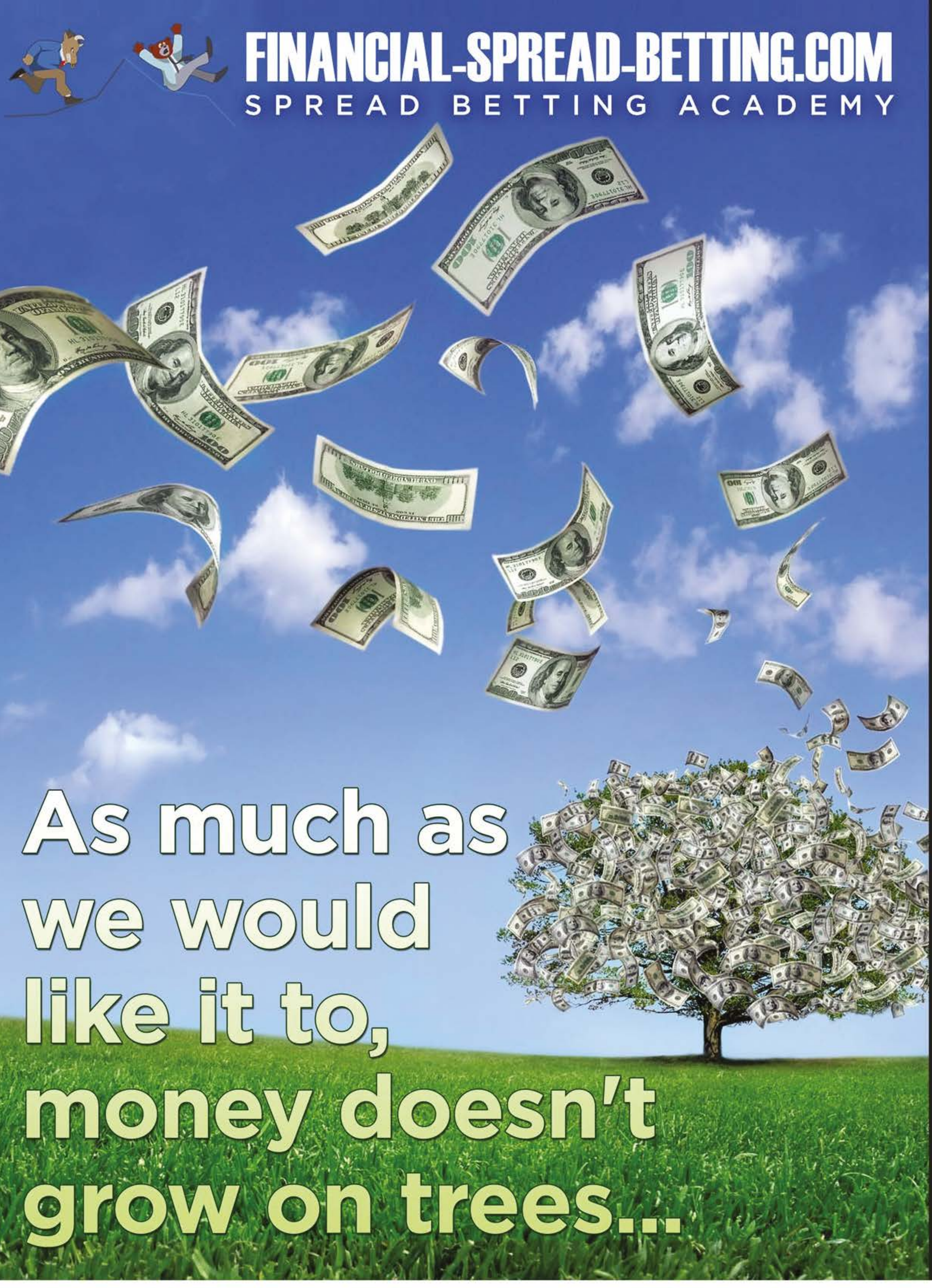
under-delivered. They have little by the way of commodities, and the economy is predominantly that of a service industry. It's considered to be one of the most stable economies in the world.

The Swiss Franc became very popular in the years following the financial meltdown, alongside London properties, as a safe haven. With the Euro looking very unstable, too much money was chasing the Swiss Franc. As a result it appreciated greatly. We can see here that without an interest rate differential to speak of, it gains against the US dollar to the tune of almost 60% at the extremes.

In August '11 the SNB (Swiss National Bank) reduced the rate to 0.125%, and after a breathing space this did have the desired effect of weakening the SFr. However, it did start to appreciate again in 2015 leading to the current rate of -0.75%. So was that a carry trade exercise? You'd imagine that borrowing in SFr, like the Japanese Yen, would have been a great idea, but we don't see a predictable effect here. Another major curve ball is the massive fall just after the cut to -0.75%. It happens in the bar after the cut, and that's why I've marked it in the dotted line, so it's clear to see that in one session it ranged from 1.02 to 0.74. That could have been costly to be on the wrong side of. And don't forget that you can, depending on the specific rules of your spread betting company, get wiped out on a move like that, as the price only has to touch a certain level, not have been filled for a stop or limit to be triggered. In that situation an option or covered warrant might have been a better bet since it would manage the

downside completely, but still benefit from leveraged gains.

The traditional economic model that claims interest rates are supposed to provide a prediction of exchange rate changes is flawed, then. An issue called the Peso Problem is one spanner in the works. If you have a strong currency upon which a weak currency is pegged, say the Mexican Peso to the US dollar, then traditional economics would say that higher interest rates in Mexico should predict a depreciation in the exchange, but instead rates stay high and of course the exchange rate is powerless to move. Arbitrage persists. Research shows that exchange rates are disconnected from macroeconomic fundamentals. This is why the carry trade can function. But for us private investors seeking to benefit it's better just to stick to Technical Analysis, even if we target the particular currency pair because of carry trade potential in the first place.



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BY ROBERT SUTHERLAND-SMITH

THE LIMPOPO DISPATCHES

THE BEST DEFENCE

This month, your Limpopo correspondent takes the absence of his customary near neighbours – the Methodist Scottish missionary; the Cambridge educated witch doctor and graduate (cum laude) of the Mayfair Hedge Fund Academy; and the ancient actuary without a name – who are holidaying together plane spotting in the old Syrian city of Aleppo.

I peruse UK defence shares, as we dance to the mood music of War and Peace III in the Balkans… sorry, I mean the Middle East… enacted as a drama in which Vladimir Putin plays the Tsar and Tayipp Erdogan plays the sick man of Europe (meaning that he is sick of Europe) as the Sublime Porte (the proper, sometime title of Ottoman Sultans).

I first contemplate the nature of markets in light of their depression at the beginning of the year, proposing psychoanalysis as the missing analytical tool in the investment banker's tool kit.

There has been a storm out there with swirling winds – and I am not talking about the inclement weather; I refer to the markets. The King James Bible has an excellent account of such conditions: "The wind goeth toward the south, and turneth about unto the north; it whirleth about continually, and the wind returneth again according to his circuits." It has been rather like that.

They don't write it like that anymore! How did we become so impoverished in our communicative faculties since the age of Shakespeare and the King James Bible? How much more riveting would market reports be if they were rendered in the English of Tudor and Jacobean England? Or even in the much later arresting literary style of Edward Gibbon? We have become a lingua-phobic, inarticulate generation, in contrast to those of our ancestors. We represent a culture that has prostituted itself to the dissembling gimmicks of marketing and PR. On some occasions, when talking PR spin (a black art dedicated to rendering all words free of true meaning) or arid business school jargon, we become unmoving and bemusing.

The aforementioned biblical description of desolation and chaos goes on to talk of all rivers running into the sea, but the sea being not full and rivers returning to their sources. There is even a reference to the Devil, like a prowling lion devouring whom he may. I am not certain what the anonymous author of those words had in mind, but they certainly seem a fair description of recent markets. It is because they describe fear and the acute uncertainty that is the current dominant psychological condition of stock markets in early 2016. As the old pagan market adage puts it, "markets always move between poles of greed and fear". We are clearly a long way from greed and well into fear.

What reason and detachment teach us

We need to recall what President Franklin D. Roosevelt said during the Great Depression and market collapse in the early nineteen-thirties: "The only thing we have to fear is fear itself." That was not a glib, self interested invitation for investors to cross the road without looking, but a reminder that although markets are always (allegedly) right, they are often a neurotic collective public mind transmitting the fears of crowds.

As always, it is important to try to detach oneself from all of that to regain the small voice of reason and objectivity if the individual has to make judgements that employ a useful mix of individual insight, instinct, experience, logic and, dare I say it, luck. But detachment from the herd is important when attempting to reach conclusions that you cannot reach simply by running with it.

A panicking market is of course an investment fact to be taken into account. But so, too, is a judgement about the validity of the fears and concerns that a particular panic projects – is it a legitimate panic or the other kind? Remember, there have been more bear markets than facts to justify them all. Hence the jest: "he is a great investor; he predicted ten of the last five recessions". Some are right and some merely a misguided exaggeration of a small supply of bearish facts. Nevertheless they are important. As my hero John Maynard Keynes – who knew more than most and was a fine hand at investing – once bitingly observed, "market trends can last longer than you can stay solvent". Investment, like everything else in economic existence, is an opportunity cost game (an economists' notion meaning that you want to employ your resources as advantageously, as often, and as long as you can). Of course you

do, but it's that most irritating kind of advice, the 'counsel of perfection'. It's akin to that advice given by pedantic old Polonius to a mad young Hamlet: "neither a lender nor a borrower be." True – but almost an impossibility!

A number crunching market thinker once asked himself: "how rich do you become, if you get things right all of the time?" I do not recall the actual numbers but the finding was of phenomenal proportions. In essence, if an investor was to act with minimum 'opportunity cost' by always getting out of the most expensive share at the top and into the cheapest stock at the bottom, wealth would come like a great tidal wave and make someone rich enough to buy up most of the world's stock exchanges in one lifetime. It would probably also make such a successful investor either very depressed or mad.

Anyway, that is the kind of theoretical potential against which we all do badly – even the great Warren Buffet. If we can be right some of the time – more often than not – we are doing as well as the Gods of probability permit. It is a reminder of how little we understand markets most of the time. Professional fund managers, with all their panoramic external resources, know that. When I was a young fund manager, I was told by a senior one that if I got my decisions right fifty one per cent of the time, I would be doing well.

"LIKE HELL, MARKETS ARE OTHER PEOPLE! YOUR SUCCESS DEPENDS NOT EXCLUSIVELY ON WHAT YOU DO, BUT ALSO ON WHAT THEY DO."

Why is that? It is mainly because, like hell, markets are other people! Your success depends not exclusively on what you do, but also on what *they* do. You need enough of the others to make the mistakes which will allow *you* to benefit from them. Hence, the need for detachment; and for keeping your head when all about you are losing theirs, as somebody put it. In bull phases, investors move like a happy herd of elephants across the plains, one following the other, moving north simply because the elephant in front is doing the same. Then suddenly there is a shot and we elephants stampede.

Markets are herds who desire the comfort of travelling in the reassuring conformity of opinion. They take encouragement from that! We are made for comfortable conformity and we panic when an elephant's tail in front of us – one which we were hanging onto with our trunk – is suddenly gone. At that stage, markets come to resemble human beings again. How do you analyse that?

War and Peace: looking to the defence sector for equity investment

This week, Thales, the French defence company, referred to a shift in defence spending in the EU, pointing to a series of announcements in 2015 that indicate increased military spending in France and Germany – no doubt a delayed Putin benefit response. Thales saw top line sales revenue rise by 8% last year with new orders increasing 31%. Thales has done well exporting its military aircraft systems, including sales to the Middle East where falling oil revenue does not seem to have diminished demand for defence equipment. (They even sold their stuff to India under the outraged, competitive nose of the UK's **BAE Systems (BA.)**, rather tarnishing the BREXIT idea of more trade with the Commonwealth by UK companies.)

The UK Aerospace and Defence sector consists of eight companies, two of which are FTSE100 companies: **BAE Systems (BA.)** and **Rolls-Royce (RR.)**. Another four are FTSE250 shares: **Cobham (COB), Meggitt (MGGT), Senior Engineering (SNR)** and **Ultra Electronics (ULE).** The following are the shares that look attractive to me at the moment.

Cobham (COB)

My eye alighted on Cobham because of the dividend yield and chart position. It has a good price to book ratio but most of the book is made intangible by the big goodwill figure. Nevertheless, the company was highly cash generative in last year's operations, with operating cash flow of almost three times the reported earnings figure.

Cobham is a company that earns its livelihood in the world of electronic wizardry. It is a provider of specialist technologies and what it calls 'subsystems', operating on a divisional basis of four business units: communications and connectivity; systems used in survival; advanced electronic systems; and aviation systems.

Together, they supply products for communications systems, including those in aircraft; monitoring equipment for police and national security agencies; and systems and equipment used for safety and survival in extreme environments. It addresses demand needs in commercial, defence and security markets, including and importantly those of the USA.

Looking back, reported net income was on the slide in the three years up to December 2014. Nevertheless, Cobham's management have shown a strong commitment to dividends, which have increased in each of the last five years. Apart from a strong attachment to paying dividends in tough conditions, the share price has a beta value of 0.589, which means that its share price has a relatively low correlation to the mar-

ket at large. It is, in short, not the kind of share to buy if you want to buy one that performs in line with the market.

2015 results from Cobham were on the face of it pretty good – but evidently, not good enough for some. Orders rose 13% to £2.148 million, sales revenue increased 12% to £2,077 million, and underlying trading profit jumped 16% to £332 million. Earnings per share improved a more modest 5% to 19.5p, which was directly followed by a commensurate 5% increase in the annual dividend to 11.18p.

These shares now trade on a price to underlying earnings multiple of 12.2 times and a dividend yield of 4.93% - very good value, one might reasonably conclude. The earnings yield is 8.1%. Operationally, the underlying group trading margin picked up from 15.5% the previous year to 16%. Net debt was down a little, from £1,223 million to £1,207 million.

In their review of the year, management described this performance as robust, with the firm having successfully integrated a new business – Aeroflex – and enhanced its core interests by divesting a number of businesses with technological offers which did not match with the group's overall growth strategy. All of this will be dilutive of earnings this year.

Moreover, the company saw this year as stable as a result of overall global macroeconomic trends in defence and security markets with no underlying improvement this year. Demand in some of the firm's commercial markets will be subdued. Consequently, the company will continue to top work on the cost base with an increased focus on cash flow generation and debt reduction. The statement that there would be an earnings bias towards the second half of the current year, robbed the market of better short-term expectations – hence the bearish response in the share price to good annual results.

"ALTHOUGH ROLLS-ROYCE IS OFTEN THOUGHT OF IN TERMS OF MILITARY DEFENCE EQUIPMENT, DEFENCE IS A SMALL CONSTITUENT OF TOTAL GROUP ACTIVITIES."

We were therefore invited to raise our eyes towards the medium term where a confident management sees the company maintaining its leadership position in the firm's core markets, leaving Cobham well placed to deliver medium-term growth.

With Cobham, we are presented with a company that is delivering shareholder value in not the easiest of times. The shares look good longer-term value, providing above average dividend income whilst we wait for the dilution effect of corporate changes to work its way out of the system this year.

Moreover, if continental Europe is witnessing an inflection point in military spending, this should feed into positive sentiment for the defence sector worldwide. I judge Cobham shares to be good value for longer-term capital growth and with an attractive above-average dividend income attached. If you are looking for a progressive dividend policy in action, you can find it in Cobham shares.

Rolls-Royce (RR.)

Rolls-Royce recently produced its annual results for the year to December 2015. It is well known for its defence business. However, this needs to be put in context with the company's other activities.

Although Rolls-Royce is often thought of in terms of military defence equipment, defence is a small constituent of total group activities. That it should loom larger is an understandable perception given the company's long association with the military, including its part in 'their finest hour' as the supplier of the Merlin engines which powered the Battle of Britain spitfires.

In the year just ended, Defence actually accounted for only 15% of group turnover, in contrast with civil aero engines, which contributed more than two thirds of Group sales. Going for-

"MEGGITT IS FOCUSSING ON MAKING ITSELF BOTH FINANCIALLY AND OPERATIONALLY MORE EFFICIENT AS IT WORKS TOWARDS IMPROVING ITS BOTTOM LINE."

ward, to judge from the order book position, military aero engine sales will shrink further in relation to civil work. The order book for the civil aero engine division is not only a massive £67 billion; it is also 129% of last year's order book figure of £52 billion.

Although defence orders were positive at a considerable £4.3 billion, they accounted for a relatively smaller proportion of last year's sales – £4.5 billion against actual sales of £15 billion in 2015 (in percentage terms, a mere 28% as opposed to 129%). In short, you should not buy Rolls-Royce shares on defence spending considerations alone, but rather, and predominantly, on the prospects and performance of its civil aviation business.

Last year, in volume terms, sales of defence equipment fell by 5%, in comparison with a 3% increase in civil aviation sales. Essentially, Rolls-Royce saw weaker volumes in engine sales for helicopters and military training aircraft. However, volumes were reported as being up in the supply of engines for transport and patrol aircraft. Despite the 5% drop in overall defence volumes, profits were up 4%.

Rolls-Royce shares have broken out of the recent share price downtrend. To the market's satisfaction, its problems seem to be getting addressed by the new CEO, with the era of profit downgrades perceived to be over. The share price has come down from a 2013 peak of 1,200p and looks as though it may move in a sideways trading range until clear progress is made in the form of improved profit and net margins. The shareholder 'activists' from the US who have swung aboard with a significant shareholding will keep the focus on that. Hopefully, talk of a foreign takeover of one of our last great engineering companies, with all the importance it has to UK corporation tax and the balance of trade account, will just remain talk. That at least will keep a flame under the situation.

Meggitt (MGGT)

Meggitt designs and manufactures components and sub-systems giving functionality to applications used in the civil aerospace, military and energy markets. Its five business divisions are: Meggitt Aircraft Braking Systems; Meggitt Control Systems; Meggitt Polymers & Composites; Meggitt Sensing Systems; and the Meggitt Equipment Group.

It seems to me that Meggitt's results for the year have come in pretty much as expected. The top line saw a rise in revenue of 6%. Orders also rose by a more modest 1%, no doubt reflecting the decline of the energy sector. Conversely, civil aviation saw 4% growth in 'organic' sales revenue while revenue in military applications remained flat.

Operating profits in statutory accounting terms remained static, pre-tax profit increased 1% and earnings per share rose a reported 5% to 23.2p. However, the statutory figure of earnings per share under-represents the underlying earnings per share figure, which although down 2% over the year, was at 31.6p 35% greater than the statutory earnings result.

Like other such companies, Meggitt is focussing on making itself both financially and operationally more efficient as it works towards improving its bottom line. It has, for example, improved its working capital requirement whilst at the same time increasing its investment in research and development which, the management claim, will benefit revenue growth in the years ahead.

The company has also placed much emphasis on improving its production systems which this year saw a significant improvement in the number of defective production items per million - down 87% - whilst also improving delivery time performance by 14%. Such improvement in productivity is an encouraging example in an economy which generally lags in that department. Moreover, management report that they are successfully bedding in two recent acquisitions. Elsewhere, although free cash flow has improved, it should also be noted that the company's net debt has increased by 83% to just over £1 billion.

Meggit shares at 415p (last seen) are valued on 13 times the now historic earnings figure for 2015, with a well covered annual dividend yield of 3.3% after the 5% increase in last year's dividend payout. I add that the earnings yield is an attractive 7.6%.

In the month prior to these annual results, the Meggitt share price had risen 19% against the increase of 5% in the market, in the shape of the FTSE 100 Index. The performance and delivery of the management looks satisfactory and the valuation fair. However, one should reasonably expect a share price correction after such a rise in the share price. I judge the shares to be a hold at this stage.

BY RICHARD GILL, CFA

SMALL-CAP CORNER

INVESTING IN RESTING – THREE SMALL-CAP HOTEL INDUSTRY SHARES TO BOOK INTO

Given the many challenges which the industry faces, hotel stocks have never really been high on the watch list of the typical private investor. Often laden with debt (taken on to build up their property portfolios), subject to high refurbishment and maintenance costs, rising minimum wage levels and exposed to declines in the global economy, the risks hoteliers face are varied and great.

Significant technological advancement has also harmed the industry over the past decade. Internet based aggregators such as Expedia and Trivago have improved knowledge amongst the customer, forcing room prices down and also taking money out of the industry via commissions. And, mainly at the lower end of the market, disruptive firms such as AirBnB are eating into demand – in 2015 an estimated 80 million nights were booked through the online booking site's platform. For that reason I do not like the look of UK listed budget operators **Safestay (SSTY)** and **easyHotel (EZH)**, especially given their high valuations.

Despite these challenges there is still good money to be made in hotels. The UK especially has been attracting a lot of cash recently, with estate agent Savills reporting that transaction volumes (purchases of hotels) in the UK market hit £8.1 billion in 2015. This was the highest level since a record £8.3 billion of deals were completed in 2006.

I believe that investors averse to the sector should look again as there are some good individual investment stories amongst the UK listed hotel operators. Having analysed the industry here are my three favourite small cap plays...

PEEL HOTELS

The smallest pure play hotels business listed in London is **Peel Hotels (PHO)**, which owns a portfolio of nine middle market establishments in the UK. These extend from Dunfermline

Company	EPIC	Capital (£m)	Yield (%)	Historic PE	Listing	Float date
InterContinental Hotels Group	IHG	5794.3	1.98	27.8	Full	15/04/2003
Millennium & Copthorne Hotels	MLC	1306.1	1.6	11.6	Full	25/04/1996
Dalata Hotel Group	DAL	631.2	N/A	68.7	AIM	19/03/2014
PPHE Hotel Group	PPH	267.9	2.98	10.6	Full	17/07/2007
Elegant Hotels Group	EHG	95.9	3.24	7.6	AIM	26/05/2015
Action Hotels	AHCG	78.2	4.09	46.5	AIM	23/12/2013
easyHotel	EZH	58.4	0.35	95.4	AIM	30/06/2014
Safestay	SSTY	19.2	0.54	47.5	AIM	02/05/2014
Peel Hotels	PHO	14.4	1.46	19.5	AIM	23/12/1998

UK listed "pure play" hotel operators ranked by market cap (Data source: Sharescope)

in the north to Bournemouth on the south coast, but notably the firm has no presence in London. Mainly located in city and town centres, Peel's hotels are 3/4 star venues which cater for the tourist and business traveller, as well as having extensive banqueting, training and conference facilities.

The business listed on AIM in 1998 when founder and current Chairman Robert Peel bought the Bull Hotel in Peterborough, an asset which the company still owns today. Peel has significant experience in the industry having been CEO of Thistle Hotels from 1977 to 1998. The company remains primarily family owned, with Peel and his brother Charles having just under 60% of the shares.

Numbers

A small business, Peel Hotels is also quiet on the corporate front, generally only making a handful of announcements to the market every year, with two of those being the interim and final results. To be frank, there has not been too much to report over recent years, the firm's last hotel acquisition being in May 2009. With the company suffering from the effects of the 2008/9 economic downturn, the strategic focus since then has mainly been on reducing debt and improving/upgrading the existing portfolio.

As a result, revenues grew only grew modestly between 2010 and 2015 – from £14.18 million to £16.45 million. Profits/losses were mainly small to negligible over this period. But then in 2015 Peel turned a corner, posting a 181% increase in pre-tax profits to £0.96 million. The strong results also enabled the company to return to the dividend list for the first time since 2009, with a 1.5p per share payment being announced.

This performance was driven by a 6% rise in revenues, along with higher gross margins. But more significantly,

PEEL HOTELS PLC

KEY HOTEL INDUSTRY MEASURES

RevPAR

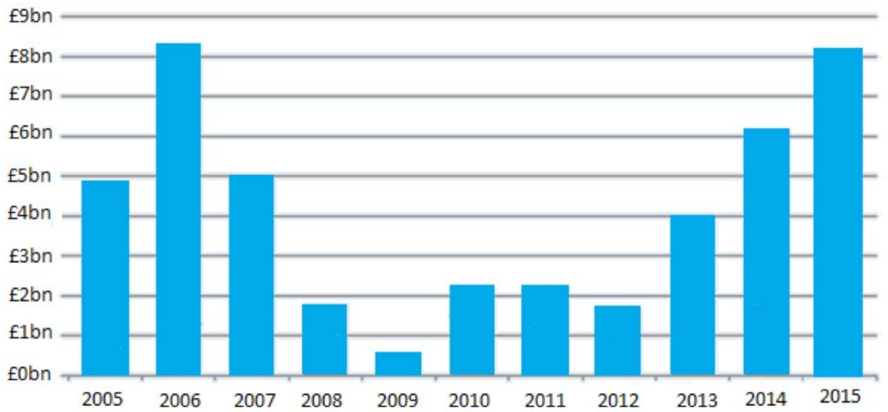
Revenue per available room. Calculated by dividing revenues by the number of available rooms over a certain period.

Occupancy rate

The number of rooms booked divided by the total number of rooms available – expressed as a percentage. E.g. 90 rooms booked out of 100 = a 90% occupancy rate.

Average room rate

Revenues divided by the number of rooms sold.



UK hotel investment volumes (Data source: Savills)

The Midland Hotel in Bradford (Source: Company website)

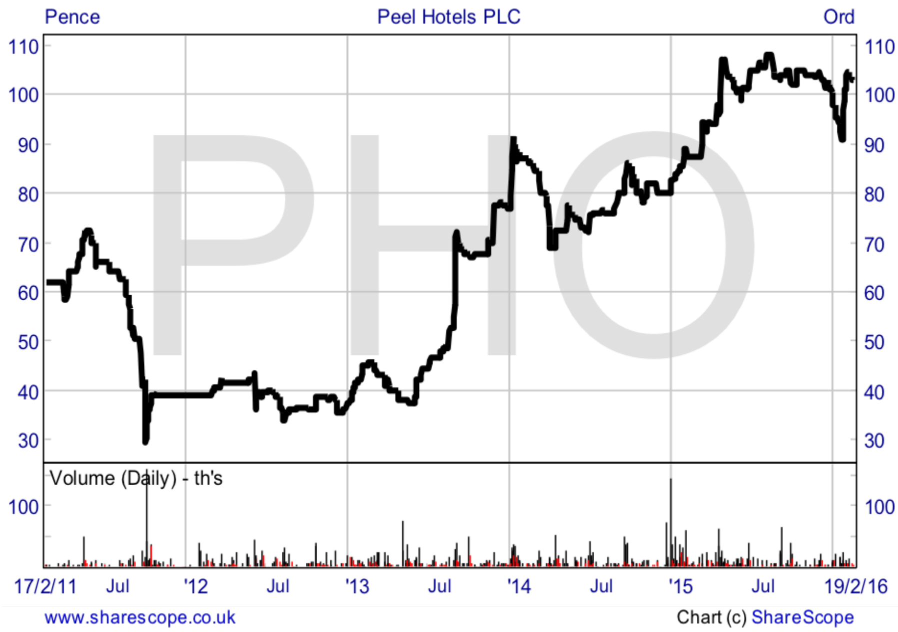
finance expenses for the year were considerably lower after an onerous interest rate swap instrument expired in April 2014. Following the reduction of base rates to all-time lows in 2009 the structure of the swap meant that Peel was exposed to additional interest payments, which in the 2014 financial year amounted to £352,000.

More recently, interims to 16th August 2015 reported on further progress, with sales up by 4.6% to £8.95 million after RevPAR, occupancy and room rates all rose. Underlying pre-tax profits were up by 26% at £0.5 million and net debt was reduced to £10.3 million. Gearing was a modest 44.1%, with interest being covered 2.6 times by operating profits.

Valuation

At the current price of 103p Peel Hotels is capitalised at £14.43 million. The shares have not delivered outstanding returns for investors on a capital basis, growing at a compound annual rate (CAGR) of just 1.66% since the first day of dealings in March 1998. However, there were additional returns via some reasonable dividends which were paid prior to 2009.

What attracts me about the current valuation is the significant discount



to net assets. As at 16th August 2015 net assets stood at £23.36 million, or 166.7p per share. The shares therefore trade at a 38% discount to the current NAV – or 62% upside should the shares move to trade at par to net assets. There could be further "hidden value" here given that the assets are valued on the balance sheet at cost.

Unfortunately, it has long been the case that the market has valued Peel Hotels at a substantial discount to NAV. The discount has closed in recent years on the back of the improvement in the UK economy and a related improvement in sentiment – at one point in 2011 the discount was above 80%.

As such, it seems unlikely that a substantial short-term re-rating is on the cards here. Instead, a sale of individual hotels could be a potential value creating event, with the primary exit opportunity being a complete takeover of the business. And in my opinion that would not be completed at a price any less than NAV. With the greatest respect to Robert Peel, he is coming up to his 70th birthday and could want to realise value from the business soon. I note he has publically said that the company would be *"great ... for some young, up-and-coming entrepreneur to take over..."*

Other attractions of Peel Hotels include a modest historic dividend of 1.5p per share, equating to a yield of 1.46%. Investors also enjoy an additional perk, a discount of 50% on room rates.

For patient investors who believe in the takeover argument the shares are worthy of a buy.

PPHE HOTEL GROUP

Previously known as Park Plaza Hotels **PPHE Hotel Group (PPH)** is a company I first covered on the Master Investor website in August last year when the shares were trading, at the time, at a record level of 650p. Since then they have broken the 680p barrier but as I write have since slipped back to 637.5p. The falls look to have come on the back of nothing more than market sentiment as two trading updates since my original analysis have flagged that trading is in line with expectations. As such I see some good potential for gains here.

The Business

As a reminder, PPHE owns and operates four-star hotels located in major cities and destinations in Europe. Under an exclusive licence from hospitality giant Carlson the firm has the rights to develop and operate the Park Plaza brand in Europe, the Middle East and Africa. Second major brand art'otel is fully owned by the group, with PPHE also having a minority interest in the Arenaturist group, one of Croatia's leading hospitality companies.

The company currently has a total portfolio of 38 hotels, with more than 8,300 rooms available. A €200 million, fully financed investment programme provides significant growth potential for the medium to long-term. Planned developments, including a new hotel near London Waterloo and an art'otel in trendy Hoxton, are expected to add over 1,000 rooms by the end of 2016 and another 500 by the end of 2019. The development pipeline was recently expanded, with the firm signing a hotel management agreement with Battersea Power Station Development Company for a 160 plus bedroom, luxury lifestyle art'otel, planned to open in 2019.

With nine hotels and nearly 2,800 rooms in operation the UK is PPHE's main market, contributing just over two-thirds of revenues in the six months to June 2015. The Netherlands, Germany and Croatia are the company's other major countries of operation, with Hungary and Israel making a minor contribution. Flagship assets include the Park Plazas at Westminster Bridge and Victoria in London, as well as the art'otel in Amsterdam.

Recent trading

Unlike Peel Hotels, PPHE is a lot more active on the corporate front, announcing quarterly trading updates to the market. The most recent of these reported on the year to December 2015 and revealed that the numbers were in line with expectations.

pphe HOTEL GROUP

The headline figures showed hotel revenue up by c. 12% year-on-year, driven by continuing strong demand across the portfolio, boosted by the strength of sterling against the euro. The firm reports its results in euros so a strengthening pound provides a boost on translation of the numbers (but not for much longer – see below).

Underlying growth was still strong, however, with revenues up by 5% on a constant currency basis. RevPAR grew by 12.1% to €127.3, with the average room rate up by 11.3% at €150.9 and

Park Plaza, Westminster Bridge

occupancy rates up by 60 basis points at 84.3%. Elsewhere, everything seems to be going well with the planned development pipeline.

As alluded to above, 2015 will be the last such year of PPHE reporting its results in euros. To reflect the large and increasing UK presence, from 2016 the accounts will be reported in sterling. I note that, while still weaker than in 2014, the euro has reversed its negative trend against sterling since mid-November, gaining around 11%. As such PPHE's move seems timely given that the accounts will now benefit on translation from a strengthening euro – the reverse of the previous situation.

Valuation

In my opinion PPHE shares look attractive on an asset, earnings and income basis. My base case net asset value (NAV) calculation is comprised of the following:

– Net tangible assets – NAV as at 30th June 2015 of €349.27 million less intangibles of €31.18 million = €318.09 million.

– Fair value upside – Property, plant and equipment (PPE) is measured on the balance sheet at cost, less accumulated depreciation and impairment losses – a highly conservative accounting method. In contrast, "fair value" represents the last independent valuations carried out on properties, but this figure is only reported in the full year accounts. Using the December 2014 figure this equates to €167.66 million – total property portfolio valuation of €990.66 million less the PPE net book value of €823 million.

Total = €485.75 million, which at current exchange rates equates to £378.63 million or 862.9p per share.

Assuming that the shares should trade at least at parity with NAV then this implies 35% upside from the current price. I also see further upside to the base case scenario given that no value has been given to intangibles, there is upside from development projects and further potential fair value upside generated over 2015.

On an earnings basis the shares look good value on a multiple of just 8.8 times market forecasts for 2016. There is also a 3.6% yield on offer for the year should a 23p per share payment be made as expected. Both of these valuation metrics are amongst the most attractive in the sector.

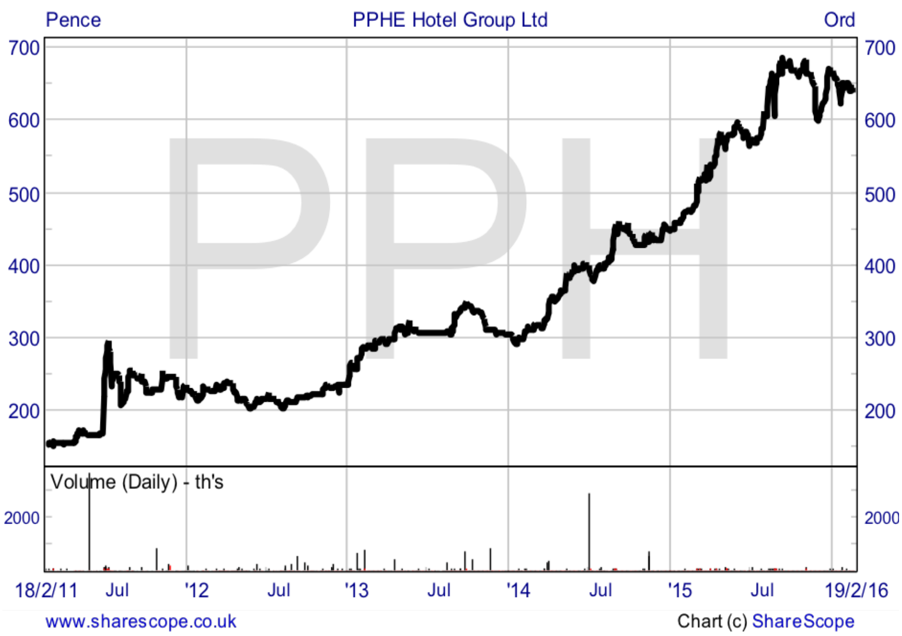
High levels of net debt (€535.9 million as at 30th June) have been suggested as one reason for the low valuation. But the gearing level of 59.3% is not too excessive and interest coverage of 2.9 times operating profits in the first half of last year is comfortable.

For growth, value and income PPHE ticks all the boxes.

ELEGANT HOTELS GROUP

Finally, we end with a trip to a more exotic location. Listing on AIM in May last year is **Elegant Hotels Group (EHG)**, the freehold owner and operator of five luxury hotels and a beachfront restaurant on the island of Barbados in the Caribbean. The hotels are either 4 or 5 star establishments, situated along the west and south Barbados coastlines and offer a total of 333 suites and 150 rooms. This gives the company a c. 25% share of the high end tourist rooms available in the country. Peak season is December to February, as holidaymakers look to get some winter sun – average temperatures at this time of year are c.26⁰.

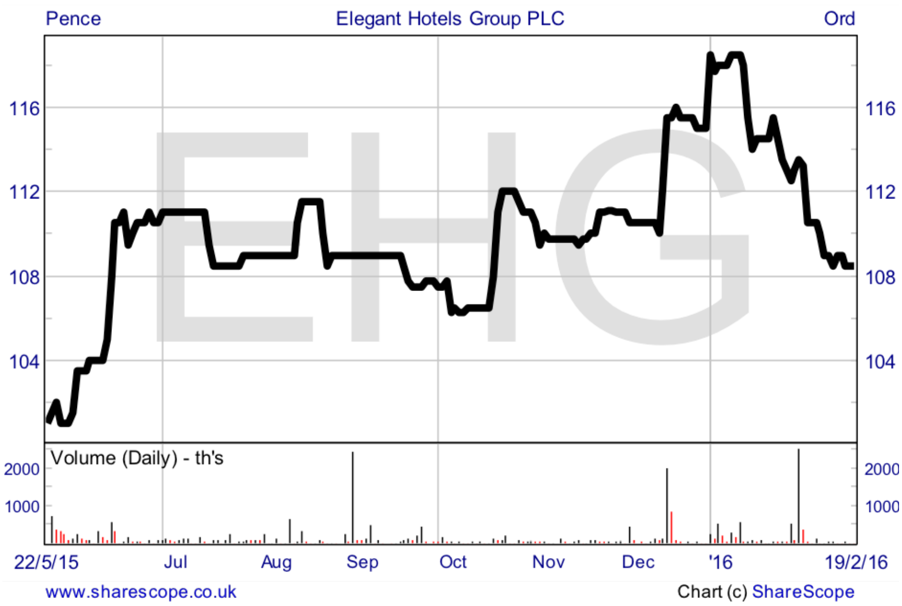
The company's expansion strategy is focussed on acquiring new assets in Barbados as well as elsewhere in the Caribbean. Along these lines, the portfolio is shortly set to rise to six hotels,



with the firm agreeing in early February to acquire the 4 star Waves Hotel and Spa for $18 million. Waves is a 70 bedroom, all-inclusive resort with a prime beachfront location. Other features include 1.8 acres of freehold land, a restaurant, bar, gym and spa. Subject to bankers' approval the deal is expected to complete by the end of February. The hotel will then be closed for a $4 million refurbishment/re-brand and opened for business again in July. Other acquisition opportunities are also being explored.

Elegant Hotels' locations (Source: Company website)


Some of the facilities at the Crystal Cove hotel (Source: company website)



Numbers

Elegant Hotels has a decent historic trading record and this continued in the financial year to September 2015. Revenues grew by 4.3% to $60.1 million in the period as higher average daily room rates complemented a stable 68% occupancy rate. Demonstrating Barbados as a growing tourist destination, the total number of tourist arrivals for 2015 up to the end of October grew by 14.7%, with arrivals from the key markets of the UK and the United States, up by 12.7% and 28.2% respectively.

The period attracted significant one-off costs due to the IPO and a re-financing, but on an adjusted basis operating profits were up by 16% at $19.2 million. On the balance sheet, the £32.2 million raised at IPO helped to reduce net debt by 61% to $40.8 million at the period end, with adjusted operating profits covering finance expenses by over six times. The loan to value ratio was strong at just 17%. The company also announced a total dividend payment of 3.5p per share, which covers the firm's five months as a listed entity.

Valuation

Like PPHE above, Elegant Hotels appears to have significant hidden value on the balance sheet. It also values its properties at cost on the balance sheet, as opposed to at "fair" value as determined by the latest revaluation.

Property consultants CBRE valued the firm's properties at $235.5 million as at 15th April 2015, a figure well above the latest balance sheet valuation of $145.3 million. When added to net tangible assets this additional upside give a total "fair value" NAV of $196.04 million, which equates to 157p per share. This implies 45% upside from the current price of 108p.

Elegant Hotels also offers the highest yield in the UK hotel sector. The company stated at IPO that it intends to pay a 7% yield based on the 100p IPO placing price. That implies a payment of 7p per share, or a yield of 6.48% at the current share price. Costing c.$4.4 million this is well covered by forecast operating cash flow and also leaves ample room for the estimated $3.5 million of capex.

Overall, an Elegant investment.

BY SWEN LORENZ

AN INTERVIEW WITH TOMAS CARRUTHERS

CEO OF THE SOCIAL STOCK EXCHANGE (SSX)

Swen Lorenz: Tomas, one of the most successful long-term investments over the past few decades was Philip Morris, the cigarette manufacturer. Philip Morris would certainly qualify as a typical "sin stock". Why should any investor want to invest in shares that are listed on the Social Stock Exchange? Please explain to us this oxymoron, and why any one of our readers should even continue reading?

Tomas Carruthers: *I could launch into a philosophical debate about how Milton Friedman got it wrong back in 1970 with his famous New York Times essay, or highlight the growing financial inequality gap in the developed nations, but the important thing to remember about impact investing is this: it's not philanthropy. Granted, companies with an objective of delivering a positive impact wouldn't go selling their grandmother to squeeze another couple of pips out the deal, but these are real companies being run with the aim of delivering a financial return as well as a positive social or environmental impact. One of our member firms, Ashley House, has posted a total return of 125% over the last 12 months. Another, Good Energy, is up 100% since it came to market in 2012. These companies prove that social/environmental impact and shareholder benefit shouldn't be considered as mutually exclusive.*

SL: Are there independent statistics to back up your claims?

TC: *I think the important factor to consider here is the weight of money that is now being put behind impact investing – for years this has been the preserve of high net worth investors and private equity, but entities like The Social Stock Exchange are truly democratising access to this market. JP Morgan claimed that, globally, in 2015 some $60bn was projected to be invested for impact, and this figure is growing exponentially each year. Investors clearly want to think about more than just the financial return.*

SL: What is your background, and how did the Social Stock Exchange come into being?

TC: *I have spent over two decades building and growing retail financial services companies, including ESI which became E*Trade UK, and Interactive Investor. The Social Stock Exchange came into existence in the summer of 2013 and was launched by the Prime Minister as part of the G8's Social Impact Investment Forum that was held in London. The Exchange is backed by a number of parties including Big Society Capital and the Joseph Rowntree Foundation, and I was appointed as CEO at the end of 2013.*

SL: I understand that last year, you agreed on collaborating with ICAP's ISDX, the "Alternative AIM market". What exactly did this partnership entail?

TC: *Our agreement with ISDX gives our members access to list their securities on a segment of their market. To trade here, clients must first be admitted as members of The Social Stock Exchange, but this provides a streamlined and lower cost route to access capital markets. Looking to the future, we are aiming to grow a single venue where any investor can find impact opportunities.*

SL: How many companies are now listed on the SSX, and how do they qualify for an SSX-listing?

TC: *We now have 32 member clients. Around half are listed, with the others be-*

"JP MORGAN CLAIMED THAT, GLOBALLY, IN 2015 SOME $60BN WAS PROJECTED TO BE INVESTED FOR IMPACT, AND THIS FIGURE IS GROWING EXPONENTIALLY EACH YEAR."

ing privately held. But when they come to tap capital markets, they will be able to do so with the validation that they are an impact business and can access our own network of investors to help meet their funding goals. Of the 13 listed firms, two are only listed on our segment of ISDX, a further three are dual listed and the remainder are either traded on AIM or the main market.

Qualifying for membership isn't easy. Over half the companies who initially apply get turned down. The process involves the production of a detailed impact report, which is then put in front of an independent admissions panel. The impact report then needs to be resubmitted on an annual basis to ensure that the company is delivering against its stated objectives.

SL: Is the idea of social impact very different from the Corporate Social Responsibility programmes that many companies have nowadays?

TC: *This is a world away. CSR may have started out with good intent, but it quickly became seen as a side-show. Businesses were attempting to gloss over their absence of social responsibility with a once-a-year event to give something back to the community. Membership of the Social Stock Exchange is only granted to those companies who have – and continue to maintain – a social or environmental impact at the very core of their operation.*

SL: Back to the investment aspect of the SSX. You claimed that in the long run, investors will be better off investing in companies that are conscious of their overall impact. Is there already some statistical evidence for this or do we have to simply take your word for it?

TC: *As we noted previously, some of our members have already posted stellar total returns, but the question does stray into a more holistic look at how financial markets need to serve people in the future. The credit crisis of 2008 exposed the myriad of shortcomings of capital markets. Wealth inequality is now growing apace despite the best endeavours of policymakers, and the current structure cannot last. This is a consequence of the failure of today's capital markets – and indeed capitalism. We live in a democracy, so the current rules will have to change if greater equality – and a more democratic approach to capitalism – doesn't materialise. You could say that we're future-proofing capital markets.*

As we've already said, this isn't philanthropy – one of our members is Golden Lane Housing, part of Mencap. They issued a retail bond in 2014, paying 4.375% over seven years. What's not to like about that? Your money is in asset backed bonds, it's doing social good, you get a tidy interest payment each year and – all being well – your money back at the end of the term.

"YOU COULD SAY THAT WE'RE FUTURE-PROOFING CAPITAL MARKETS."

SL: At the moment, you have a universe of 31 companies listed on the SSX and they have a combined value of £2.1bn. Are there plans in place to grow this further during the current year?

TC: *Yes, we remain committed to growing the number of member firms. We are also in talks with a number of local governments over building a regional social stock exchange network, allowing local firms better access to local capital, and there are a number of other exciting collaborations underway.*

SL: You are going to be at the Master Investor Show on April 23rd. Can our readers and delegates meet you at the exhibitor booth of the Social Stock Exchange?

TC: *Absolutely! We will be there along with a number of our member firms, who will be keen to explain their investment propositions. Capitalism is changing; it needs to change more to ensure it can serve the needs of everyone. Even if that's something the typical Master Investor delegate might not want to think about, it's a topic that needs to be addressed quickly. The current investment construct needs to adapt.*

SL: One final question! If you look five or ten years into the future, what do you think the SSX will have delivered to private investors in the UK?

TC: *There's a weight of momentum building behind this idea of investing for impact. We will be looking to raise awareness of how impact businesses can access capital markets, and how investors can ensure their money works well both for them and for society as a whole. We can't say this enough – this isn't philanthropy and you're not impairing your returns if you invest for impact.*

SL: Many thanks for the interview, Tomas!

To learn more about the Social Stock Exchange, visit: http://socialstockexchange.com**.**

BY SAMUEL RAE

CURRENCY CORNER

TWO FUNDAMENTALLY DRIVEN CURRENCY PREDICTIONS FOR 2016

These are uncertain times for the global economy. China continues to weaken, the US equities markets are looking increasingly bearish and the less we say about Europe, the better. It's also a great time to be a currency trader. Uncertainty translates to weighted sentiment, and weighted sentiment translates to standout bias. If those reading have read this column before, or are familiar with my strategy, they'll know my currency operations are primarily technically driven. I focus on key levels and candlestick patterns. The underlying fundamentals are what create these patterns, however, and I will generally form a bias that dictates how aggressive or conservative I am with my targets and risk parameters. Bullish EUR/USD? I'll be a little more aggressive with my longs, and conservative with my shorts. Bearish, vice versa.

Here are two of my favorite pairs, and the underlying fundamentals that anchor my bias as we head into the second quarter of the year and beyond.

First up, USD/JPY. Japan, and specifically its economy, has long been a favorite topic of mine. It doesn't make for great casual conversation, but when I get the opportunity to write about it, I'll always take it. The last few years have been particularly interesting. Shinzo Abe is desperately trying to reignite the stagnant economy, and alongside his finance minister, Akira Amari, has implemented a wave of policies ranging from public construction to legislation that makes the nation more accessible to stem cell biotech research. So far, however, they've not really worked. Consumer spending remains weak, inflation nonexistent and business sentiment flat. To make matters worse, the aforementioned Amari just resigned on allegations that he accepted a construction-related bribe. We've also got a potential sales tax rate hike towards the end of the year, which could have a serious impact on the retail sector, if the first one, in 2014, is anything to go by. Without it, however, the Japanese government won't be able to fulfill its mounting ageing-population driven social security bill.

The whole situation is pretty messy and, in my opinion, bearish for the Yen. There are some analysts suggesting the Yen is far more undervalued than it should be (part of Abe's policy was to weaken the Yen to increase export activity) and that actions will soon be taken to curb an oversell. In turn, they suggest that this will boost the Yen, which flies in the face of my bias. They're probably right – long term. I don't see any such action before at least 2017. Japan simply can't afford to take the risk.

So, a messy economy, expected further weakness and the sudden resignation of the guy charged with orchestrating Abe's economic reform policies underlie my expectations for a weaker yen, and in turn, a bullish USD/JPY.

"A MESSY ECONOMY, EXPECTED FURTHER WEAKNESS AND THE SUDDEN RESIGNATION OF THE GUY CHARGED WITH ORCHESTRATING ABE'S ECONOMIC REFORM POLICIES UNDERLIE MY EXPECTATIONS FOR A WEAKER YEN, AND IN TURN, A BULLISH USD/JPY."


WASHINGTON

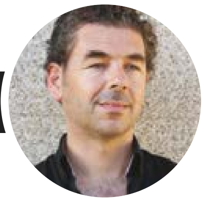
Shifting circa 5,000 miles south, let's now look at the Aussie. Australia is also in trouble, but for very different reasons than Japan. For nearly two decades, Australia has relied heavily on growth in China to fuel its domestic expansion – and with great results. GDP reached its highest ever levels in 2013; the property market (especially in major cities) is on fire; and consumption, retail activity and employment are all strong. What's happening in China at the moment, however, looks set to bring the party to an end. Recent estimates put the mining industry (a large portion of which attracted Chinese capital) 70% of the way through a multi-year decline. Construction projects are starting to stall, and property prices will quickly reverse if reduced capital inflow from Asia impacts business and consumer sentiment (which it will).

When things start to fall apart, the Reserve Bank of Australia will be quick to pull the trigger on an interest rate cut. The RBA has been pretty stubborn over the last six months, holding the nation's base rate at 2% despite pretty much global expectations of a cut; but it won't be able to hold out too much longer – especially if major economic data releases continue to trend in the wrong direction.

When it does eventually cut – I see at least two cuts to 1-1.5% before we close out the first quarter of 2017 (and that's a conservative estimate in my opinion) – the Aussie dollar will quickly weaken. It won't be a bad thing for the Australian economy – just as with Japan a weakened currency will make Australian exports more attractive, especially at a time when the USD is so strong – but it will be bearish from a trading perspective.

Couple this with my predictions for an equities-market driven shift to risk-off sentiment, and the ensuing greenback strength, and I get a firm bearish AUD/USD bias.

Let's see how it all plays out.



BY FILIPE R. COSTA

THE GREATEST INVESTORS & TRADES

JESSE LIVERMORE: FIGHTING AGAINST EMOTIONS

"I absolutely believe that price movement patterns are repeated and appear over and over, with slight variations. This is because humans drive the stocks, and human nature never changes."

— Jesse Livermore

Boom and Bust in Real Life

In current market conditions where investors are assured a wild ride, it is worth remembering the life of one of the greatest traders ever, Jesse Livermore: the man who gained and lost several multimillion-dollar fortunes. If volatility could be personified, it would certainly appear as the life of Jesse Livermore, which was lined with success, drama and failure, until the day it ended in tragedy. On November 28, 1940, in the cloakroom of the Sherry Netherland Hotel in Manhattan, Jesse Livermore, aged 63, shot and killed himself, leaving a wife and two sons behind. Luckily, he also left a legacy of trading rules that still help traders today while also establishing some of the foundations of behavioural finance.

Suffering from chronic depression, Livermore was unfortunately his own worst enemy. He had always been able to recover from his market losses and life mistakes and build a new empire from scratch; but in his sixties, during one of the worst periods of his life, he was no longer psychologically strong enough to bounce back and instead decided to put an end to his life. In the suicide note he left to his wife, one can feel the desperation and sadness of a man who was suffering from acute depression:

"My dear Nina: Can't help it. Things have been bad with me. I am tired of fighting. Can't carry on any longer. This is the only way out. I am unworthy of your love. I am a failure. I am truly sorry, but this is the only way out for me. Love Laurie"

In life, as in financial markets, emotions play a crucial role in the final outcome. Livermore spent his whole life developing a trading strategy that could effectively deal with emotions. He believed that everything was in the tape such that, for a trader to be successful, he just needed to stick to the tape. People change but financial markets remain the same, with price patterns repeating over an over again. Emotion is distracting and is always waiting to fool everyone. Financial markets are full of traps. A successful trader must learn how to read the tape and to stick to the rules.

"'THROUGH TIME, PEOPLE HAVE BASICALLY ACTED AND REACTED THE SAME WAY IN THE MARKET AS A RESULT OF: GREED, FEAR, IGNORANCE, AND HOPE. THAT IS WHY THE NUMERICAL FOUNDATIONS AND PATTERNS RECUR ON A CONSTANT BASIS', CLAIMS LIVERMORE."

More than half a century after his death, Livermore's trading rules and strategies are still used by many traders. But, ironically, not even Livermore was able to stick to his own rules all the time. He sometimes ignored them and ended up losing his entire fortune. The rational, emotionless man who laid the foundations of behavioural finance just doesn't exist. Livermore is one of the best examples of how hard it is to fight emotions in order to take unbiased decisions.

The Great Bear of Wall Street

Jesse Lauristen Livermore, the "Boy Plunger", or even the "Great Bear of Wall Street" as he became known, was born in Massachusetts on July 26, 1877. He married three times (Netit Jordan 1900-1917, Dorthea Wendt 1918-1932 and Harriet Metz 1933-1940) and had two sons (both with Dorthea). He soon became interested in financial markets, and started making bets on equities at bucket shops where he gained the reputation of the "Boy Plunger". At the age of 15 he had accumulated over $1,000 in profits which is equivalent to $28,500 today (or £19,650).

Helped along by his mother, Livermore soon left home to escape a life of farming. He started his career at the Paine Webber brokerage in Boston where he was responsible for transferring prices from ticker-tape to quotation board. While being just a humble job, it allowed Livermore to learn how to read the tape, a feature that was crucial for all his trading and strategy. He later moved to Wall Street to face real action, starting trading on the big board in the office of E. F. Hutton.

Livermore's life was full of triumph and drama. At the age of 15 he had already accumulated a decent amount in trading profits but he managed to lose everything after the marriage with Netit. Despite his prior successful betting at Bucket Shops, as soon as he opened his own brokerage account, he lost $2,500 (which is equivalent to $72,500 today, or £50,000). Without money to trade, he tried to convince his wife, Netit, to sell jewellery he gave her previously, for him to have a new start at the big board. This contributed to the deterioration of their relationship, which finally ended in 1917, but allowed him to rebuild his wealth, as he made a huge profit shorting Union Pacific and other equities in 1906 just before a major earthquake. His "guess" earned him $250,000 (around $6.8 million at today's prices, or £4.7 million).

In 1907, just before one of the worst panic episodes in the history of the New York Stock Exchange, Livermore thought that too much margin was being used, which would end in a crash when speculators were forced to sell due to margin calls. Unlike what had happened in other periods, where buyers had taken the opportunity pro-

vided by margin calls to buy at lower prices, this time there was not much capital available. That meant that when speculators started to sell, there would be no buyers to absorb the shares, and the market would crash. Prior to the summer of 1907, credit conditions started tightening and a number of businesses and Wall Street brokerages went bankrupt during the summer. The market kept rising but Livermore felt that something was really wrong and that sooner or later speculators would have to sell, which would lead to a liquidity squeeze. In October, the Knickerbocker Trust in New York City and Westinghouse Electric collapsed, and investors panicked, leading to the 1907 Panic on Wall Street. Livermore accumulated a personal net wealth of $3 million (around $78 million at today's prices, or £56.8 million), as he had previously accumulated large short positions.

Soon after the 1907 Panic, Livermore listened to another person's advice and opened a trade in cotton. After being down he added to this losing position while closing a winning position in wheat. He ended losing 90% of the profits he had accumulated during the 1907 Panic. Livermore was by then a victim of emotion, as he failed to stick to his own rules that would have prevented him from following someone else's advice, from adding to a losing position and from selling a winning position with no clear reason. Trading should stick to rules to eliminate emotion because it is exactly emotions that lead to profit opportunities. Those who can abstain from acting on fear, greed, ignorance and hope have access to huge profits. This repeats over and over again and all that matters is to read the tape while sticking to the rules. "Through time, people have basically acted and reacted the same way in the market as a result of: greed, fear, ignorance, and hope. That is why the numerical foundations and patterns recur on a constant basis", claims Livermore.

“IN 1929 HE BEGAN SHORTING THE SHARES OF SEVERAL EQUITIES, ADDING TO HIS WINNING POSITIONS. AFTER THE 1929 COLLAPSE, HE ACCUMULATED $100 MILLION IN PROFITS, WHICH IS EQUIVALENT TO $1.38 BILLION TODAY (£0.95 BILLION).”

Accumulating a Fortune... and Losing It All

Once again Livermore was able to regroup and get set for more prosperous times. In 1929 he began shorting the shares of several equities, adding to his winning positions. After the 1929 collapse, he accumulated $100 million in profits, which is equivalent to $1.38 billion today (£0.95 billion). That was a brilliant comeback. But as before, he couldn't secure his winnings. During the bull market period that followed the Great Depression, he lost his fortune again. In 1934 several judgements accumulated against him and in 1934 he filed for bankruptcy.

Livermore had always been able to come back from bankruptcy; but that was something that would not happen this time round. Being in his sixties, he

Livermore's 10 Percent Loss Table

Starting Position	Amount Lost	Remainder	Loss, %	Gain Needed to Recover Loss, %
$1,000	$80	$920	8.0	8.7
	100	900	10.0	11.1
	200	800	20.0	25.0
	300	700	30.0	42.8
	400	600	40.0	66.6
	500	500	50.0	100.0

Source: *"Jesse Livermore: World's Greatest Stock Trader"*

"LIVERMORE KNEW THE IMPORTANCE OF IMPOSING RULES WHEN TRADING, BUT WAS NOT ABLE TO STICK TO THEM WHEN IT REALLY COUNTED."

was not as robust as he was before. His chronic depression was severe by then. On November 28, 1940 he committed suicide. Oddly, he was the fifth husband of Harriet Metz, and the fifth that committed suicide.

Livermore put an end to his life at one of the worst moments in terms of wealth, but he still left a huge trust fund to his wife and sons that was set apart from everything else in a way that ensured he could never touch it in case he was bankrupted, to ensure his family was protected from his ups and downs. Even though there was boom and bust, Livermore and his family lived a wealthy life. They managed to own a place in Manhattan, a floor at the Fifth Avenue, a house in Great Neck, a summer house in Lake Placid, a house in Palm Beach, two yachts and several Rolls-Royces.

Trading Rules

Livermore's trading rules were quite simple and can be summarised as follows:

- Rule 1 – Don't lose money. A trader should establish a position gradually at different prices instead of trading the full quantity at once. He believed that when establishing a long position a trader should purchase first a portion at some price and then wait for the price to rise. The rise in price is a confirmation of the upside trend and then the trader could add to the winning position. The opposite – adding to a losing position – should never be done.

- Rule 2 – Always establish a stop. He believed that the maximum amount one should risk in a single trade is 10%. A stop should be set to avoid a loss from growing too large. This is a key money management rule, because every time a trader loses in a position, he needs a subsequent higher gain (in percentage terms) to just offset the loss.

- Rule 3 – Keep cash in reserve. Cash is king, so a trader should always have some for an opportunity that may arise at any later date.

- Rule 4 – Let the position ride. Instead of setting a limit order, a trader should only sell a position if there's a good reason to do it, otherwise he should let it ride.

- Rule 5 – Take the profits in cash. Instead of keeping the profits in his trading account, a trader should cash out part of the gains and keep them in a safe place, particularly if they are substantial. This was crucial for Livermore's family after his suicide.

Some Final Words

Livermore knew the importance of imposing rules when trading, but was not able to stick to them when it really counted. Human nature makes us succumb to our emotions and break with the rational rules we previously set. That's why patterns in the market repeat over and over again.

Livermore was "a person of great secrecy, mystery and silence... [who] strove to control his emotions and thereby overcome the human frailty of passions that we all suffer from" (in *Jesse Livermore: World's Greatest Stock Trader* by Richard Smitten). He was the master of crowd psychology and market timing. His legacy is of high importance today, at a time when financial theory still insists on basing its conceptions on a rational, emotionless individual that is believed to always drive markets towards efficient outcomes.

BY MARIA PSARRA

SCHOOL CORNER

BUILDING LONG-TERM WEALTH WITH DIVIDEND INCOME

I finished my last Master Investor article by saying that investors should *"Ignore the daily noise and focus on creating wealth. Not just money, but long-term, lasting wealth. And yes, there is a huge difference between the two, but we can discuss this another time."* That time is now.

So what really is the difference between money and wealth? I shall attempt to provide you with my own explanation of this by using a metaphor. As I write, it is the 14th of February, also widely known as St. Valentine's Day. Before you know it, it has come and gone. You hopefully had fun, overpaid for a fancy four-course meal in an expensive restaurant, exchanged gifts with your loved one, and now you hope that come the same date next year, you will once again be lucky enough to celebrate in a similar fashion. Of course, come the next morning you may realise that you have now spent way more than your personal budget. Even worse, the person you spent it with is not even really the love of your life.

I know, ladies and gentlemen, I am unromantic, but bear with me. What I have just described is the real-life equivalent of making money in the short term, and quite likely losing it soon after. Now let us contrast this to long-term, lasting wealth. Sticking with the same metaphor, let us assume that instead of only celebrating on one specific day each year, you decide that you shall instead love and take care of someone for the long term, whether this is for *"as long you both shall live"*, or as I personally like to interpret it, *"for better or worse, and until one of us decides we are better off apart"*. Together, you will create something valuable that lasts through the years, supports you through your rainy days, and can be eventually passed on to your children. This is long-term, lasting wealth. It is not built in one day, and hopefully once you have it, you are wise enough to not lose it in one day either.

According to the Oxford Dictionary wealth is *"An abundance of valuable possessions or money"*. So how does one create *and* keep this for the long term when involved in the financial markets? There are many different ways, but for the benefits of this article, we shall focus on dividend income. Now how does one use dividend income to create wealth? One starts by selecting good quality dividend paying stocks. These are stocks of companies that pay a stable, high dividend compared to the dividend yield of the index of which they are a constituent. (For example, at the time of writing this article, the FTSE 100 dividend yield is 4.57%, the S&P 500 dividend yield is 2.37%.) They should also have a high dividend growth rate (that is the forecast annual growth rate of a company's dividend based on historical dividend payments and dividend predictability), as well as high dividend safety (dividend safety is an indicator expressing the company's ability to continue paying dividends at current or at higher rates in the future).

One then picks a good price level to buy into these stocks. But remember, neither you nor anyone else – regardless of what they might tell you – will *ever* consistently identify market "bottoms", but one should be able to iden-

tify price pullbacks, and also clearly identify, based on one's fundamental analysis, when a stock's price is below its current fundamental valuation, and look to take advantage of such opportunities to buy in. However, when one buys for dividend income, one has a much better cushion against market downturns and the perceived need to pick the best possible price.

“WHEN ONE BUYS FOR DIVIDEND INCOME, ONE HAS A MUCH BETTER CUSHION AGAINST MARKET DOWNTURNS AND THE PERCEIVED NEED TO PICK THE BEST POSSIBLE PRICE.”

It's then time to sit back and relax; that is, one does not re-arrange the dividend portfolio's individual components each week or month, let alone each day. Remember, you bought into these stocks because you believe in the companies' long-term prospects. However, one should also always stay well informed, be vigilant, and stand ready to get rid of any of the stock holdings should a company decide to cut its future dividends. Don't get me wrong, this may still be a great company, and cutting their dividend may be the best decision their management ever made in order to protect the company's long-term profitability. But income-hungry investors did not sign up for this when they included this share in their dividend income portfolio. Ergo, said stock no longer matches the portfolio's requirements, and ought to be sold.

Last but not least – this is extremely important – when investing in stocks for dividend income, one should make full use of tax-efficient wrappers. By this I mean ISAs and SIPPs. Everyone has an annual allowance, so why not use it? Dividend income is taxable, but is tax-free if it is paid within an ISA or SIPP wrapper (please do ask your financial adviser for further details).

Happy trading and investing everyone!

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

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

BY CARL SHAVE

THE END OF DIVIDEND TAX AS WE KNOW IT

The Chancellor of the Exchequer, George Osborne, announced in last year's Autumn Statement that from 6th April 2016, dividends from limited companies that are currently tax-free will be taxed. As a business owner myself, I remember my ears pricking up at the announcement, but I couldn't have predicted the number of complaints I'd hear from small business owners and investors in my capacity as a commercial loans and finance specialist. So, what are the proposed changes and how will they impact businesses?

In a nutshell, from 6th April 2016 the notional 10% tax credit on dividends will be scrapped. However, a new £5,000 tax-free allowance will be introduced and dividends received by an Individual Savings Account (ISA) or Self-Invested Personal Pension (SIPP) will be unaffected, regardless of the status of the taxpayer. No income tax will be due when the dividend shares are held in an ISA or SIPP.

Currently, dividends paid by UK companies carry a notional tax credit of 10%, which is then used to fully or partly offset any tax due. This means basic rate taxpayers have nothing to pay, higher rate taxpayers have an income tax liability of 25% (rather than 32.5%) and it's 30.5% for additional rate taxpayers (instead of 37.5%).

"YOU'D BE FORGIVEN FOR THINKING THE NEW DIVIDEND TAX EQUATES TO DOUBLE TAXATION AS DIVIDENDS ARE PAID OUT OF COMPANY PROFITS THAT HAVE ALREADY BEEN TAXED."

When the draft legislation comes in, dividends above £5,000 will be taxed at 7.5% (basic rate), 32.5% (higher rate) and 38.1% (additional rate). Dividend income will be treated as the top band of income for that individual. No tax will be deducted at source, so individuals receiving a dividend income above £5,000 will need to complete a self-assessment return.

You'd be forgiven for thinking the new dividend tax equates to double taxation as dividends are paid out of company profits that have already been taxed. However, HMRC cites the following as the reason for the change:

"This measure will help address the incentive for some people to set up a company and make payments as dividends rather than as wages simply to reduce their tax bill, enabling the government's plan to reduce the rate of Corporation Tax to 18% by 2020.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"ARGUABLY, SMALL BUSINESSES WHO CAN AFFORD TO PAY SUBSTANTIAL DIVIDENDS OUT OF COMPANY PROFITS ARE SOLVENT AND SUCCESSFUL, BUT COULD FUTURE GROWTH POTENTIALLY BE STUNTED BY THE IMMINENT DIVIDEND TAX CHANGE?"

"The measure will modernise, reform and simplify dividend taxation, creating a fairer system. Only those with significant dividend income, or those who are able to pay themselves dividends in place of wages, will pay more tax. Around one million individuals will pay less tax on their dividend income due to the new Dividend Allowance."

So, will some taxpayers really be better off? Yes. Higher and additional rate taxpayers receiving £5,000 or less in dividends won't pay anything, where currently they pay 25% (£1,250) and 30.5% (£1,525) respectively on the whole sum. And let's not forget, your £11,000 personal allowance also applies to dividend income, so you could receive up to £16,000 a year tax-free if you haven't used your personal allowance elsewhere.

I'm by no means a tax adviser, but if someone were to ask me what I'd do as a business owner to mitigate the impact of the new measures, I'd consider the following:

Either take out as much as possible in dividends before 6th April or look at transferring your shares into an ISA or SIPP. I would strongly suggest that you seek professional advice from a qualified financial consultant first, as transferring shares into an ISA is not quite as straightforward as it sounds.

HMRC claims the change will have "a negligible impact on businesses", but there's genuine concern among small business owners/investors that they'll be hardest hit. By HMRC's own admission, the change is designed to have a negative impact on business owners who are deliberately accumulating cash within the company and paying salaries and dividends within tax-free limits.

Here are some examples of how companies paying small salaries (to preserve state pension entitlement) and larger dividends (to reduce National Insurance contributions) will be worse off.

Assuming you've used your personal allowance for other income, under the current rules, a £32,000 dividend would fall into the basic rate bracket and be taxed at 10%, or £3,200. You would then receive the notional 10% tax credit, effectively making your tax liability nil. Under the new rules, only the first £5,000 would be tax-free (covered by the new dividend allowance) and you'd have to pay 7.5% tax on the remaining £27,000, or £2,025.

Let's again assume your £11,000 personal allowance has been used and look at a more extreme example for a higher rate taxpayer. A company you've invested in has had a great year and you're now due a £100,000 dividend. Great news, right?

It's even better news if you get it before 6th April. Here's why... Under the current rules, you'll pay 10% on the first £32,000 (£3,200) and 32.5% on the next £79,111 (£25,711) - a £100,000 dividend is grossed up to £111,111 for tax purposes. You'll then receive a 10% tax credit of £11,111, so your total tax liability will be £17,800.

As I understand it, under the new rules, you'll get the first £5,000 tax free, then you'll pay 7.5% on the next £27,000 (£2,025) and 32.5% on the next £68,000 (£22,100). However, with no tax credit to offset, your total tax liability will be £24,125. That's an increase of £6,325.

Arguably, small businesses who can afford to pay substantial dividends out of company profits are solvent and successful, but could future growth potentially be stunted by the imminent dividend tax change? Ultimately, it'll mean less money being returned to business owners and investors, who would, in all likelihood, re-inject that money into the business at some point to aid growth and expansion.

HMRC might claim that "more than three quarters of all those who receive dividend income will either gain or be unaffected by these changes", but it'll be hard to convince those who will be affected that the government has the interests of small business at heart.

About Carl Shave, Director, Just Mortgage Brokers

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

BY CAROLINE DREWETT

STARTUP BRITAIN

Britain's startup scene has been lagging behind its counterparts in America and elsewhere in recent years. But the UK is not only catching up; arguably, it is taking over as one of the best places to start a company.

If someone mentions startups, the first thing you think of is the tech industry. Geek chic is well and truly in vogue thanks to the last few years, which have seen films such as *The Social Network* glamourise the Facebook journey, as well as two Steve Jobs films, the latest of which is up for multiple Oscars. Google regularly ranks top as the UK's best employer, with Apple gaining the number one spot across the pond. Silicon Valley in California has been booming with tech startups for years, but many commentators – including some of Master Investor's own – have predicted the bubble will soon burst. With endless money being pumped into the next big success story, investors are slowly starting to think twice about parting with their cash and looking elsewhere.

However, America's greatest strength in business is something that Britain often fails to replicate: its attitude towards risk. Failure is not a dirty word in the States; rather, it is proof that a company has drive, determination and has aimed high.

"AMERICA'S GREATEST STRENGTH IN BUSINESS IS SOMETHING THAT BRITAIN OFTEN FAILS TO REPLICATE: ITS ATTITUDE TOWARDS RISK. FAILURE IS NOT A DIRTY WORD IN THE STATES."

Richard Branson is trying his hardest to debunk the risk myth over in the UK; his social media is filled with quotes encouraging followers about the positives of risk and ambition. He recently published a post entitled "How much failure is just enough to trigger success?" on Virgin's *In Focus* website, a platform which helps entrepreneurs gain insight and knowledge into how to get started.

Just because more Americans are bold enough to take the startup leap of faith, it does not mean that they hold the same levels of success as us Brits. *Business Insider* recently featured a New York based startup which was proud to have become profitable "within just five years". *Just five years*, as opposed to the three years that many UK companies base their funding goals on. Starting is one thing, but becoming profitable and sustaining growth is a different story altogether. Only 45% of Brit-

"STARTING IS ONE THING, BUT BECOMING PROFITABLE AND SUSTAINING GROWTH IS A DIFFERENT STORY ALTOGETHER. ONLY 45% OF BRITISH BUSINESSES ARE PROFITABLE WITHIN FIVE YEARS."

ish businesses are profitable within five years, so what are the benefits of staying in the UK rather than travelling to Silicon Valley in search of fame and fortune?

Firstly and most importantly, the London startup scene is still relatively new. Commentators place it up to an astonishing twenty years behind Silicon Valley. Being a part of something new is not necessarily negative; it means much less competition, and the market is less likely to be competitive and saturated. Of course, this also means that investors are arguably more tentative about parting with their money, which stands in stark contrast to the situation across the pond, where crowd funding and startup investment is now just as familiar as the traditional methods of investments such as stocks and shares.

Secondly, there is diversity within the strands of startups that are proving successful. The only strand of startups that is well and truly secure is FinTech, of which the City of London seems to have in abundance. As so many FinTechs function with a B2B mode, it is relatively easy for gaps in the market to be followed through. In simple terms, they find a niche, sell to a finance company, and the rest is simply code, develop, improve, and repeat. British C2C (consumer to consumer) products have traditionally found it harder to find their feet. Not only do you need a good product, but you need to convince the masses that they need it enough to part with their hard earned cash for it. Many consumers do not even know what they want or need, so entrepreneurs need to predict trends for them.

So where's the competition, other than California and New York? Asian cities like Hong Kong and Singapore are having a startup resurgence and are now receiving government assistance to promote the entrepreneurs of the future. In India, four entrepreneurs have had huge success with WhichApp, an app designed to help consumers work out which apps to download or buy. They are aiming for five million users by December 2016 – that's five million people downloading an app solely to decide which other apps to use. Similarly, in Malaysia there are now startups which discover startups. Companies like StartUpMalaysia are the one stop shop to help cash-rich, time-poor investors sieve through the startup scene looking for the next big thing. If you can succeed as a startup for startups, you know the trend is becoming more stable and reliable.

"WITH SHOREDITCH AND HACKNEY NOW A HAVEN FOR STARTUPS, ENTREPRENEURS ARE IN GOOD COMPANY IF THEY START A BUSINESS THERE."

Closer to home, startups are succeeding in just about any and every area, even those already deemed saturated. Oppo, a new ice cream brand has just become the most successful food and drink company to reach its target via crowdfunding platform Seedrs. To compete against the likes of Ben and Jerry's and Haagen Dazs, the East London based startup credit their success as being down to having an "easy to understand product that people can imagine buying". Whilst most of the food giants are fighting the government's sugar tax and the publicity that comes with it, Oppo have simply created a sugar-free ice cream with fewer calories than a large apple.

With Shoreditch and Hackney now a haven for startups, entrepreneurs are in good company if they start a business there. Not only can they meet up with other entrepreneurs at numerous events, but they can keep costs down with any of the hot-desking options. That means that an afternoon of meetings in another part of town won't cost you in terms of office rent. Or if you want to take on extra staff, you don't need to up and move to a bigger building, but just pay for extra desk hours. Now more than ever, London is an expanding place for startups, as it is sitting beyond the stages of an unknown market, but it hasn't yet been fully developed. This gives investors just enough confidence to back an idea, whilst startups aren't competing against every other Millennial in Britain for funding.

BY EVIL KNIEVIL (AKA SIMON CAWKWELL)

THE BEST OF THE EVIL DIARIES

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

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

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

8th February

I made a quick £5,000 on being long **Glencore (GLEN)** last week and, rather to my surprise, find that the price has not retreated this morning. However, there is a huge short position in this stock – perhaps 1bn shares or c. 7% of the issued equity, where it is capitalised at around £14bn. Given that I am assured that this company is making $2.5-3.0bn a year on basic trading and, at the same time, bringing its debts under control, one can begin readily to see that Glencore might well double on, say, a two year view. Now 100p.

*****

Oppression corner (1):
Tom Hayes is now to take his case to the Criminal Cases Review Commission. I hope that this will free him. To recap., he has been found guilty of criminal conspiracy when in fact all possible conspirators have now been found not guilty of that same charge. This is a legal nonsense. In any event, there remains the extraordinary fact that Tom merely carried out his masters' bidding. How on earth is it possible that they have never been called to account? The fight goes on.

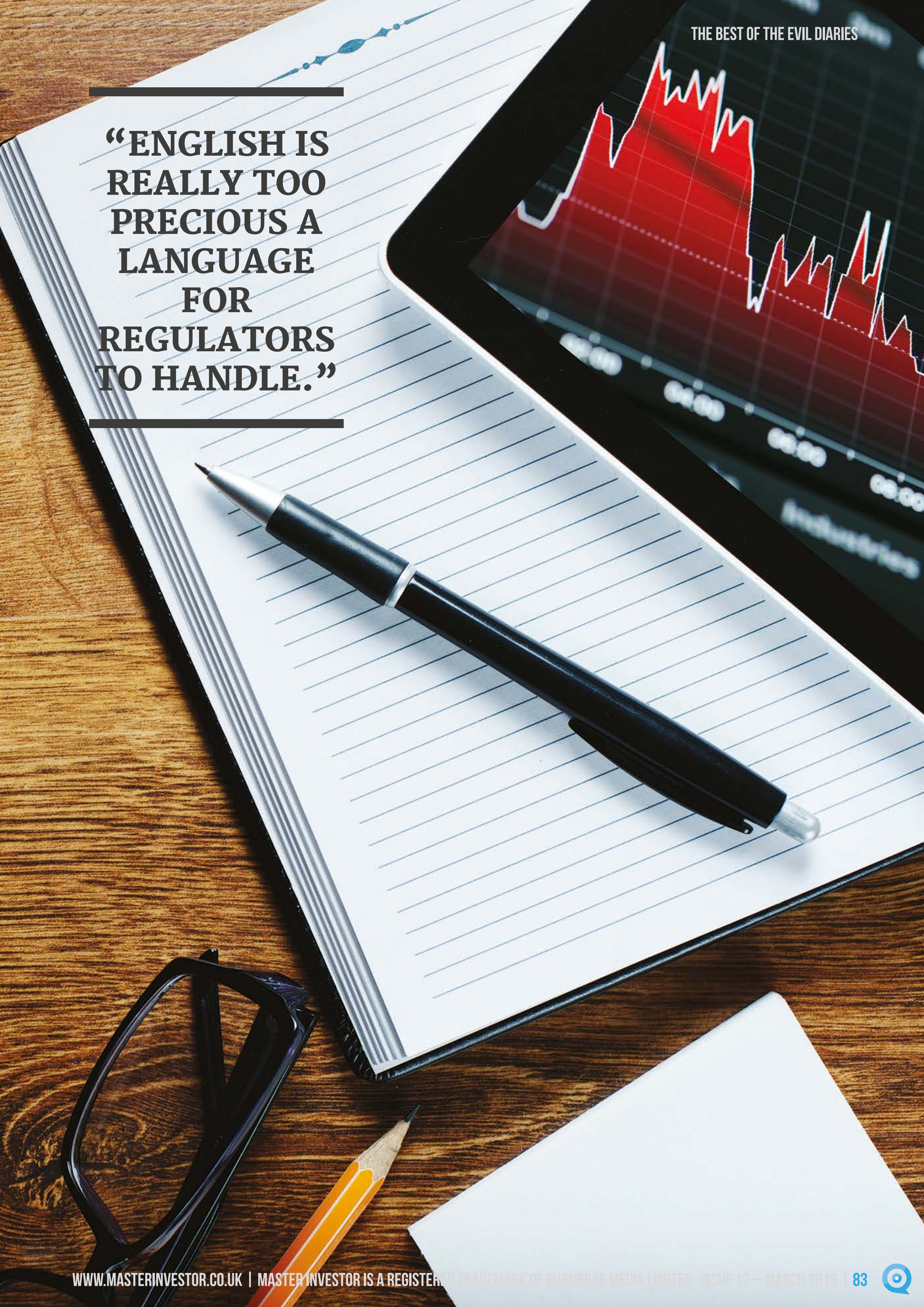
Oppression corner (2):
Navinder Sarao, an entirely separate and different case, seems not to have broken any UK law when trading as he did. This should mean that, regardless of any curious twists in American law, he cannot be extradited there. Goodness knows what all this has cost Mr Sarao so far.

10th February

English is really too precious a language for regulators to handle. Yesterday, I got from the FCA the term "complex instrument" instead of complex investment (the term used by Charles Stanley when causing me/my family grief – watch this space). To the FCA official who gets out of giving a proper answer to my enquiry, these two terms are the same. He'll nonetheless retain his job. The FCA is dependent upon the ascendancy of idiocy.

Elsewhere, in today's DMail I read that regulators are trying to crack down on market manipulation. It would be helpful if this could be defined. It can't. Therefore a vast sum is to be spent on seeking to achieve the impossible.

*****



"ENGLISH IS REALLY TOO PRECIOUS A LANGUAGE FOR REGULATORS TO HANDLE."

Finally, over in the world of tennis, there is a move to find out about the incidence of rigged tennis matches. This latter is an intolerable corrupt practice and it is impossible to imagine that it is not. But, this morning, we learn that "court-siding" is a corrupt practice. For latecomers I explain court-siding: This is the practice of taping some transmitter to one's leg (underneath one's trousers) and broadcasting to one's mates points scored as they happen. Even umpires have been paid by bookmakers to provide this results service. All this is alleged to be corrupt. It is of course nothing of the sort. It is merely an instance of someone doing something quicker than the others. This just conceivably may be contrary to the rules of tennis and those visiting tennis tournaments (I have no idea why) but it could not possibly be described as corrupt.

"IT DOES SEEM THAT MASTER INVESTOR'S ANNUAL ASSEMBLY (23RD APRIL IN ISLINGTON) HAS CAUGHT THE PUBLIC'S IMAGINATION BIG TIME."

11th February

It has taken a long time to gather this far but it does seem that Master Investor's annual assembly (23rd April in Islington) has caught the public's imagination big time. I'll try and persuade the organisers to include a serious drinks assembly area. There is no guarantee of success. So, here's hoping.

12th February

After hours last night in America, **Zillow (Z)** collapsed again – this time to $16 – whilst **Nu-Skin (NUS)** collapsed from $30 to $24. What is really happening is that these essentially useless companies (so ably highlighted as such by Andrew Left of Citron years ago) have finally come to be seen as such by the American retail investor. This is a profound change and it certainly has not stopped yet. I, for my part, got some **Tesla (TSLA)** away at $159 yesterday afternoon and shall sell each recovery burst.

I have also read a coruscating attack upon **Twitter (TWTR),** the share price and not the medium – this former is now around $14.50. MAU (Monthly Average Users) are now declining. Growth stock? I think not.

*****

When Dame Margaret Hodge was in charge of the HoC Public Accounts Committee she established an astonishing reputation for stupidity and hypocrisy combined and offered through her foghorn of a voice. She was so stupid that she failed (and I presume still fails) to realise that she is immediately and perpetually seen as a liar.

I rather thought that when she departed in favour of Meg Hillier we the people would find a subtler animal. Au contraire: yesterday Ms Hillier, whose voice is marginally less repulsive, set about quizzing Google's UK boss on Google's corporation tax bill. She decided to ask this hapless chap what his pay is where this topic is of virtually no relevance and, quite possibly, could not be answered instantaneously and accurately. But the Hillier harridan pushed on trying to whip up public hatred of those whose pay is materially higher than the average wage. She merely made herself look stupid. P.S. She does not so realise. We of course pay Hillier's salary.

photogearch/Shutterstock.com

16th February

Some readers may recall that perhaps seven weeks ago I remarked upon the fact that I, using my PoA on behalf of my brother-in-law and my London-based son-in-law, had been unable on Monday 21st December to buy **Watchstone (WTG)** (nee Quindell) since the regulators at Charles Stanley had decided that Watchstone was, for their purposes, a complex instrument. When of course Watchstone could not be so classified.

As a result, the two people who in effect sought to buy Watchstone missed out on a good profit.

I will not here go into the details attaching to how Charles Stanley handled matters subsequently that day. But for sheer uselessness and silliness CS have been quite impossible to beat. The matter now goes off to the Financial Ombudsman Service and we await the result.

CS emphasised that they had an absolute right to refuse to do any business that on the face of it they had agreed to do. They averred that they had no obligation ever to explain their conduct. That would even be true even if all their weird internal rules had been explained to their clients and potential clients on, say, a website. Of course they have not so been explained in this instance and, I expect, many other instances. They simply refuse to explain themselves.

I am told that their position in law is indefensible.

In the interests of fair play I asked the FCA for their comments. They absolutely failed to assist. Now, there's a surprise.

23rd February

Those with longer memories will recall the 360 economists who opined very early on in Thatcher's reign that her policies would be disastrous when in fact the policies proved to be just what the country needed.

Today we get the update in the form of 200 "Business Chiefs" who have signed a letter to The Times declaring that Brexit will put jobs at risks. They should have stressed that this would be so if in fact those remaining within the EU elected to be utterly irrational and anti-social. The "Business Chiefs" simply do not know that they will so elect.

With these round robin jobbies, one has to be extraordinarily careful about this sort of expression of opinion. One has to try to work out what is in it for them, the "Business Chiefs". (Incidentally, it is not very helpful to try to assess the credentials of these "Business Chiefs" but, to take one example, I see Lady Ruth Rogers MBE, Owner of the River Cafe (no less) has attached her name. As restaurant owners go I doubt if she is the best informed. For me, Rocco Forte would be a better bet. And Rocco is an Outer. And so on and so forth.)

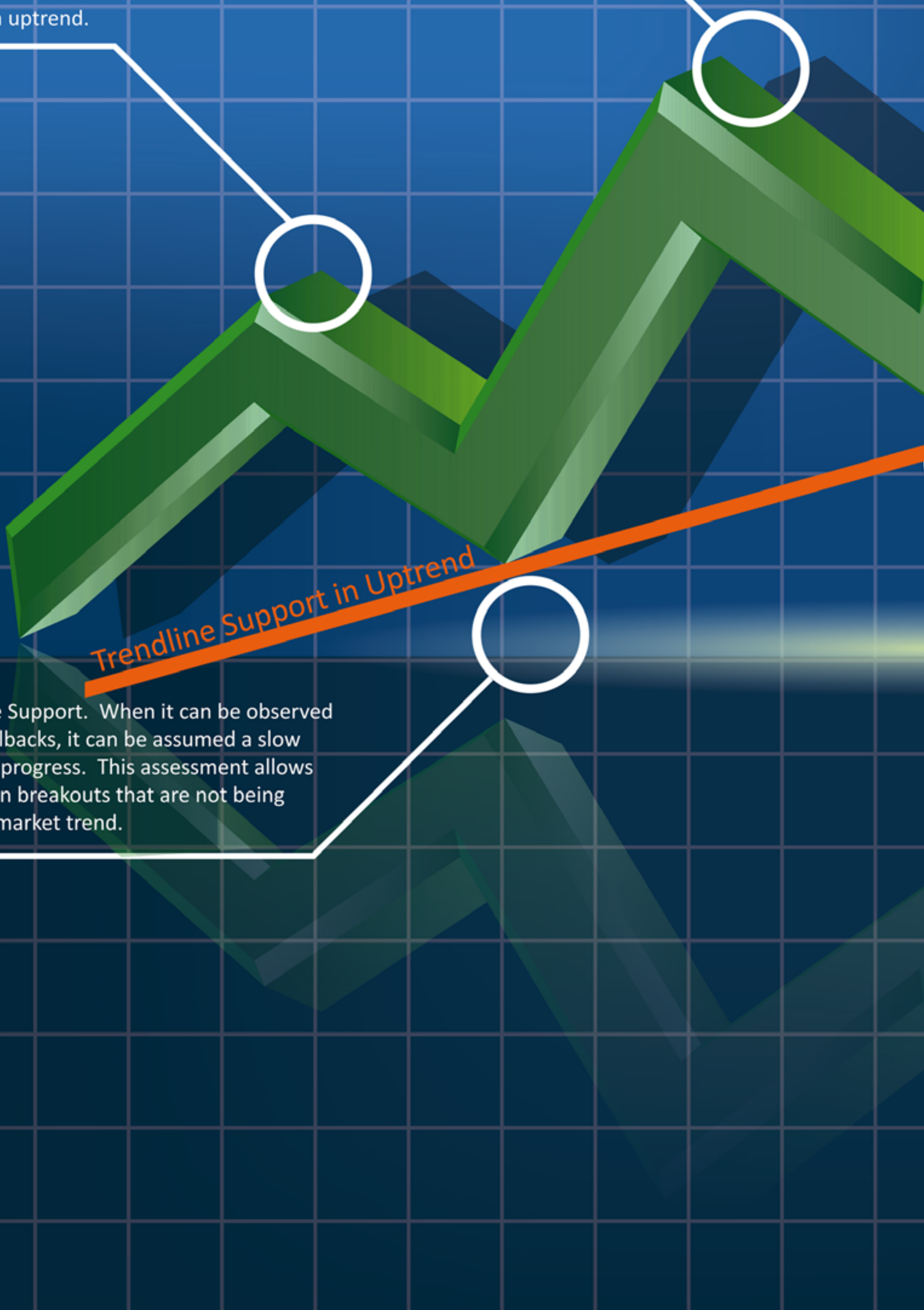
In any event, this sort of letter, if it is to offer anything remotely interesting, must surely cover what happens to the upside if we Brexit. Needless to add, the letter is woefully incomplete in this regard. These "Business Chiefs" are merely self-important networkers. Oh I know they go round getting government contracts etc. and think that they are frightfully important. But that is all they offer. Intellectual integrity? Fergeddit.

"THESE 'BUSINESS CHIEFS' ARE MERELY SELF-IMPORTANT NETWORKERS."

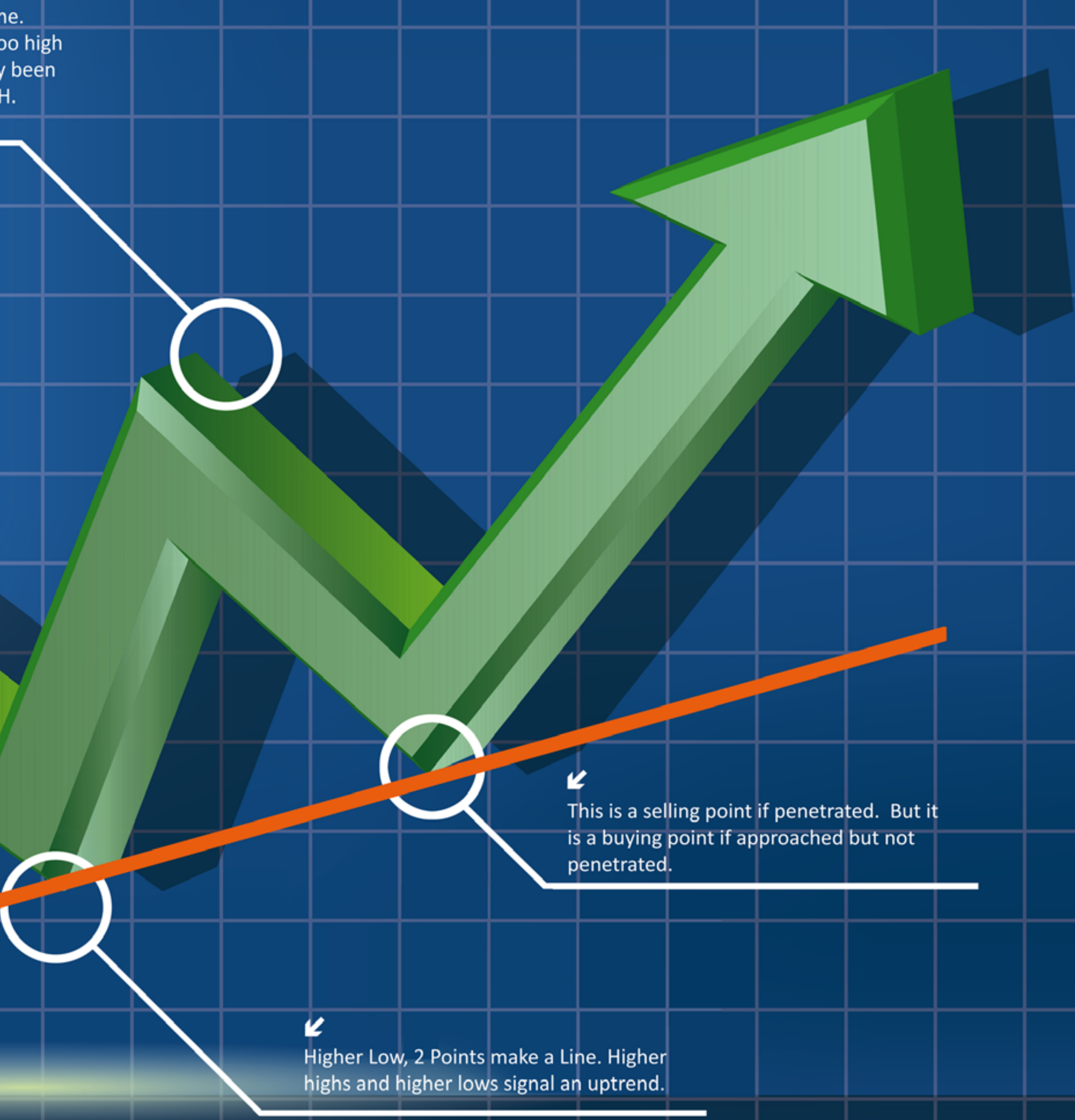
Newsflash! Uptrends don't come in a straight li
The market can go down. The prices are a bit to
to be a buyer now. The easy money has already
made at this point. We BUY LOW and SELL HIG
A good time to take some profits.

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

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



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



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FEBRUARY 2016

BEST OF THE BLOG

Britain should vote Brexit before the Eurozone meltdown

Despite David Cameron's embarrassing imitation of Oliver Twist in Brussels last week, his negotiations ended up mired in the minutiae of trivial amendments to the UK's relationship with Europe. Small restrictions to child benefit and vague wording about exemption from a common currency and "ever closer union" are the thin gruel that our hapless Prime Minister is now presenting to the nation as evidence that he has achieved real reform.

It was not really his fault that he had to deal with such meaningless drivel. Since he had to get agreement from the 27 other member states on every single point, it was inevitable that his initial demands would be diluted. But will these issues really be at the forefront of people's minds when they vote on 23 June? Certainly not.

In Brussels last week, I was presented with "facts" by an EU official (who presumably believes them) suggesting that Britain was bust, a lagging economy, and poorer than France. As an economist and a businessman with extensive interests in the EU, I know the opposite to be

"THE UK IS REALLY THE ONLY DYNAMIC LARGE ECONOMY IN EUROPE, ENJOYS SUPERIOR GROWTH, LOWER UNEMPLOYMENT, AND HAS A PER CAPITA GDP THAT IS SIGNIFICANTLY HIGHER THAN THAT OF FRANCE AND ITALY."

true. The UK is really the only dynamic large economy in Europe, enjoys superior growth, lower unemployment, and has a per capita GDP that is significantly higher than that of France and Italy.

Some might argue that the UK's superior economic performance is because we are in the EU, but I contend the opposite. Without the net transfers of wealth that we make to the EU on an annual basis, without the red tape that comes with being a member, and without the inevitable compression of wages that occurs because we must take in all comers, the UK would grow even faster.

By Jim Mellon

Click here to read the full article

A cash ban is on its way in Europe

The European Union is considering the possibility of banning €500 banknotes in a move to fight corruption, fraud, and even terrorism. The high value of these banknotes makes them *"too useful a vehicle of corruption and other illegal activity"*, anti-fraud authorities claim. We should force people to execute transactions using electronic money and through plastic cards because *"traceability is paramount in fighting corruption and fraud"*, they add.

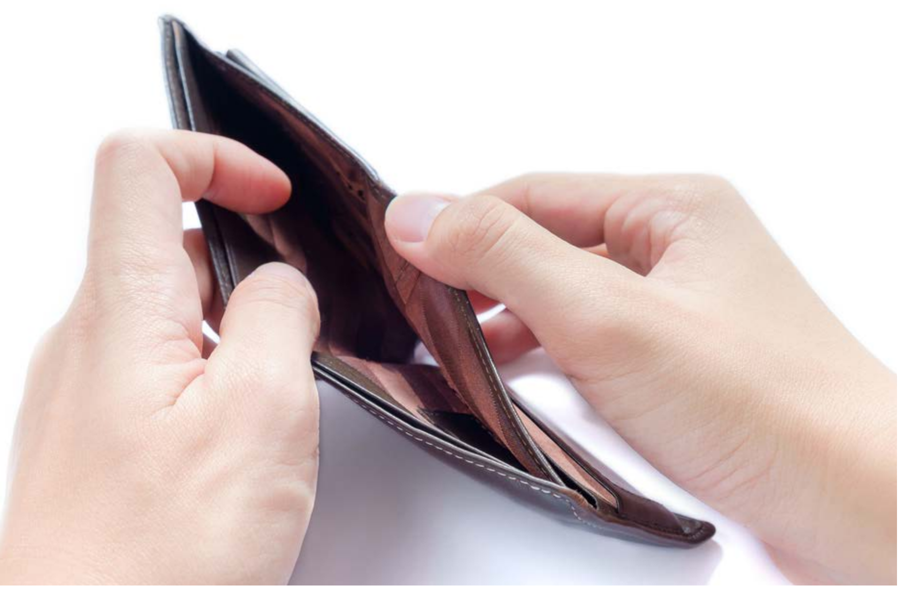
And now for the real reason to ban the 500-euro note: central banks are desperately trying to find a way to overcome the lower bound on interest rates. Banning the highest banknote denomination increases the costs of holding hard cash, which is the same as *reducing* the lower bound.

"CENTRAL BANKS DON'T WANT TO MESS WITH NEGATIVE RATES, AS THEY FEAR DEPOSITORS WOULD CONVERT ELECTRONIC MONEY INTO HARD CASH."

From night to day physical currency was turned into our worst enemy to the point that we should ban it completely. It is often argued that cash finances terrorism, allows people to conduct illegal activities, and makes it difficult to collect taxes. It is also suggested that cash is a burden on banks because they need to keep branches open in remote locations and maintain ATM machines. Sometimes it is even insinuated that cash allows people to be forgotten; to make purchases while still preserving the right to privacy. Heaven forfend! Hardly ever is it pointed out that cash is one of the last remaining tools in the hands of people that impose a limit on central bank action. This last feature could be seen as the yellow and red cards a referee keeps in his pocket during a football game. The simple fact they exist (even if seldom used) effectively caps players' behaviour, as they fear the referee may pull the cards out of his pocket. By the same token, central banks don't want to mess with negative rates, as they fear depositors would convert electronic money into hard cash. Now imagine a football game where the players know the referee is unable to show them a card. *Do you think players' behaviour would change?*

By Filipe R. Costa

Click here to read the full article



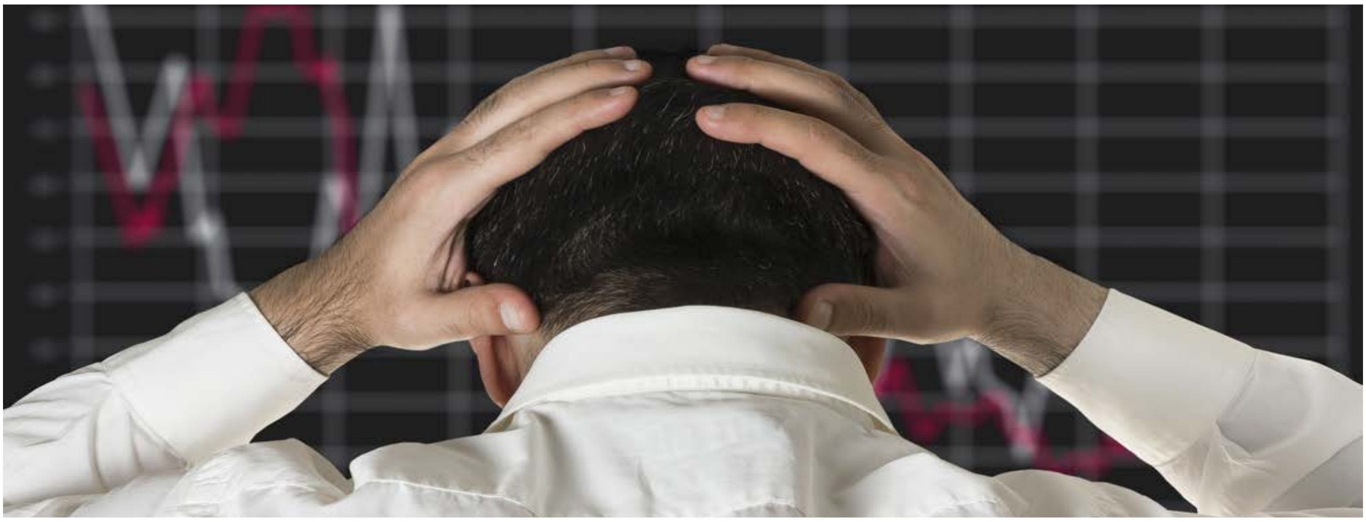
Why I don't think we're heading for a re-run of 2008-09

The return of Banking fears! The news that the mighty Deutsche Bank is under suspicion takes us back to the psychology of seven years ago when most us, including central bank chairmen, realised that we had banking crisis and disaster on our hands. This article attempts to differentiate between the circumstances then and the circumstances now. Whatever is or is not up with Deutsche Bank, we are most certainly not, thank the Lord, back to the conditions of 2008.

Did the onset of the global banking crisis really make itself apparent seven to eight years ago in 2008? That makes it remarkable because we are still living with its economic consequences; or at least its principle consequence of changed economics and more slowly, a changing politics.

I refer to the electorate's much greater mistrust of 'establishment' politicians on both sides of the Atlantic and probably, across Europe. The realisation that the next generation will be worse off than the preceding generation – even in the USA whose citizens were brought up to believe that succeeding generations get better off as a result of free enterprise and the American Constitution, under God. In Arizona we see the triumph of anti-establishment politicians. Donald Trump, who worryingly refers to himself in the third person, and whose every fourth or fifth word is 'great'. And then we have Bernie Sanders, the 'socialist' democratic candidate. Had he described himself as a 'socialist' several decades ago, he would have probably ended up before Senator Joe McArthy's notorious committee charged with un-American activities as a fellow traveller in Communism.

Even the British in their fatalistic way got it into their heads that things would get better for each succeeding generation. Perhaps it will. Maybe the great banking crisis and its implications will prove a temporary intermission in a longer term trend of economic progress. It is, after all, arguable that quantitative easing, which promoted the value of assets above the value of



"WHATEVER IS OR IS NOT UP WITH DEUTSCHE BANK, WE ARE MOST CERTAINLY NOT, THANK THE LORD, BACK TO THE CONDITIONS OF 2008."

money – the stuff that most people live on, called wages or salaries – is a passing phenomenon; something that will be reversed in due course, with wages and salaries once again having the ability, from time to time, to rise faster than profits and financial assets.

By Robert Sutherland-Smith

Click here to read the full article

Mr Putin Sells the Family Silver

On 01 February we learnt that Russia is planning to privatise seven major state-controlled companies.

They are: **Aeroflot,** the airline; **Alrosa,** the diamond miner; **Rosneft,** the oil major; **Bashneft,** an oil minor; **Russian Railways** (the most romantic railway company in the world, in my personal view); **VTB,** the state-wide retail bank; and **Sovcomflot,** the shipping concern. These are all huge and, as far as I can tell, well managed companies which generate massive cash flows and (with the possible exception of Russian Railways) healthy profits.

(Yes, many readers will associate Aeroflot with the bad old days of the Soviet Union when the stewardesses were all ex-USSR female shotput champions. I know this to be true because one of them karate-chopped me when, as a young adventurer, I complained, somewhere over Stavropol, that the mare's milk was off. Yet I can assure you that these days, on all counts, on the London-Moscow route at least, Aeroflot compares very favourably with BA – and is invariably cheaper.)

It is has been widely asserted in the media (the FT amongst others) that this is part of some kind of desperate attempt to plug the hole in Russian state finances caused by the precipitous fall in the oil price over the last year.

Russia is now into a second year of recession, its economy having contracted by about four percent last year. Further, state finances have deteriorated because the state's tax base is overwhelmingly reliant on oil revenues. Russian citizens pay a flat-tax, regardless of income, of just thirteen percent. That's why my favourite actor, Gérard Depardieu, is now a Russian citizen. Corporation tax is modest. So the government is facing a serious budget deficit this year.

Privatisation is not new in Russia: you might say that it has been the consistent theme of state policy since the dissolution of the Soviet Union over Christmas 1991. But there have been no privatisations since Vladimir Putin returned as President in 2012. (Recall that the current Prime Minister, Dmitry Medvedev, was an interregnum President from 2008 to 2012.)

By Victor Hill

Click here to read the full article

BY RICHARD GILL, CFA

READ TO SUCCEED

QUALITY INVESTING: OWNING THE BEST COMPANIES FOR THE LONG TERM

BY LAWRENCE A. CUNNINGHAM, TORKELL T. EIDE AND PATRICK HARGREAVES

A BOOK REVIEW

"Always buy quality, it's cheaper in the long run."

— Tony Hancock

There are many ways in which investors come up with new stock ideas. Whether it be via perusing the charts through technical analysis, looking for low priced firms with fundamental value analysis or simply by following the ideas of others, all are common and well ingrained approaches. But one often overlooked aspect of stock selection is "quality". This is an often used word within the investment industry but somewhat hard to define.

In *Quality Investing* that is exactly what the authors attempt to do: explain the key characteristics of quality companies in an investment context, backed up with numerous examples gained over their decades of experience in the markets. More importantly, the book will teach you how to find these companies yourself and make some decent long-term profits.

The book began as a side project at AKO Capital, the authors' fund management firm, which currently has $9 billion of funds under management. And their views are well worth listening to. With a long-term approach, taking stakes in high quality listed companies, AKO's long-short fund has outperformed the market (MSCI Europe) by a compound annual growth rate of 6% per annum since it was founded in 2005. Amongst other things, its focus is on bottom-up stock picking and on companies with "outstanding" management teams.

What is quality?

"...even though quality cannot be defined, you know what quality is".

- Robert Pirsig in
Zen and the Art of Motorcycle
Maintenance

As mentioned above, "quality" is a frequently used word in equity investment. But it can be difficult to know what it actually means. In contrast, other investment approaches such as growth, value, momentum etc. have pretty well understood definitions.

So, what exactly is quality investing? To quote the authors, *"Quality investing is a way to pinpoint the specific traits, aptitudes and patterns that increase the probability of a particular company prospering over time..."*

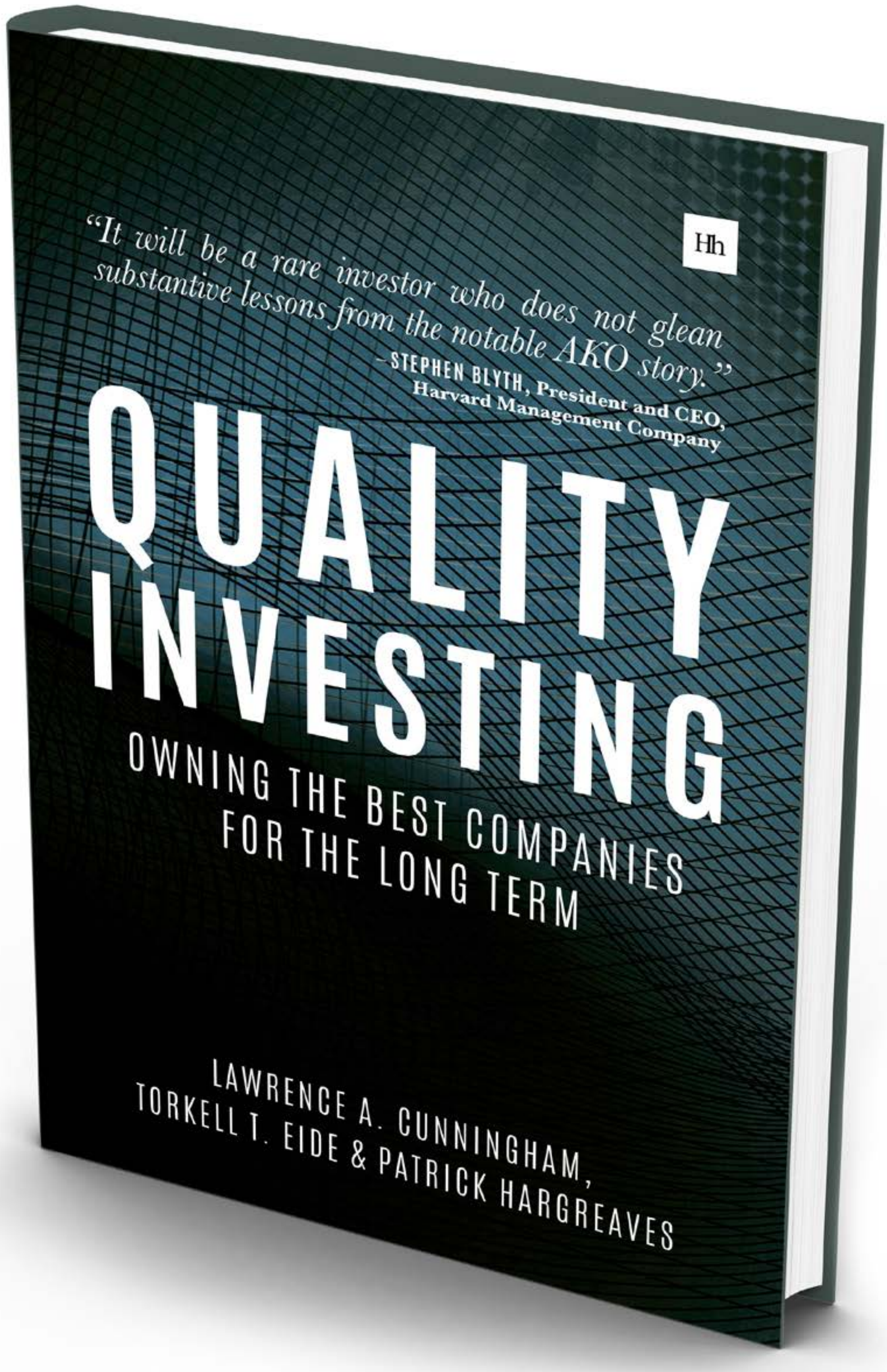
Traditional finance theory says that abnormal returns cannot be delivered by firms long-term. Instead, returns revert to the mean as the factors which have delivered excess gains are eroded away. But "quality" companies have a number of characteristics which enable them to defy the theory and consistently deliver abnormal returns over time.

Specifically, the authors note three factors which point toward quality in a company:

- strong and predictable cash generation.
- sustainably high returns on invested capital.
- attractive growth opportunities.

While all are desirable, if a company exhibits all three traits then investors could be on to a winner. The rationale behind this is simple. If cash flow is strong and there are opportunities to make decent returns via reinvestment, then over the long term earnings will grow and the share price will follow.

The core text of the book is comprised of four chapters looking at the features of a quality investment and then looking at the "patterns" which enable quality companies to deliver strong financial results – such as recurring revenues, pricing power and strong brands. The authors also examine potential pitfalls that companies which exhibit quality characteristics may come across, along with how investors can implement a quality investment strategy.



A quality company

To get the full range of features which a "quality" company exhibits you will have to read the book. But to give one example let's use Unilever – also a favourite company of the fund managers Nick Train and Terry Smith, whose investment approaches are very similar to those referred to in the book.

Unilever is the FTSE 100 listed consumer goods company with a history going back over 100 years and a global presence in almost 200 countries. It is that global outlook which has driven its strong growth over the years. Brands have been built up in multiple geographies, with extensive distribution and sales networks giving a huge advantage over competitors. In Indonesia, for example, Unilever's distribution network is larger than the country's postal system. These extensive set-ups also enable the company to know more about its customers and launch new products more easily.

If you are in any doubt about the quality of Unilever, look at the chart below. Currently capitalised at c.£90 billion who says elephants don't gallop?

Not as easy as 1,2,3

Unfortunately, the characteristics used to identify quality companies cannot be reduced to simple quantitative measures. And those factors may change over time and within different industries. As the authors state, *"Quality investing is a process of life long learning rather a static prescription".*

And of course a quality approach is not the only way to success in investing. Notably, it is entirely possible to make money on the raft of (to put it in a mild way) lower quality companies on the market – especially in the small cap arena where sentiment can often come before fundamentals.

"QUALITY INVESTING IS A QUALITY BOOK OF WHICH I HAVE NO REAL CRITICISMS."

But for those investors who are interested in making steady and relatively predictable long-term returns, the quality investing approach is definitely one worth following.

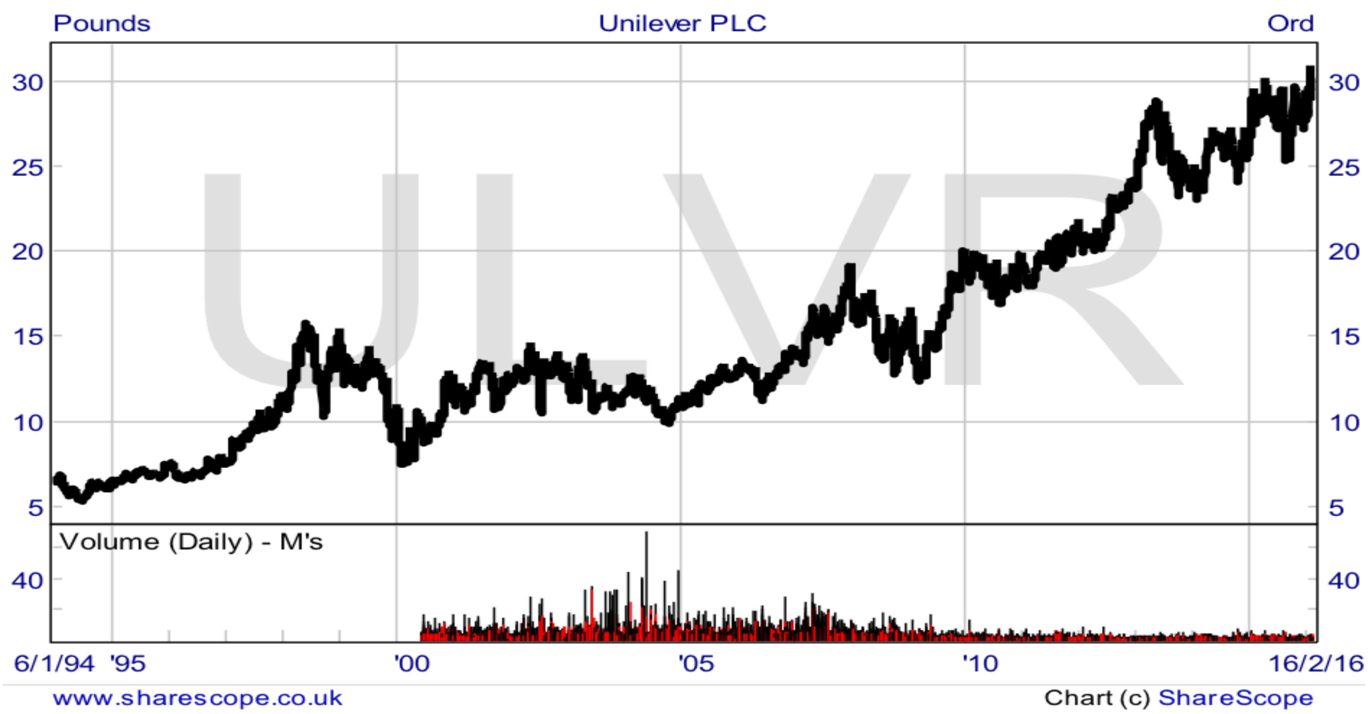
Conclusion

Quality Investing is a quality book of which I have no real criticisms. The only real downsides (and they are small) is that it mainly focusses on larger stocks and probably won't be much use to day traders who look to profit on short-term, sentiment driven share price movements. In addition, the book is mainly focussed on analysing larger European companies – blue-chip stocks which have built up their businesses to a certain level but could still go further.

While the philosophies covered can also be applied to small cap stocks the book's focus is aimed at relatively low risk investors who want to make annual gains in the high single-digit range, as opposed to those who want to find stocks with the potential to make more short-term, multi-bagging returns. But that is by no means a bad thing – as we all know small cap stocks can lose a large chunk of their value over a very short period of time.

Overall, for anyone new to investment this book is a great introduction to the industry, as it identifies how investors can pick out generally low risk companies which have the potential to generate decent compound returns over the long term. It is also an ideal complement to the knowledge of seasoned retail punters and finance professionals alike.

Quality Investing can be purchased from our friends at Harriman House.



BY JOHN KINGHAM

THE FINAL WORD

WHY I LOVE BEAR MARKETS

It took me a very long time to realise it, but bear markets really are a long-term investor's best friend. Not that you'd know it from all the panic-inducing hype put out by the mainstream media. But despite the relative smallness of this latest bear market, the oft-repeated mantra of being greedy when others are fearful is still the single most important idea that investors are ever likely to hear.

This idea is entirely counterintuitive. After all, why would anybody want to buy something that's going down in value, or sell something that's going up? Surely it makes more sense to hang onto whatever's going up and sell what's going down?

That's exactly what I used to think. I remember selling virtually all of my stock market investments in 2003. The market had gone down for three years in a row and I was worried that those declines would be permanent. In my case – and I think this applies to most investors who panic when prices are falling – I was focusing on the wrong thing. I was focusing on the market price of my investments rather than the investments themselves. This is a key distinction and it's an area where stock market investors would do well to learn from property investors. For most property investors what matters is the property itself and its ability to generate cash. Yes, the market price of the property is important, but only when the investor is looking to sell, which is typically many years or even decades in the future. As long as the property is cash flow positive what the market value of the property is this week or this year is virtually irrelevant.

"MOST STOCK MARKET INVESTORS FOCUS FAR MORE ON THE PRICE OF COMPANIES THAN THEY DO THE LONG-TERM CASH GENERATING ABILITY OF THOSE COMPANIES, AND THAT'S USUALLY A HUGE MISTAKE."

But most stock market investors focus far more on the price of companies than they do the long-term cash generating ability of those companies, and that's usually a huge mistake. Take my younger self from 2003. All I could see was that the FTSE 100 had fallen from around 7,000 in 2000 to 3,500 in 2003 – a 50% decline in market value. I sold out because I had no idea how low it would go, and whether it would ever come back up again.

I was totally focused on the market price, but what about the cash generating abilities of the companies that made up the FTSE 100? In other words, how did the dividend change between 1999 (just before the peak of the market) and 2002 (just before the bottom)?

In index point terms, the FTSE 100's dividend in 1999 came to 141 points (the yield was just 2.1% at the time). In 2000 the dividend fell to 135 points and stayed at the same level in 2001. By 2002 the dividend had rebounded to 140 points and in 2003 it reached a new all-time high of 143 points. Amazingly enough, during that 50% bear market decline between 2000 and 2003, the FTSE 100's dividend only declined by 4%.

Imagine a property investor who decided to panic sell and lock in a 50% capital loss just because the rent on their property fell by 4%. Most people would think that was crazy, but that is effectively what I and many other investors did in the bear market of 2003.

So if selling is usually the wrong thing to do in a bear market, what is a more sensible course of action? The answer is to do what most people do when goods are on sale: *Grab your wallet and start shopping.* The evidence from history is that this is almost invariably a good idea, as long as you have a multi-year investment horizon, which should be true of almost all stock market investors.

Here's one example of what I mean by "evidence from history":

By looking at the S&P 500's cyclically adjusted PE ratio (CAPE – which compares the current price to the ten-year average of inflation-adjusted earnings) at a particular point in time, and then comparing that valuation ratio to the index's subsequent average total returns (measured over all periods from one to 30 years), we can see how today's valuation and an index's future returns relate to each other.

"I THINK IT IS REASONABLE TO EXPECT THE FTSE 100 TO PRODUCE AVERAGE TOTAL RETURNS THAT ARE IN THE REGION OF 10% PER YEAR OVER THE NEXT 30 YEARS."

The results are very interesting:

- When the S&P 500's CAPE ratio was below 10, the average future total return was 9.8% per year.
- When CAPE was between 10 and 20, the average future return was 6.6% per year.
- When CAPE was between 20 and 30 the average future return was 2.7% per year.
- When CAPE was above 30 (which happened only twice between 1881 and 1985, which is the period this example covers) the average future return was a not very impressive 0%.

So when CAPE was high (i.e. during major bull markets) subsequent returns were poor, and when CAPE was low (i.e. during major bear markets) subsequent returns were excellent.

In terms of the S&P 500's historic bull and bear markets:

- Returns after the 2000 bull market have so far averaged a terrible -2.5% per year.
- Returns after the late '60s bull market averaged less than 1% per year.
- Returns after the late '70s and early '80s bear markets averaged a very impressive 13.8% per year.

- Returns after the 1932 Great Depression low averaged 12.4% per year.

The idea that bear markets are excellent buying opportunities stands the test of time for most investors in most markets at most points in history.

For investors who are in the accumulation phase and who still have at least a decade to go before switching to the income phase, bear markets are not something to fear; they are something to look forward to. They are an opportunity to buy good companies and good indices at low valuations, with high yields and with valid expectations of high future returns.

So where are we today, with the FTSE 100 hovering around the 6,000 mark, which is more or less where it was almost two decades ago? Thanks to the recent bear market, the FTSE 100's CAPE ratio is currently just 11.8 and although the FTSE 100 is not the S&P 500, I think the UK market is likely to produce returns that are broadly similar to the US market when starting from similar valuation levels.

On that basis I think it is reasonable to expect the FTSE 100 to produce average total returns that are in the region of 10% per year over the next 30 years. Given that the UK market's long-run average return has been around 7% a year, I expect this recent bear market will once again prove to be a good opportunity for long-term investors.

About John

John Kingham is an experienced private investor, investment blogger and newsletter publisher. His professional background is in computer software for the insurance industry, where he worked for clients ranging from Lloyd's syndicates to some of the world's largest general insurers.

In 2011 John left the computer software industry and began publishing UK Value Investor, a monthly investment newsletter for defensive value investors.

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MARKETS IN FOCUS

FEB 2016

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
Bovespa	5.9	-1.3	
Russian Trading System	2.7	1.1	
Dow Jones	0.3	-5.2	
FTSE 100	0.2	-2.3	
S&P 500	-0.4	-5.5	
CAC 40	-1.4	-6.1	
NASDAQ 100	-1.8	-8.5	
S&P/ASX 200	-2.5	-7.1	
Euronext 100	-2.8	-6.2	
Hang Seng	-2.9	-11.4	
DAX Xetra	-3.1	-11.6	
IBEX 35	-4.0	-11.4	
Nikkei 225	-8.5	-15.5	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Iron Ore	17.0	13.0	
Gold	11.0	17.0	
Sugar (No. 11)	8.4	-6.8	
Platinum	7.1	4.6	
Cocoa	6.1	-8.6	
Silver	4.6	7.9	
Copper	3.9	0.1	
Crude oil (Brent)	1.8	-2.0	
Crude oil (Light Sweet)	0.1	-8.9	
Palladium	-1.3	-12.4	
Soybean	-2.2	-0.2	
Coffee	-3.4	-8.6	
Natural Gas	-26.2	-27.6	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
EUR/GBP	2.8	6.1	
AUD/USD	0.8	-2.1	
EUR/USD	0.5	0.2	
EUR/CHF	-1.9	-0.2	
GBP/USD	-2.2	-5.5	
USD/CHF	-2.4	-0.4	
GBP/AUD	-2.9	-3.3	
USD/CAD	-3.1	-2.2	
EUR/JPY	-6.8	-6.3	
USD/JPY	-7.2	-6.5	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.50%	Mar 17	Apr 14
ECB	0.05%	Mar 10	Apr 21
FED	0.50%	Mar 16	Apr 27
BOJ	-0.10%	Mar 15	Apr 28
SNB	-0.75%	Mar 17	Jun 16
BOC	0.50%	Mar 09	Apr 13
RBA	2.00%	May 05	May 03
RBNZ	2.50%	Mar 10	Apr 28
BOS	-0.50%	Apr 20	Jul 05
BON	0.75%	Mar 17	May 12

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Anglo American PLC	73.1	60.4	
Glencore PLC	48.9	47.3	
Fresnillo PLC	38.5	41.2	
Centamin PLC	36.5	43.8	
Randgold Res Ltd	30.6	56.5	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Mediclinic Int PLC	-23.4	-19.8	
St Modwen Prop PLC	-15.9	-21.2	
Telecom plus PLC	-15.8	-20.6	
Capita PLC	-14.7	-17.1	
Henderson Group PLC	-14.7	-24.0	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Mining	23.6	14.1	
Forestry & Paper	13.7	-3.2	
Industrial Metals	9.8	-6.6	
Aerospace & Defense	7.1	5.3	
Electronic & Elect Equip	6.9	-0.9	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Real Estate Inv & Servic	-7.6	-15.9	
Life Insurance	-7.3	-15.1	
Real Estate Inv Trusts	-6.4	-11.7	
Electricity	-4.7	-9.1	
Pharmac & Biotech	-4.0	-6.5