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INFLATION

HOW TO PROTECT YOUR PORTFOLIO FROM INVESTORS' WORST ENEMY



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WELCOME

Dear Reader,

At times, I have trouble deciding what's more shocking: the utter predictability of certain events, or the unwillingness of the majority of investors to accept that we are living in times of rapid, far-reaching and tumultuous developments.

Case in point: the ongoing crisis at Deutsche Bank.

A few months ago, I posted a note about Germany's largest bank on my personal Facebook profile. I do this whenever I want to test a thesis on a small but clever and diverse audience. My personal Facebook website is in many ways my secret test laboratory.

The reaction to my initial posting about Deutsche Bank wasn't kind. Back in those days, suggesting that something was afoot in Germany was akin to outing yourself as a conspiracy theorist.

Fast forward to today, and it's evident that the warning signs were indeed better taken seriously. It has reached a point where there isn't any need for me to say much about Deutsche Bank's crisis. The dire situation of the largest bank in Europe's largest economy is currently front-page news the world over.

"What next?" is the obvious question. If Deutsche Bank cannot be trusted anymore, what is there in this world that remains safe?

What strikes me right now are the number of (super-wealthy) people I meet who tell me, openly and directly, that the scenario they are preparing for is one where the western world's pyramid of debt will collapse. No-one I have spoken to was so daring as to predict exactly when it will happen, and the general assumption is that "it could be in two years or in 20 years". It's shocking, however, that most self-respecting family offices nowadays seem to work on the assumption that it will happen and that investors need to prepare for it.

Obviously, this is yet another hypothesis that is currently too much to stomach for ordinary investors and the mainstream media. Maybe that's all the more reason to look at it more closely? Quite possibly, there aren't just losses to be avoided, but there is actual money to be made. Crisis equals opportunity, after all!

Master Investor will stay on the pulse for you.

Regards,

Swen Lorenz Editor, Master Investor



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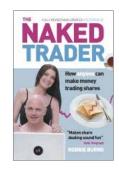
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In the second instalment of this series, entrepreneur Caroline Drewett looks at how Millennials can still get on the property ladder with confidence following the end of Help to Buy.



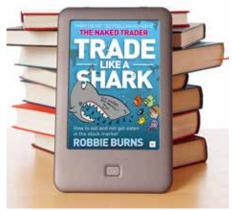
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We look back at some of the most popular pieces from the Master Investor Magazine website during the month of September.



Read to Succeed Trade like a Shark

Richard Gill, CFA, reviews *Trade like a Shark*, the latest book from 'Naked Trader' Robbie Burns. The book explains how traders can control their emotions to make sure they eat, and don't get eaten, in the markets.



The Final Word – The markets – The only true democracy

Adrian Kempton-Cumber calls it as it is. Think you live in a democracy? Think again. The only real democracy – where the prevailing views of the majority of participants hold sway all the time – is the markets.



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Market data for the month of September.



MELLON ON THE MARKETS

THE THINGS KEEPING ME AWAKE AT NIGHT

With the gaggle of visitors to my Spanish lair abating with summer, I've had a lot of time for thinking lately. It's been a quiet time for markets, seemingly, but there have been opportunities, some of which we've taken, and others which we outright missed. But you only need one or two to stay ahead of the pack. However, the images out of Syria have been more than disturbing; they are horrific, and they represent two things. One, there are no easy solutions to badly drawn maps. And second, Syria is becoming a 'pocket' battlefield for Russia, which remains determined to regain its lost status.

On the first point, the Sykes-Picot treaties/secret agreements of 1916, which resulted in a French administration being established in Syria after the First World War, have proved disastrous. The reason that Syria is in such a mess isn't simply because the Americans and Brits didn't intervene, or that Russia has been interfering, or that ISIS came along: it's because a flawed division unreflective of tribal realities - realities that persist today – was undertaken by the French and the British in a rushed division of assets post the Great War.

Further flawed foreign policy decisions, until recently including support for the Assad family, have compounded the situation and laid the blame fairly and squarely at the feet of the British and French, and it is well-deserved blame. So, yes, while I believe that economic migration

is a real problem for us in the developed world, and that we need to do everything we can to limit it, and to filter it to include only skilled migrants, Syria is different.

It's our fault, in some ways, that this is happening and we should do everything to help the poor people of Aleppo and elsewhere within that benighted country, as well as the refugees who huddle on our borders. They are (some of) the Jews of today, homeless and without means, through no fault of their own, and we need to do a lot more to render assistance.

Now, you might well ask, what has this got to do with markets?

Two important things, as it happens:

1. The Syrian crisis will have a big part to play in shaping the atti-

tude to borders within the EU. You might not be familiar with this, but in early October a referendum in Hungary will take place to determine if immigration should be banned. If the result is YES, then Hungary will be seriously at odds with EU policy, and its whole existence within the EU may be in doubt. The Hungarians (along with all of their Eastern European counterparts) love the transfers from the EU (new roads, farm subsidies, new infrastructure etc.), and they LOVE the remittances from workers in other EU countries (hence the Eastern sulk over Brexit). They don't, however, like inward immigration into their largely homogeneous populations. This Hungarian referendum is an iceberg that is just in sight of the bridge of the Euro Titanic, so watch it carefully. I think it could



cause some serious turmoil in Euro markets, including a further sell off in Euro bonds, further declines in EURO STOXX, and a further down leg in the Euro Dollar rate. And then, of course, there's the Italian referendum in November...

2. Normally, I take the view that geopolitical risks (South China Sea, North Korea, etc.) are best covered by holding gold and by praying. But the reckless intervention in Syria by an opportunistic Russia is actually raising my stress levels, and is flashing red for world markets. The Russian economy, which never diversified from fossil fuels in the good years and continues to suffer from capital flight, is still in a bad way. It has shown some marginal signs of recovery, but the outlook for many of its people is bleak. But greyness and hardship is a regular feature of the Russian landscape, and its people adore "strong" leaders a la Putin, and they have a masochistic stoicism. It must be the cold. In the face of a poor economy, Russia has been adding to its military capability and has been pushing the envelope of Western indecision. First, Crimea, then sabre rattling on Ukraine, then Latvia and Lithuania, and now Syria. From Western leaders, there is lots of wordy condemnation, but no action. If there is ONE live flashpoint that really worries me, it is this. If NATO, for instance, doesn't respond to an incursion into the Baltics, then Russia will just keep going. But I think that NATO, whether led by Clinton or Trump, will not respond. The answer to all this? Be cautious on markets, which is especially pertinent as volatility is abnormally low and valuations are high. Oh, and buy more gold.

Meantime, I am starting work on a new book with Al Chalabi and we hope to make it ready by the time of Master Investor 2017 on March 25th. If you haven't got tickets, better apply now. It's free to our readers, so it's worth emailing rebacca@burnbrae.com or going to the masterinvestor.co.uk website for yours. It's going to be HUGE this year, and we are super excited about the companies exhibiting and the quality of the speakers. Of course, it's the UKs biggest investor show and it just keeps getting better.



"I AM STARTING WORK ON A NEW BOOK WITH AL CHALABI AND WE HOPE TO MAKE IT READY BY THE TIME OF MASTER INVESTOR 2017."

In terms of stocks, I am very bullish on **Gilead (NASDAQ:GILD).** It's on about 7x earnings, and boasts a huge cash pile and very smart people at the top. After Medivation was taken over, it also appears a prime juicy takeover target. **Arrowhead (NASDAQ:ARWR)**, headed up by the brilliant Dr Chris Anzalone is another company with great prospects, as is **Synergy Pharma (NASDAQ:SGYP)**, headed up by Gary Jacob; both will be at Master Investor 2017.

I have mentioned **Aurora Labs** (ASX:A3D), the Australian 3D company headed up by David Budge – it's up almost 10x since the IPO, and that was only three months ago! I hope they will be at the show as well, and you should definitely check out their technology. I thank my old mate Anthony Baillieu for the tip here. He's on a roll!

Portage (OTC:PTGEF), founded by my friend Dr Greg Bailey and myself, is doing really exciting stuff, and although it is traded on the Canadian exchanges it is well worth checking out. I believe it could do an Aurora Labs in due course. I imagine they will be at the show, along with the other JV that Greg and I have, Salva Rx (LON:SALV). Meanwhile, Greg and Dec Doogan (ex-head of R&D at Pfizer) are establishing a new

company which aims to invest in life extending businesses.

Sticking to cutting edge technology, Lorne Abony is doing a terrific job at **Fast Forward (LON:FFWD)**, and I am super bullish on that company. I expect him at the show, and he can update investors on how that company has made some TERRIFIC investments.

At the Master investor show, I hope to talk about some of the new opportunities we are seeing in, amongst other things, anti-ageing, AR and VR (buy and hold **Sony (TYO:6758)**), 3D printing, and also in a basic industry that we are currently researching. This could be the trade of the decade. Meanwhile, it's time to stick with gold and the US dollar, and short any bond you can nail down!

Happy hunting!

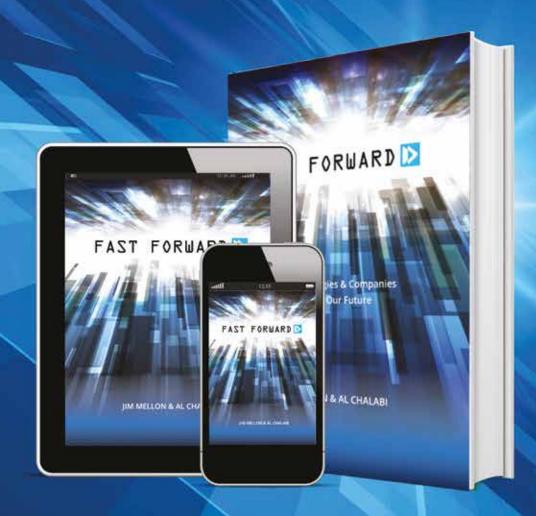
Jim Mellon



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THE UK AND THE PROMISE OF INFLATION TO COME

It's been a long, hot September, and global activity remains muted. The Fed has put tightening on Ice with the market now anticipating modest interest rate rises through next year, while the Bank of Japan is chucking the kitchen sink of extreme monetary policy at the problem of deflation. While markets struggled with a host of conflicting signals and global events, we were sitting sweltering in the office wondering about where the UK economy goes next following the Brexit vote.

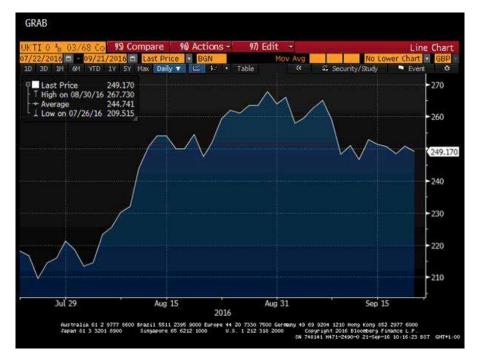
One of the KEY issues we are pondering is the extraordinary volatility of UK inflation linked Government bonds – the so-called Linker Gilts market. It's a key indicator of future inflation expectations.

Although there is a "feel good" factor after the world didn't immediately end on the Brexit vote, and a discernible feeling that recovery might be around the corner, the latest numbers from the Bank of England show inflation remains stubbornly flat at 0.6%, far short of the Bank of England's 2% inflation target. The last data was well shy of the modest 0.7% expectations economists had for the last set of inflation numbers.

Yet, August and September has seen the price of Linker bonds rising rapidly, hinting at swiftly rising inflation expectations. That's the clear dislocation between the Bank's monthly look-back snap-shot of the historical numbers, and what the market expects is going to happen in the future. Linkers tell us inflation will rise!

Take a look at the chart below: this shows the performance in price terms

for the benchmark 0.125% Linker due 2068 – it's moved in a 21% price range from a price of 213 to 267 and back to 250 over the course of the summer. That is a very clear signal inflationary





expectations are rising.

The reason for volatility in Linkers – which in the current zero inflation world pay a massively negative yield – is they represent potential leverage on inflation: the value of Linkers will increase exponentially, as the interest they pay increases as inflation rises. The reason they are so volatile is expectations of future inflation are rising – and rising fast. That's a game-changing concept for investors who believe the "new normal" of low rates and low inflation.

"LINKERS TELL US INFLATION WILL RISE!"

For the last few years markets have become lazy, getting used to the idea of QE Infinity – the central bankers will keep playing with monetary policy and keep interest rates low. The consensus seemed to have been that we're in a "new normal" economic era of low interest rates and low inflation – even deflation and all the ills that suggests.

Should we be surprised that inflationary expectations are rising?

The UK is not doing half as badly as many expected. Brexit proved to be a short-term tea-cup of unfounded fears. (Yes, I'm very aware many Casandras believe Brexit is not yet over, and still has the potential to cripple the UK economy. But let's assume, for very good reasons, that they are as wrong today as they were wrong pre the referendum.) And it's clear the export sectors of the UK economy have taken a boost from lower sterling.

I'm delighted to report my own favourite UK export, Scotch whisky, has seen a massive boost in sales. (For the record, one of the smoky, iodine & seaweed-tasting Islay Malts works for me every time if anyone is thinking of my perfect Christmas gift.)

Let me put exports in context, and explain why whisky is significant. The word comes from the Gaelic "Uisqe Beatha", meaning Water of Life. It accounts for 25% of the UK's food and drinks exports. It's an entirely UK product – not relying on imports to create the finished (very good) good. In terms

of GVA (Gross Value Added) of £5 billion to the UK economy, it's bigger than steel, textiles, shipbuilding or computers. It's nearly one-third the size of the UK's auto sector, and half the size of Pharma and Aviation.

In short, my favourite tipple is a pretty significant part of the real UK economy that's doing rather well. How many other sectors will see similar upside from the weaker currency and the resurging economic can-do confidence that now characterises the UK?

The other side of that currency weakness growth is higher import prices – and that is one source of the rising inflation expectations. If raw materials and finished goods are getting more expensive – that will create inflation. Or will it?

Oil prices have shown a remarkable inability to rise. OPEC is no longer the dark controlling monopoly it once was. The failure of the producer states to agree on production, the continued overcapacity and supply and limited expectations of any scarcity are not threatening any kind of oil spike this year. As a result, oil, a major inflation source is not a significant danger. It





"AFTER 30 PLUS YEARS IN MARKETS I'VE REALISED WE CAN NEVER PREDICT ANYTHING WITH ANY DEGREE OF CERTAINTY - NO MATTER WHAT LOGIC AND QUANTS TELL US."

looks like oil prices are settled in the sub-\$50 barrel range – which is less than 50% of the price just 18 months ago!

That oil price doesn't look likely to soar – even if there is global recovery. Such renewed growth would require an uptick in China growth -which is unlikely as that economy continues its readjustment from command to consumer economy. The fact that US production of fracked and shale oil has become the swing producer means there is little chance of a demand/supply dynamic shock into the foreseeable future. With that in mind, I think we can discount oil as a major source of inflation.

Neither are any of the world economies growing swiftly enough to threaten bottlenecks pushing up prices or wages. Nope, growth is steady, but not frantic. Unlike Europe, where growth is absolutely comatose, here in the UK it's progressing modestly without straining anything.

So why should we still prepare for and fear inflation?

There are many reasons to do so. Not least amongst them is *because it's pru-*

dent. After 30 plus years in markets I've realised we can never predict anything with any degree of certainty – no matter what logic and quants tell us. No see-ums have a disturbing tendency to bite us just when we've discounted all threats. Let me introduce a key concept: Blain's Market Mantra, Rule 1: "The market has but one objective: to inflict the maximum amount of pain on the maximum number of participants."

Inflation is one such threat. It's the kind of thing you can diligently search for, miss and get ambushed by. We think we know what drives it - wages and price pressures - but it's also about confidence, sentiment and other immeasurable indefinables. This is the critical aspect of inflation - it's an imperfect proxy for activity in an economy. A functional economy will suffer inflation as these bottlenecks develop pushing up demand. Equally a disfunctional economy will suffer from inflation from similar bottlenecks crushing supply. (The best examples of this are economies like Germany in the 1920s and present day Zimbabwe.)

Perhaps the biggest driver of future inflation will come from the eventual normalisation of the economy. Normalisation... a return to real interest rates? Surely not – that implies a sell-off in bond markets, a collapse in stocks and currency ructions, all of which would crush confidence, which would surely cause the fragile economic recovery to stall? Again... perhaps not.

Unlike Japan and Europe where central bank monetary experimentation has got their respective economies precisely nowhere, both the UK and the US seem to have a spark of economic life about them. It's also clear that global central bankers are no longer wedded solely to QE, ZIRP and NIRP, (Quantative Easing, Zero Interest Rates and Negative Interest Rates). In recent months the financial authorities have been dusting off old files as they



consider Plan B – fiscal policy to reflate economies.

"PERHAPS THE BIGGEST DRIVER OF FUTURE INFLATION WILL COME FROM THE EVENTUAL NORMALISATION OF THE ECONOMY."

And that's where it becomes interesting to consider why inflation is so low and why economic activity, eight years after the collapse of Lehman Brothers, remains so fragile. I absolutely blame Central Banks for the absence of inflation. The reason we have no inflation today isn't just because economic growth has stalled – it's also because the economy has become horribly distorted.

I rather suspect the horrible truth will soon be out. The last seven years of extreme monetary experimentation has created a mutant economy, where the only beneficiaries have been holders of financial assets. It made perfect sense to follow central banks in buying the bonds they've been chasing, and buying stocks as yields in bonds collapsed.

As the returns from some instruments have been guaranteed by QE, investors have followed these assets. They've been loath to invest in real plant, infrastructure or job creation – why take real economy risk when their expected economic returns look so limited by artificially low rates? Instead they invest in financial assets because these returns are being inflated by monetary policy.

Doh! Far from creating growth, the last eight years of central bank experimentation and regulatory overkill of the banking system has actually engineered this slowdown. Financial gravity dictates that what goes up... must come down.

QE and ZIRP has the effect of sucking all the financial momentum out of economies - corporates borrow billions, not to invest in creating jobs and wealth, but to buy back their stock - further fuelling financial-asset inflation. Eventually the economy sinks into an entropy-minus state where the only game is financial assets fuelled by increasingly pointless further monetary injections. Markets are utterly addicted to repeated hits of government stimulus in the form of artificially low rates and asset purchase programmes - creating a massive moral hazard risk when the bubbles inevitably burst.

Yet, it might be time to encourage real investment in the real economy by spanking these distorted financial assets into touch – forcing money to back the real world instead. Higher rates will trigger a massive correction in bonds and stocks – but that may well be a very good thing!

And it will create a switch from financial assets (stocks and bonds) to real assets like capital expenditure, plant and assets. That could be a wonderful thing – giving hope to the under-employed but also creating the real-world

demand and supply bottlenecks that cause inflation – thus triggering a bout of good old-fashioned honest-to-goodness inflation.

How to invest

First on my list are real assets, infrastructure, plant, machinery, planes, trains, automobiles and even ships. In the newly developing Alternative Assets market we are creating financial instruments that depend not on government distortion of rates, but on real cash flows – deals secured on plane leases, long-term power contracts, property and housing, and consumer spending. It's a fascinating and diverse market.

Meanwhile, we're also thinking about how recovery and inflation impacts the economy. One aspect I'm thinking about is skills shortages and wages. For instance, this country is desperately short of trained engineers who will be required in recovery. If we are about to experience skills shortages across the economy, how would I create an investment to realise that view? There are ways, and just as soon as I've figured them out, I'll let you know.



About Bill

Bill Blain is Head of Capital Markets at Mint Partners, and a regular market commentator.

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THE DIVIDEND HUNTER

FIVE INFLATION-BEATING DIVIDEND STOCKS

One of the things I like most about dividend investing is that there's a good chance the income will grow faster than inflation. Take the FTSE 100's dividend as an example. CPI inflation since 1986 has run at an annualised rate of 2.6% per year, whereas the FTSE 100's dividend has grown by an annualised rate of 4.9% over the same period. So the index's dividend has grown by 2.3% a year even after adjusting for inflation (and of course there have been substantial capital gains since 1986 as well).

Passively investing in a FTSE 100 tracker is one way to access the inflation-beating nature of dividend income. However, as an active investor I prefer to pick individual dividend-paying stocks in an attempt to get a market-beating dividend yield today and market-beating dividend growth tomorrow.

So with inflation in mind, this month I'm going to look at a group of companies that have raised their dividend by at least 2% (the Bank of England's inflation target) every single year since 2008. Within the FTSE All-Share there are about 50 such companies. That's too much for one article so I'll restrict the list to stocks with a yield of more than 3% and then look at the five most consistent growers:

The Restaurant Group (LON:RTN) – FTSE 250 – Travel & Leisure

Share price: 385p Dividend yield: 4.5% 10-year dividend growth

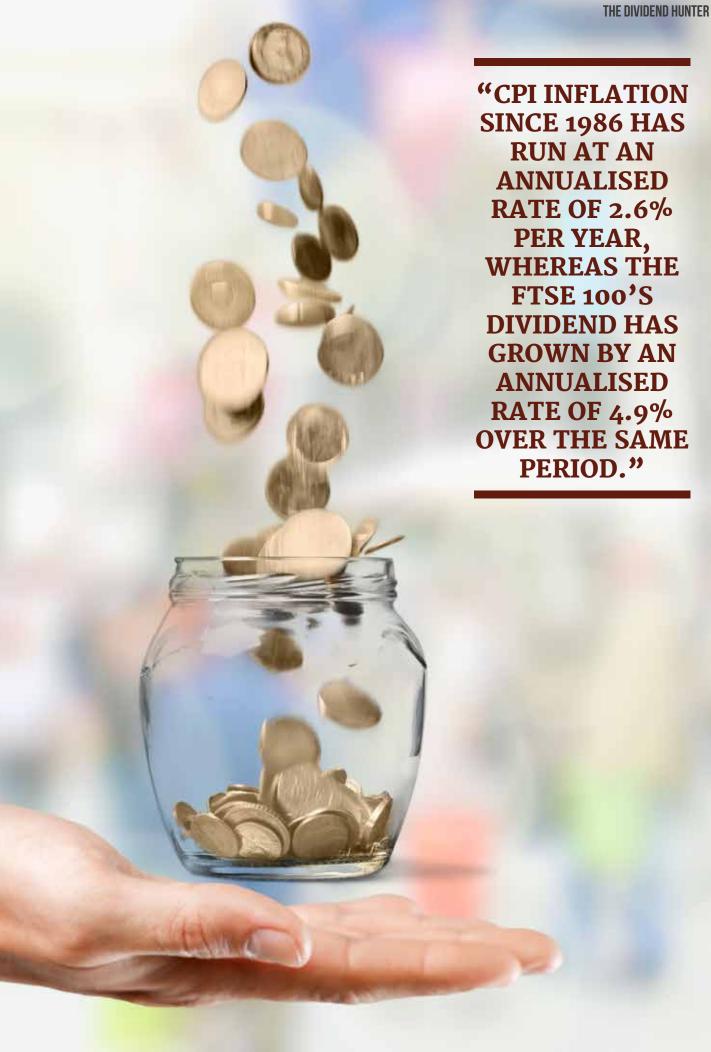
rate: 11.2%

The Restaurant Group (which I'll call TRG) is the company behind popular themed restaurant brands such as Frankie & Benny's, Chiquito and Coast to Coast. These restaurants are located primarily in out of town leisure parks, although it has quite a few high street sites as well. The company also has a significant airport and railway concessions business.

TRG has grown incredibly consistently in recent years, with revenues,

normalised earnings and dividends increasing in every single year since 2008. The company also has very little debt and a post-tax return on capital employed of almost 20%. With a dividend growth rate of more than 11% this has been one seriously successful business.

However, its 4.5% dividend yield suggests that the company has some problems, and that's true. TRG's share price has fallen by about 50% from its early-2015 high and this has coincided with increasingly negative announcements from the company. In response, a new Chairman and board have taken charge and instigated a full review of the company's strategy. On the positive side the initial findings from the review suggest that recent underperformance





is largely self-inflicted and fixable. The weak economic backdrop is not helpful, but many problems stem from Frankie & Benny's trying to move up market towards "authenticity" and away from "value". With our current weak economy most customers still prefer value. The new board are attempting to fix these issues, which is good to know because I'm a TRG shareholder.

Sky (LON:SKY) - FTSE 100 -Media

Share price: 852p Dividend yield: 3.9%

10-year dividend growth rate: 10.6%

I think it would be hard to describe Sky as anything other than an extremely successful company. For a long time it was pretty much the monopoly supplier of satellite TV in the UK, but in more recent years it has successfully transformed itself into one of Europe's leading entertainment and communications businesses.

Along with its progressive dividend, revenues and earnings have increased fairly steadily over the years. I say "fairly steadily" because in the last couple of years normalised earnings have taken a hit, largely thanks to a recent and very large acquisition. Personally I'm quite negative about large acquisitions as I don't like the debts and disruption that often accompany them. In this case there are significant debts involved, but I think any disruption should be minimal.



Disruption should be minimal because the acquisition was of Sky Deutschland and Sky Italia. These are of course very closely related companies, in more ways than one (for a start, all three companies had the same major shareholder, 21st Century Fox, recently spun out from News Corporation).

Thanks to this acquisition, Sky's debts are now extremely high relative to its historic post-tax profits. Those profits have averaged about £1 billion in the last few years while post-acquisition debts stand close to £9 billion. That sort of debt ratio is way outside my comfort zone. For most companies, having debts nine-times larger than annual earnings is a disaster waiting to happen (a reasonable analogy is having a mortgage nine-times your household's total income). In this case though it might not be quite that bad. If Sky can double its profits within the next decade, which is something the

acquisitions should help it to do, then I think it stands a good chance of being able to grow its way out from under those debts. Alternatively, if it can't do that then a rights issue could be a serious possibility when the next recession rolls around.

Overall I like Sky but I'm not a shareholder, although it is something I'm considering.

Stagecoach Group (LON:SGC) - FTSE 250 -Travel & Leisure

Share price: 213p **Dividend yield:** 5.4%

10-year dividend growth rate: 9.6%

As a provider of public bus and rail transport, Stagecoach is a relatively defensive business. This is, in part, why it's managed to grow its dividend so consistently over the years. Along with an impressive dividend growth rate of almost 10% a year, its revenues and earnings have also increased steadily. However, normalised earnings growth has lagged some way behind both revenue and dividend growth. The dividend is covered well enough so that this situation can continue for quite a few more years, but it cannot continue forever. At some point, if the dividend continues to grow faster than earnings, the dividend will eventually exceed the company's earnings and that of course would be unsustainable.

Even if dividend growth does slow down I don't think that in itself would make this a bad investment. With its current dividend yield of more than 5%, investors could still receive an excellent long-term return even with much slower dividend growth than the company has achieved in the past. There are, however, more acute problems than gently slowing growth.

My main worry with Stagecoach is its debt and pension obligations. In the last five years the company generated profits of about £140 million after tax, compared to borrowings of about £800m. The ratio between debt and average post-tax profits is almost six. which is more than I'm comfortable with, even for a defensive company like Stagecoach. Unlike Sky, which has just made two massive acquisitions

that can reasonably be expected to help the company to outgrow its debts, Stagecoach has no such escape plan. My worry is that a severe recession, or the loss of a major bus or rail franchise, would leave the company unable to pay the interest on those debts.

"MY MAIN WORRY WITH STAGECOACH IS ITS DEBT AND PENSION OBLIGATIONS."

That's bad enough, but the company also has a very large defined benefit pension scheme. The Stagecoach Pension Scheme currently has pension liabilities of almost £1,400 million and a pension deficit of more than £100 million. The ratio between pension liabilities and average post-tax profits is 10, which is more than I'm willing to accept. On top of that a whole year's worth of profits will probably need to be paid into the pension in order to remove that deficit. If that doesn't generate a strain on the dividend I'll be very much surprised. And one more thing: pension fund liabilities have a nasty habit of growing. Stagecoach's pension liabilities have grown by 25% in the last five years alone, so if the company fails to grow its earnings it could eventually be eaten alive by its own pension scheme (or less poetically, it could have to raise cash via a rights issue to pay down the deficit).



Overall I like Stagecoach and I think it's a good company, but the current size of its financial obligations is more than enough to stop me from investing.

British American Tobacco (LON:BATS) – FTSE 100 – Tobacco

Share price: 4,939p Dividend yield: 3.1%

10-year dividend growth rate: 10.1%

Cigarettes are not to everyone's taste, but the companies that produce them often make very good investments. British American Tobacco (BAT) is fairly typical in this regard, having paid a progressive dividend over many years, backed by consistently increasing earnings. Although BAT does have a lot of debt in absolute terms (about £17 billion) its debts are only about four-times its average post-tax profits, which I don't think is excessive for a company operating in a sector as defensive as Tobacco.

However, as with most companies this pleasant picture is not without some dark clouds. While dividend and earnings growth has been impressive, revenue growth has not. In fact revenues have been declining since 2011 and are lower today than they were in 2009. Earnings have been increasing thanks to widening profit margins and share buybacks, but neither of those factors can offset declining revenues forever. At some point BAT's revenue declines will have to come to an end, and preferably (for shareholders) that will happen sooner rather than later.

One reason for declining revenues is a changing cultural attitude towards smoking in western markets, helped along by ever tightening regulation. In Australia, cigarette packaging is now standardised for all brands, with each packet being produced in a vile brown colour with extremely unpleasant photos placed in prominent positions. The risk for BAT is that this aversion to cigarettes becomes widespread across the



"AT SOME POINT BAT'S REVENUE DECLINES WILL HAVE TO COME TO AN END, AND PREFERABLY (FOR SHAREHOLDERS) THAT WILL HAPPEN SOONER RATHER THAN LATER."

world. The long-term answer seems to be in various forms of electronic smoking, which are less dangerous for customers and which have so far proven to be surprisingly popular (surprising to me at least).

Other than the potentially very longterm switch to electronic smoking, I can't see any obvious threats looming for BAT. With its reasonable yield and good historic growth rate I remain a shareholder.

Capita (LON:CPI) - FTSE 100 - Support Services

Share price: 990p Dividend yield: 3.2%

10-year dividend growth rate: 12.5%

Capita is the UK's leader in business process management and professional support services. The company provides a vast array of mostly technology-based services such as customer management, administration, IT, HR, regulatory compliance and many more, to both corporate and government clients. These services are typically provided through multi-year contracts, a feature which has helped Capita to produce steady dividend growth over many years.

As well as steady dividend growth the company has generated rapid revenue growth, but normalised earnings have not fared so well. They peaked in 2013 and have been declining ever since, largely as a result of rapidly increasing amortisation (depreciation of intangible assets) and impairments of goodwill (reductions in the appraised value of intangible assets).

Amortisation has been growing rapidly because the company's intangible assets have been growing rapidly, and they in turn have been growing rapidly because the company has been making a large number of relatively large acquisitions.

For me this is a problem. I have been burned in the past by companies that use acquisitions to grow, partly because a) acquisitions are often complex, costly and risky to integrate; b) you can end up with a company whose constituent parts you know nothing about; and c) acquisitions can be doubly risky when paid for with borrowed

In Capita's case the third point is a particular problem. The company's debts are now almost ten-times its average post-tax profits and that's more than double the amount I would be comfortable with. (Would you be comfortable with a mortgage ten-times your household's total income?) Although its interest payments are currently sustainable, a UK recession or rapid increase in interest rates (when the debts are rolled over) could prove to be a serious problem. It is primarily because of these acquisitions and debts that I don't expect to be a Capita shareholder anytime soon.

A note of caution

Looking back at those five companies I think they highlight the difficulty of looking for stocks that combine a decent dividend yield with consistently inflation-beating dividend growth. You don't normally find both in the same place, and when you do it is often (but not always) because there are significant risks. Caution then, should always be your watchword.

About John

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

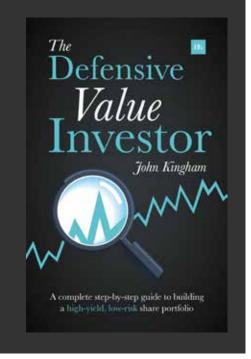
John is also the author of The Defensive Value Investor: A Complete Step-By-Step Guide to Building a High Yield, Low Risk Share Portfolio.

His website can be found at: www.ukvalueinvestor.com.

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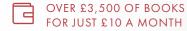


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FUNDS IN FOCUS

HOW TO INFLATION-PROOF YOUR PORTFOLIO

There is a growing feeling that UK inflation could pick up dramatically over the next few years. You can see this from the increase in the five-year break even rate, which is based on the yield difference between conventional gilts and those linked to the RPI. In August this hit a 13-month high of 2.6%.

One of the main drivers is the weak exchange rate. The pound is down around 10% against the US dollar since the EU referendum and if it stays at this level it is likely to mean a significant increase in the cost of imports once translated into sterling.

Another cut in interest rates is a distinct possibility and this would be expected to send the exchange rate even lower. Negative real interest rates – interest rates that are less than inflation – could also be inflationary in their own right as in theory it would discourage people from saving, although at these low levels it is difficult to predict.

The problem for the government is the high level of national debt, which can only really be serviced if they can generate enough growth and inflation to reduce its real value. This suggests that governments will do whatever it takes to get inflation back to more normal levels and investors need to make sure that they are well prepared.

Index-linked bond funds

The most obvious way to protect against inflation is to invest in index-linked bonds. With a normal bond, the coupon and the principal are fixed in nominal terms, so you

know exactly how much cash you will receive if you hold it to maturity. An index-linked bond is rather different as the coupon and the principle will change in line with inflation.

Rising inflation expectations enabled the UK Index-Linked Gilt sector to be the best performing area of the market in August with an average return of 10.52%. It is now the most successful part of the fixed income universe over five years with a gain of 61.6%, which shows the way investors are thinking.

The problem if you want to buy them now is that the recent strong perfor-



mance has pushed the prices to such a high level that in many cases the real yields are negative. For example, in August the UK's Debt Management Office sold an £850m 20-year index-linked gilt with a record low yield of -1.72% and yet it was oversubscribed by 1.6 times. This only really makes sense if you expect inflation to be higher than is currently being priced in.

There are 14 open-ended funds in the UK Index-Linked Gilts sector with the best performer over the last five years being the £235m AXA Sterling Index-Linked Bond fund with a gain of 70.6%. This was followed by Schroder Institutional Index-Linked Bond and Newton Index-Linked Gilt Exempt with five-year returns of 69.9% and 68.5% respectively.

"THE KEY IS TO FIND A MANAGER THAT INVESTS IN COMPANIES WITH STRONG PRICING POWER THAT ARE ABLE TO PASS ON ANY COST INCREASES TO THEIR CUSTOMERS."

If you would prefer a cheaper alternative there is the passively managed £900m **iShares Barclays Capital GBP Index Linked Gilts (INXG)** ETF, which provides exposure to a portfolio of 29 UK index-linked gilts. It has ongoing charges of 0.25% and is up 42.1% over the last five years.

Other options

There are several well run multi-asset funds with a large exposure to index-linked gilts that would provide a more balanced investment. A good example is the £3bn **Ruffer Total Return** fund that aims to achieve low volatility, positive returns from an actively managed portfolio of different asset classes.

The managers have invested 22% of the portfolio in non UK index-linked government bonds, with a further 24% in index-linked gilts, and 6% in gold and gold equities. These should all help to protect against the impact of higher inflation and together they make up 52% of the fund.

Ruffer Total Return operates in the Mixed Investment 20% to 60% Shares sector with the accumulation shares up almost 330% since the fund was launched in September 2000. This is well ahead of both the FTSE All-Share and the FTSE Government All-Stocks fixed interest benchmarks.

Another decent alternative would be the **Troy Trojan** fund, which aims to achieve capital and income growth in real terms over the longer term. Sebastian Lyon, the manager, currently has 13% in UK Index-Linked bonds, with an additional 8% in their US equivalents, as well as 10% in gold. He is especially cautious at the moment and has 30% of the portfolio in cash with the remainder of the fund invested in UK and international equities.

Some of the pure equity mandates would also offer a degree of protection against inflation, although they would probably not be as resilient as the multi-asset funds. The key is to find a manager that invests in companies with strong pricing power that are able to pass on any cost increases to their customers. This would enable these businesses to grow their free cash flow throughout the economic cycle.

Three of the most successful examples of this approach are: **Lindsell Train UK Equity**, which is one of the best performing funds in the UK All Companies sector with a five-year return of 124.5%; **Lindsell Train Global Equity**, a good performer in the Global sector that is up 146.7% over five years; and **Fundsmith Equity**, which has the best record in this area with a five-year gain of 166.2%.

Other equity funds that invest in resilient, cash generative companies include **Evenlode Income** and **Liontrust Special Situations.**

Gold

Many people believe that the best way to protect the value of their capital against higher inflation is to invest part of their portfolio in gold. The most



cost-effective way to do this is to use an Exchange Traded Commodity (ETC) that invests in the underlying precious metal, as this works out much cheaper than buying and storing the actual bullion.

ETFS Physical Gold (PHGP) tracks the price of gold by investing in certificates secured by physical, segregated and individually identified gold bars held in vaults in London. It has \$6.3bn in assets under management and an annual management fee of 0.39%. PHGP is quoted in sterling, although its sister product which trades under the ticker PHAU is traded in dollars to match the underlying.



If you are especially cautious you could allocate part of your exposure to ETFS Physical Swiss Gold (SGBS), which is backed by gold bars securely stored in vaults in Zurich, Switzerland.



A cheaper alternative would be the **iShares Physical Gold ETC (IGLN)**. This is smaller with net assets of \$2.3bn but has a lower Total Expense Ratio of 0.25%. It is quoted in dollars with a sterling equivalent (SGLN) also available.

Infrastructure

Other real assets should also appreciate in value in an inflationary environment, with one of the most easily accessible categories being infrastructure. In many cases these assets will have yields that are linked to inflation so that both the income and the value of your capital should benefit.

The high, inflation-linked yields of infrastructure funds are extremely attractive in the current low interest rate environment, which means that most of the closed-ended funds are trading well above their net asset value (NAV).

A good example is **John Laing Infrastructure (LON:JLIF)**, a £1.2bn fund that invests in a portfolio of infrastructure assets that are already operational. Most are located in the UK and they include several hospitals as well as the main MOD building and the M40 Motorway. The fund is yielding 5.1% and many of the underlying contracts last for 20 to 30 years with inflation-linked increases, but the shares are trading at a hefty 16.5% premium to NAV.

The HICL Infrastructure Company (LON:HICL) offers a similar sort of exposure and is even more expensive as it is on a premium of 22% and yielding 4.3%.

"THE HIGH, INFLATION-LINKED YIELDS OF INFRASTRUCTURE FUNDS ARE EXTREMELY ATTRACTIVE IN THE CURRENT LOW INTEREST RATE ENVIRONMENT."

Investors who are willing to accept a higher level of risk might prefer **Utilico Emerging Markets (LON:UEM)**, which invests in infrastructure, utility and related companies in the emerging markets. It is trading on a 10% discount and yielding 3.1%.

Another way to avoid paying over the odds is by investing in one of the openended infrastructure funds, which always trade in line with their underlying NAV. There are several to choose from and they typically invest in listed infrastructure companies rather than directly in the actual assets.



The £1.6bn First State Global Listed Infrastructure fund was launched in October 2007 and invests in the shares of infrastructure companies from around the world. About half of the exposure is to stocks listed in the US with the main sub-sectors being electric utilities and highways & railways. It is up 93.5% in the five years to the end of August.

Lazard Global Listed Infrastructure Equity was launched in February 2012 and has \$1.2bn in AUM. The manag-

ers have invested half of the assets in Continental Europe with a further 32% in the US. Over the last three years the fund has generated an annualised return of 14.1% when measured in dollars.

Property

Another area that should benefit from an inflationary environment is property, although it is subject to many other factors, including the level of interest rates and the economic outlook.

If you want to invest in a direct property fund, which owns the actual bricks and mortar, it is best to stick to one of the closed-ended options so as to avoid any problems with the lack of liquidity in the underlying holdings.

A good example is **F&C Commercial Property (LON:FCPT)**, a £1bn Real-Estate Investment Trust that holds a high quality portfolio of buildings in London and elsewhere in the UK. It suffered a sharp sell-off after the EU referendum, but has since bounced back and is trading on a 6.5% discount and yielding 4.7% with monthly dividends.

The **TR Property Investment Trust (LON:TRY)** invests in the shares of UK and European property companies and is trading at a 13.4% discount to NAV and yielding 2.7%. There are also numerous open-ended equivalents, although by definition they are all priced at NAV.

Those who prefer the housing market might be interested in the **TM Hearth-stone UK Residential Property** fund. This was launched in January 2013 and holds 181 properties that are rented out in the private sector. It has £47.5m of assets under management and has generated a total return of 25.6% in the last three years.



THE MACRO INVESTOR

US ELECTION: HOW TO ADAPT YOUR PORTFOLIO

"I just think it is important that you realise, that you're the best in the world. Whether you are a Democrat or Republican or whether you're libertarian or whatever, you are the best. And we should not ever forget that. And when somebody does not do the job, we got to let them go."

- Clint Eastwood

Republicans against Democrats

We are approaching the final count-down for the 58th Quadrennial Presidential Election to elect the 45th US President. On 8 November, the US electorate will cast ballot votes to decide who will become the next President while Barack Obama prepares to leave the White House. On one side is Hillary Clinton, who aims to extend the Democrats' term in office to twelve years, while at the same time becoming the first female President

in the history of the United States. On the opposing side is the unorthodox, and often exuberant, Republican candidate Donald Trump, who aims to put an end to the Democrats' leadership and completely revamp the US economy. Hillary Clinton has been in front for most of the time, which has been providing some respite to financial markets, as Clinton represents a smoother transition than Trump. But the race is becoming tighter and investors should give some more credit to Trump's odds of becoming the next US President. In

the final days we are assured a fierce battle between the two sides that will inevitably prove too close to call.

No matter who the candidates are, there's always a substantial difference between Republicans and Democrats, which is expected to be reflected in financial markets during the President's tenure in the form of different outcomes. Republicans and Democrats diverge in terms of Federal spending, social security policy, taxes, foreign policy, health and education priorities, degree of



public intervention and in many other important fields of action, which is expected to impact companies in different sectors in different ways, as well as the dollar, commodities, house prices, fixed income and so on.

This year, the differences between the candidates are substantial, as Donald Trump seems to be willing to break up a few international agreements and lead the United States into isolationism, which will certainly have a big impact on trade, the US dollar, and exporting companies.

The main goal of this piece goes beyond the mere profiling of the two major candidates. Much has been said before about the specificities of each candidate and how the different sectors of the economy may be affected unevenly by them. There are quite a few good economic analyses conducted by respected financial newspapers, magazines and the related press about this. The reader can also get some good analysis on the Master Investor blog, where the implications of a Clinton/Trump win on your portfolio have been disentangled in detail. My aim today is a little different. I want to put the eloquence (or lack thereof) of each candidate aside and look at the numbers from the past. I'm going to dig a little on historical data to evaluate the impact Republican and Democrat Presidents had in financial markets to find out evidence of differences that can guide investors through the coming year.

Setting the data

I collected some simple financial data for the S&P 500 index, the 3-month constant maturity T-Bill, the 10-year constant maturity T-Bond, the S&P GSCI commodity index, Crude Oil and Gold, to measure the impact each winning party has had in different market segments or asset classes. The S&P 500 should capture the impact in the broad equity market; the 3-month T-Bill and the 10-year T-Bond measure the impact in the money and bond markets; the S&P GSCI covers 24 commodities from all commodity sectors and serves as a benchmark for commodities in general; and the Crude Oil and Gold prices allow to measure the specific impact on these commodities. The data for the S&P 500, the 3-month T-Bond



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FIG. 1 - MARKET PERFORMANCE IN THE YEAR FOLLOWING A PRESIDENTIAL ELECTION

Year	President	Party	S&P 500	3-month	10-year
· cui	Trestaette	· ui ty	Jul 300	T. Bill	T. Bond
2012	B. Obama	Dem	32.1%	0.1%	-9.1%
2008	B. Obama	Dem	25.9%	0.1%	-11.1%
2004	G. Bush	Rep	4.8%	3.0%	2.9%
2000	G. Bush	Rep	-11.8%	3.7%	5.6%
1996	W. Clinton	Dem	33.1%	5.1%	9.9%
1992	W. Clinton	Dem	10.0%	3.0%	14.2%
1988	G. Bush	Rep	31.5%	8.1%	17.7%
1984	R. Reagan	Rep	31.2%	7.5%	25.7%
1980	R. Reagan	Rep	-4.7%	14.3%	8.2%
1976	J. Carter	Dem	-7.0%	5.1%	1.3%
1972	R. Nixon	Rep	-14.3%	6.7%	3.7%
1968	R. Nixon	Rep	-8.2%	6.6%	-5.0%
1964	L. Johnson	Dem	12.4%	3.9%	0.7%
1960	J. Kennedy	Dem	26.6%	2.3%	2.1%
1956	D. Eisenhower	Rep	-10.5%	3.2%	6.8%
1952	D. Eisenhower	Rep	-1.2%	1.9%	4.1%
1948	H. Truman	Dem	18.3%	1.1%	4.7%
1944	F. Roosevelt	Dem	35.8%	0.4%	3.8%
1940	F. Roosevelt	Dem	-12.8%	0.1%	-2.0%
1936	F. Roosevelt	Dem	-35.3%	0.3%	1.4%
1932	F. Roosevelt	Dem	50.0%	1.0%	1.9%
1928	H. Hoover	Rep	-8.3%	3.2%	4.2%
Average Return in the Year Following a Presidential Election		9.0%	3.7%	4.2%	
Average Return in the Full Period 1928-2015		11.4%	3.5%	5.2%	

Source: Thomson Reuters Datastream

and the 10-year T-Bond covers the period 1928-2015. The data for the S&P GSCI, Crude Oil and Gold covers the period 1971-2015.

Asking the questions

Instead of looking at specific Presidents, I want to understand if the differences in economic and social prescriptions between Democrats and Republicans in fact translate into different market performance. To measure this, I collected performance data for the full calendar year following an election year. The Presidential election always occurs at the beginning of November.

The performance under evaluation refers to the following calendar year, starting at 1 January and ending at 31 December. The first question to ask is: *Is performance conditional on the winning party?* And then comes the second question: *Which asset classes are favoured by which party?*

The data at first glance

The main data show a split of election wins of 12 for Democrats and 10 for Republicans. The average annual return for the S&P 500 in the full 1928-2015 period has been 11.4%, but just 9.0% in the calendar year following an election. It seems that the incumbent President tends to be more hawkish during the first year of his tenure, to then become more dovish towards the end of it. In fact, in calculations not shown here, I found that the average performance for the S&P 500 has been 16.8% during the third calendar year following an election. This should not come as a surprise as it is well supported by the desire of re-election, which is certainly maximised in a year where households see their portfolios increase in value. But at a time when we are heading towards the first year of tenure, the lesson to learn is that, historically, it has not been the best performer.

In terms of the money and bond markets, the average performance of a



FIG. 2 - NUMBER OF YEARS WITH POSITIVE PERFORMANCE IN THE AFTERMATH OF A PRESIDENTIAL ELECTION

Party	Number of Wins	S&P 500	3-month T. Bill	10-year T. Bond
Democrats	12	9	12	9
Republicans	10	3	10	9

Source: Thomson Reuters Datastream

"THE PERFORMANCE FOR THE S&P 500 IN THE CALENDAR YEAR FOLLOWING AN ELECTION IS ON AVERAGE 9.0%, BUT IT IS 15.8% FOLLOWING A DEMOCRAT WIN AND JUST 0.9% FOLLOWING A REPUBLICAN WIN."

FIG. 3 - MARKET PERFORMANCE IN THE AFTERMATH OF A PRESIDENTIAL ELECTION

Party	Number of Wins	S&P 500	3-month T. Bill	10-year T. Bond
Democrats	12	15.8%	1.9%	1.5%
Republicans	10	0.8%	5.8%	7.4%

Source: Thomson Reuters Datastream

T-Bill and a T-Bond for the full period is 3.5% and 5.2% respectively. Those values compare with an average first-year performance of 3.7% and 4.2%. The deviation from the full period average is more significant for the T-Bond, which seems to underperform during the first year of tenure.

While the above data certainly adds some perspective regarding the first calendar year following the election, what we want to know is how that performance varies depending on the winning party. We want to figure out whether Republicans and Democrats impact that performance differently or not. Figure 2 shows the number of years in which the S&P 500, T-Bills and T-Bonds recorded positive performance in the year following the election. When we split the data between winning parties, we observe some huge differences in performance. The S&P 500 rose 9 times out of 12 for Democrat wins but just 3 out of 10 for Republican

If we dig a little more to compute the average performance for each party,

we can reveal a stark difference between Democrats and Republicans. The performance for the S&P 500 in the calendar year following an election is on average 9.0%, but it is 15.8% following a Democrat win and just 0.9% following a Republican win.

Republican Presidents have been leading the equities market to a sluggish performance during their first year of tenure when compared with Democrats. Conversely, T-Bills and T-Bonds perform much better during the first year of tenure of a Republican President than during the first year of a Democrat President.

The differences between Republican and Democrat candidates are substantial and they do influence market performance. If Clinton wins, investors may be better off buying equities; but if Trump wins, fixed income may be the way to go. These differences in performance may prove even more pronounced this time round, as the differences between the candidates are greater than they have been during past elections.

"THE DIFFERENCES IN PERFORMANCE FOLLOWING A REPUBLICAN AND A DEMOCRAT WIN ARE TOO SIGNIFICANT TO BE IGNORED."

FIG. 4 - MARKET PERFORMANCE IN THE YEAR FOLLOWING A PRESIDENTIAL ELECTION

Year	President	Party	S&P GSCI	Crude Oil	Gold
2012	B. Obama	Dem	2.2%	4.6%	-3.9%
2008	B. Obama	Dem	-51.3%	-51.9%	-0.1%
2004	G. Bush	Rep	24.7%	49.9%	5.0%
2000	G. Bush	Rep	32.2%	0.5%	-6.3%
1996	W. Clinton	Dem	32.2%	37.9%	-15.2%
1992	W. Clinton	Dem	2.9%	0.9%	-7.0%
1988	G. Bush	Rep	25.1%	2.2%	-13.6%
1984	R. Reagan	Rep	1.3%	-8.4%	-17.8%
1980	R. Reagan	Rep	-1.9%	0.7%	-22.1%
1976	J. Carter	Dem	-7.7%	12.0%	4.9%
1972	R. Nixon	Rep	41.8%	11.5%	48.9%
Average Return in the Year Following a Presidential Election		9.2%	5.5%	-2.5%	
Average Return in the Full Period 1971- 2015		12.2%	16.0%	7.2%	

Source: Thomson Reuters Datastream



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What about commodities?

To complete the analysis, let's now look at commodities. What happens to gold, oil, and commodities in general, upon the election of a new President? The data collected is more limited here, as it covers only the period 1971-2015, but it can at least give some idea about the differences between political parties. In the time interval considered, there were 11 elections, from which seven different Presidents were elected. Tenures were split between Democrats and republicans in the proportion 5 to 6.

In the full period 1971-2015 the S&P GSCI, which is a broad-based measure for commodities, rose on average 12.2% per year, while Crude Oil rose 16.1% and Gold 7.2%. But, as with the S&P 500, the return observed by commodities in the calendar year following an election has been below the full period average. Gold, for example, declined on average 2.5%.

But the most important question is: Which party has been more favourable for commodities? The broad-commodities index S&P GSCI rose 3 out of 5 times during the first calendar year upon a Democrat win and 5 out of 6 upon a Republican win. But the biggest differences come in terms of average performance. On average, the S&P GSCI declined 4.4% during the first calendar year following a Democrat win while it rose a massive 20.5% following a Republican win. Oil rose on average 0.7% following a Democrat win and 9.4% following a Republican win and, finally, Gold declined 4.3% and 1.0% respectively. The differences are too substantial to be ignored.

A few final words

While past performance is not indicative of future performance, it tells a story that helps understand what may happen in the future. In real life there are no certainties, but at least we

can sometimes make some educated guesses to maximise the odds of getting things right. The differences in performance following a Republican and a Democrat win are too significant to be ignored. If Democrats win the election, the probability of equities rising is much more favourable than with a Republican win. Meanwhile, the probability of a rally in bonds and commodities runs in the opposite direction. This analysis certainly doesn't help much in preparing your portfolio before the election, in particular at a time where the election is becoming too close to call. But the above data helps understand how you can tweak your portfolio in terms of asset classes following the election result. You may wish to tilt your portfolio in the direction of equities in the eventuality of a Clinton win, or in the direction of commodities and bonds if Trump gets it.

FIG. 5 - NUMBER OF YEARS WITH POSITIVE PERFORMANCE IN THE AFTERMATH OF A PRESIDENTIAL ELECTION

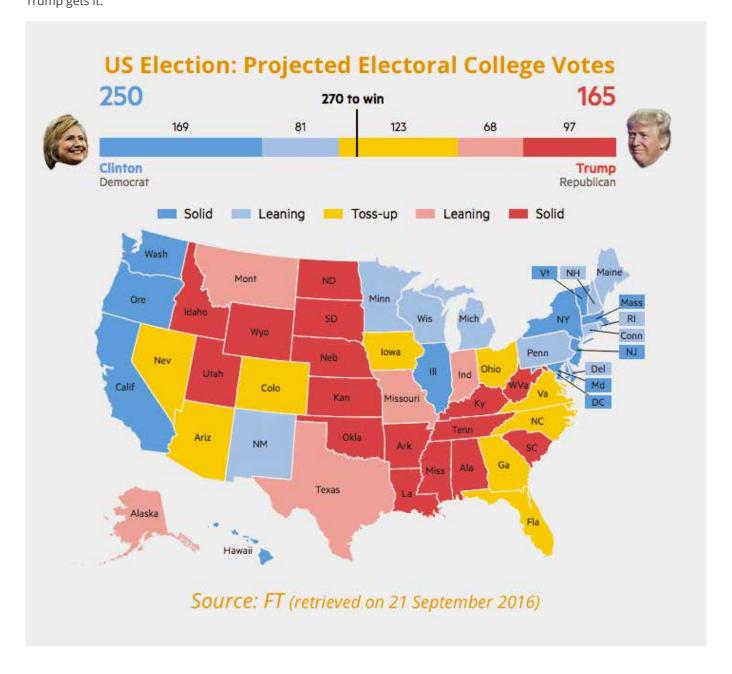
Party	Number of Wins	S&P GSCI	Crude Oil	Gold
Democrats	5	3	4	1
Republicans	6	5	5	2

Source: Thomson Reuters Datastream

FIG. 6 - MARKET PERFORMANCE IN THE AFTERMATH OF A PRESIDENTIAL ELECTION

Party	Number of Wins	S&P GSCI	Crude Oil	Gold
Democrats	5	-4.4%	0.7%	-4.3%
Republicans	6	20.5%	9.4%	-1.0%

Source: Thomson Reuters Datastream





FROM ACORNS TO OAK TREES

PROFIT FROM PROFIT WARNINGS — THREE SMALL CAP STOCKS SET TO BOUNCE BACK?

There is an old stock market saying that profit warnings come in threes. For investors this implies that any company which first announces such a warning should be avoided for some time. In other words, never attempt to catch a falling knife. But like many such clichés it is often wrong.

Profit warnings can occur for a whole host of different reasons, whether it be a one-off hit to trading, wider issues in the sector or more ingrained problems within a particular business. In the latter case that means bad news can take time to filter through, and yes an initial warning may be followed by several others. For example, Tesco had four profit warnings in 2015, and Rolls-Royce has announced five within the space of 20 months.

But it is interesting to note that most profit warnings are actually a one time event.

A study in 2009 by researchers Elayen and Pukthuanthong found that out of 3,667 profit warnings issued by US companies 65% were a one-off, with only 12% of companies issuing three or more warnings in a row. Another study, this time on UK companies, by

James Montier, found that companies which issued profit warnings fell by 16.6% on average on the day of the announcement. However, if you bought a year after the warning was issued you could do very well indeed, with stocks in his sample group outperforming the market by 22.4% over the next year.

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While buying shares after a profits warning is always risky, especially given that market sentiment can apply a further discount to the price, there are opportunities to be had. Like in all equity investments, the key is to buy fundamentally strong companies which are trading at a bargain price. Here follows three small cap companies which have recently had profit warnings. But are the shares worth buying back into?

SPRUE AEGIS

Coventry based **Sprue Aegis (LON:SPRP)** is a company I have been covering for a number of years. For those that are not familiar, the business is a supplier of home safety products, mainly smoke and carbon monoxide alarms. Flagship brand *FireAngel*, along with a number of others, is sold across the UK retail and trade markets. The company is a supplier to the UK



Fire & Rescue Services, sole supplier to a number of major retailers, including B&Q, and has been enjoying success in Europe in recent years on the back of the introduction of safety legislation.

On the old PLUS Markets Sprue Aegis performed well for a number of years, growing pre-tax profits from £1.58 million to £4.87 million in the five years to 2013 and paying increasingly generous dividends. But investors never fully reflected its success in the share price – perhaps given the illiquidity of PLUS. But that all changed in 2014 after the company decided to move its quotation to AIM after having mulled over the move for some time.

Peaking at just over 355p in March 2015 the shares have come down significantly since then after the company faced a number of negative issues.

In April 2015 a minor profits warning was announced, despite the company revealing yet another record set of results. This came as negative exchange rate movements hit margins.

But the major hit to the Sprue Aegis share price came in April this year when the company revealed a problem with batteries used in its products, which were supplied by a third party. This caused a premature end of life warning in the products, although it was not a safety critical issue. As a result a £5.5 million warranty provision was made, with the cash costs expected to be incurred over a six-year period. Combined with slower trading in the firm's French and German markets, profit guidance for the year was slashed. Investors were alarmed, the shares plunging by 54% on the day of the announcement to a near three year low.



Better times ahead?

Good progress has been made since, however, with management reacting



positively to the challenges faced by the company. To prevent the battery issue re-occurring additional screening processes have been implemented and a claim against the manufacturer has been made in the form of free replacement batteries, expected to be worth £0.1 million in 2016 and up to £0.7 million overall.

Interims for the six months to June revealed that trading was ahead of (revised) expectations, with operating losses for the first half £1 million lower than previously forecast at £0.9 million. This was despite revenues almost halving to £56.5 million after sales to the French market fell by £33.7 million – this was largely expected after a safety legislation deadline passed. UK sales grew by 20%, however, and the firm was also a beneficiary of the effects of Brexit, with the stronger euro boosting margins.

Sprue ended the half with net cash of £14.7 million, down by £7.7million after £7 million was spent on stock in order to mitigate against potential supply disruption from the relocation of a supplier's factory. With the balance sheet still strong and a return to profit expected in the second half, a maintained interim dividend of 2.5p per share was declared.

In H2 Sprue expects to benefit from new certified Panasonic battery prod"MANAGEMENT HAVE NOT SAT STILL AND HAVE ATTEMPTED TO DEAL WITH THE PROBLEMS."

ucts being sold in the German market. It should also benefit from the acquisition of Intamac Systems, completed on 18th September, which extends its market opportunity. For up to £2.8 million the company has bought source code and development rights to software developed by Intamac, which enables customers to connect and monitor Sprue's range of wireless products over the internet. Sales of internet enabled products are expected to commence in Q4 this year.

Good entry opportunity presents itself

While Sprue Aegis has had its fair share of issues over the past year or so I note that they have been largely external to the company – exchange rate movements, third-party supplier cock-ups, the effects of legislation etc. What is pleasing is that management have not sat still and have attempted to deal with the problems, as well as launching new products and making a potentially valuable acquisition.



Since bottoming out in April the shares have since recovered to the current price of 163p, capitalising the company at just under £75 million. With 2016 being a one-off year I look to 2017 forecasts from the house broker Stockdale, who are pencilling in 11.2p of earnings. Strip out the cash (adjusted for the Intamac acquisition) and the shares are being valued on a forward multiple of 12.2 times, which I believe looks good value given the strength of the business and recovery potential. The broker also expects a total dividend for 2017 of 9p per share, which equates to a highly attractive yield of 5.5%. Its 250p target price implies potential upside of 53%.

To me, shares in Sprue Aegis look like a good recovery buy.

SPEEDY HIRE

In the first few years of the 21st century the tools, equipment and plant hire business **Speedy Hire (LON:SDY)** was a stock market darling. Shares in the company grew six-fold between September 2001 and June 2007, rising to the ranks of the FTSE 250 as the firm benefited from selling its services to the booming UK construction industry. However, the shares were hammered in the aftermath of the 2008/09 economic crisis as a lack of customers and a huge debt pile hit the company hard.

As of today Speedy Hire provides its services to customers in the construction, infrastructure and industrial markets, as well as to local trade and industry. These are complemented by

support services, including the provision of training, asset management and compliance services. It operates from 206 fixed sites across the UK and Ireland, on-site at client locations and from an international office based in Abu Dhabi.



While Speedy Hire saw a recovery as the economy came out of recession, new problems quickly arose. In 2013 accounting irregularities were discovered in its Middle-East business, which resulted in the resignation of the then CEO. Following the appointment of new CEO Mark Rogerson the business appeared to be back on track, posting profits up by 50% for the 2015 financial year. Yet just two months after the results were announced a dramatic profits warning was revealed, with Rogerson quitting just 18 months into the job (and replaced by the FD Russell Down) after a number of internal problems came to light. If that wasn't bad enough, another profits warning was announced just a couple of months later. The overall effect was the company posting a statutory loss of £57.6 million for the 2016 financial year after writing off £45.9 million of goodwill.

Nailing down the problems

Upon recognising serious problems within the business, management be-

"WHILE SPEEDY HIRE SAW A RECOVERY AS THE ECONOMY CAME OUT OF RECESSION, NEW PROBLEMS QUICKLY AROSE."

gan a turnaround exercise, creating a more efficient operation and slashing overheads by £13 million per annum. And the plan looks to be working.

Speedy Hire's most recent trading update reported on the six months to September and refreshingly revealed that full-year pre-tax profits will be ahead of previous expectations. This came as the recovery plan delivered further benefits, with employee numbers down by 100 and revenues slightly ahead of budget. In addition, in August the company agreed to sell its large mechanical plant fleet for a total of £14.4 million so net debt is expected to be significantly lower than the £102.6 million on the books at the year-end in March.

Screw the shares or scoop them up?

As I write, it is almost a year to the day since the last profits warning from Speedy Hire. So those who believe in the findings of James Montier's study above should be very interested in the shares. But is the valuation right?

At the current price of 35.75p Speedy Hire is capitalised at £187.1 million. On current market consensus forecasts for 2.31p of earnings in the 2018 financial year, the shares thus trade on a rather chunky looking earnings multiple of 15.2 times. Add in the debt and the valuation looks even more stretched. On the upside Speedy Hire offers a modest forward yield of 2.5% and the shares only trade at a book value of 1.05 times – most of the assets are tangible equipment.

Overall, the price does not scream out value to me at the moment, especially given that the UK construction PMI remained lacklustre at 49.2 in August (with a figure above 50 indicating





growth). The company also has very thin margins, making just £1.7 million of net profit on an underlying basis last year on revenues of £333.4 million. I would not consider buying the shares unless the price falls down to at least the high 20s or if management can further prove they can turn around the business. Corporate action may also be a value driver, although a previously mooted buyout of rival HSS Hire (LON:HSS) does not look like a good idea to me given the firm's massive net borrowings of almost £240 million. Avoid for now.

MAJESTIC WINE

Another previous favourite of stock market punters is Majestic Wine (LON:WINE), and not just for its vast array of brilliant booze. While the company was another that suffered during

the 2008/09 recession the shares have seen two notable rallies over the past decade which delivered multi-bagging returns for investors who sold out at the right time.



The vintner currently operates via four divisions. Majestic Retail is the core of the business, making up 61% of sales in the last financial year via its 210 branches in the UK and 2 in France. Next up at 26% of sales is Naked Wines, a subscription service whereby customers fund independent winemakers to make wine at preferential prices. The business was bought for £70 million in April 2015 and at the same time Rowan Gormley, founder of Naked Wines, was appointed as CEO of the

enlarged group. These core businesses are supported by the on-trade supplier Majestic Commercial and specialist fine wine merchant Lay and Wheeler.

One too many?

Out of all the companies in this article Majestic has had the most recent profits warning, it surprising the markets at the end of September this year in a first-half trading update - refreshingly, the company actually admitted the warning in the release headline, unlike many companies which hide bad news deep down in paragraph 94.

For the year to 3rd April 2017 operating profits are now expected to be below expectations for two main reasons. Firstly, in the Commercial business sales growth was flat in the first half and margins fell by 2 percentage points. If these trends persist then operating profits could be £2 million lower than expected for the full year. Secondly, over in the Naked Wines USA business a large direct mailing campaign did not have the desired results of attracting enough new customers. As a result, Naked Wines will now make a small loss for the current year, with profits again expected to be around £2 million below expectations.

There was a reason for investors to raise a glass, however, with Majestic confirming that it remains on track to hit its strategic aim of making £500 million of sales by the 2019 financial year, up from £402 million in 2016. It also expects to resume dividend payments this year after scrapping them in 2015 in order to preserve cash.

Fill your glasses?

Following the profits warning Majestic shares saw the worst day in their history, closing down by 24% at 330p. That seemed fair given that the profits warning amounted to c. 25% of previous profit expectations. However, the shares have since slipped to a further low of 307.25p, capitalising the business at £218 million.

I see the problems experienced here as largely one-off - especially the disappointing US marketing campaign although there is clearly further work to be done at the Commercial division where an internal review is now under-

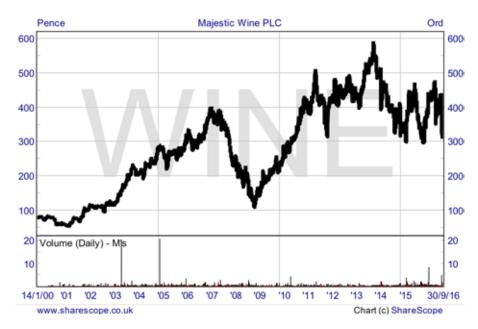
"MAJESTIC REMAINS A STRONG BUSINESS, WITH A GOOD BRAND NAME AND OVERALL PROFITABLE OPERATIONS."

way. Nevertheless, Majestic remains a strong business, with a good brand name and overall profitable operations.

On the downside, the UK wine retail market remains highly competitive, with the discount supermarkets such as Aldi and Lidl having gained market share in recent years – although Rowan Gormley recently fought back by scrapping Majestic's controversial six bottle minimum policy in order to attract more punters. There was net debt of £25.5 million as at 28th March this year but with interest cover of 11 times underlying operating profits, the position looks comfortable.

However, just like an overpriced plonk, the price here leaves a slightly sour taste in the mouth.

Despite the recent fall, shares in Majestic still look expensive to me, trading on a multiple of 24 times market consensus forecasts for the current financial year. Longer term investors might want to take a further look, however, because if the company meets its £500 million sales target I see the potential for c. 20p per share of annual earnings to be delivered. That implies a more



reasonable earnings multiple of just over 15 times.

In the short term a recent site visit for analysts and investors at the firm's revamped store in Welwyn Garden City could help to boost demand for the shares in the coming weeks (we assume there was no shortage of attendees for the boozy day out). And (with the caveat that it is the house broker) Liberum has a 415p target for the

stock, implying 35% upside from the current price.

Personally, within the sector I am more attracted to shares in **Conviviality Retail (LON:CVR)**, which trade on a lower earnings multiple than Majestic (9 times for 2018) and have a decent 6%+ yield. **But for investors who are keen to get back on board I rate Majestic Wine as a risky buy and hold.**





OPPORTUNITIES IN FOCUS

THE FUTURE OF NUCLEAR POWER

With the go-ahead for the Hinkley Point C nuclear reactor, announced on 14 September, the nuclear power industry is back in the news in the UK. Nuclear power generation is a massive global industry which currently uses a number of related technologies. Yet the sector has been overlooked by investors mainly because most (though not all) of the major players are state-owned entities. Looking towards the future, the industry could be transformed by technologies which currently reside in the realm of science fiction. Some scientists believe that nuclear fission will give way sometime soon to nuclear fusion. This has two variants: hot fusion and (the ultimate dream) cold fusion – both providing an endless source of clean electricity with no CO2 emissions. Nuclear fantasy? Bill Gates doesn't think so – he's just put money in...

A brief history of atom power

nuclear power industry emerged out of the programme to build the atom bomb during World War II – the ultra-secret Manhattan Project which began to unfold in Los Alamos, New Mexico in 1942. The British started the War with a strong lead in nuclear physics but lacked the resources to exploit it. Scientists from the USA were assisted on the Manhattan Project by British and Canadian expertise. As we all know, the project succeeded in mastering nuclear fission – splitting the uranium atom for military purposes - with devastating consequences for Japan in August 1945.

Nuclear fission, which was first discovered by German chemists in 1938 (hence the Allies' concern that the Nazis would develop an A-Bomb first) involves splitting up heavy atomic nuclei into smaller ones. In so doing huge quantities of energy are released. This can of course be used to create massive explosions; but from early on scientists realised that the energy created in fission could be used to generate electricity in a controlled and reliable way.

The basic process of nuclear power generation works as follows. Controlled nuclear fission takes place in a nuclear reactor. This reaction heats up a reactor coolant (gas, water or liquid metal, depending on the

type of reactor). The reactor coolant then produces steam in a steam generator and this is used to power a turbine. The turbine powers electricity generators. After the steam has expanded the remaining vapour is condensed in a heat exchanger and the resulting water is pumped back into the steam generator, and the cycle begins again.

Electricity was generated by an experimental nuclear reactor for the first time on 03 September, 1948 at the X-10 Graphite Reactor in Oak Ridge, Tennessee in the USA and the world's first nuclear power station to generate electricity for a power grid started operations at Obninsk (about 100 km south west of Mos-

"THERE ARE NOW SIGNS THAT AT LAST NUCLEAR POWER PRODUCTION IS TRENDING BACK UPWARDS. IN FACT, THIS INDUSTRY HAS A GREAT FUTURE."



cow) in June 1954. Yet the world's first commercial power station opened at Calder Hall, Cumbria, UK, on 17 October 1956. In the late 1950s, the UK became the global leader in nuclear power; yet it was the French who adopted a national strategy of reliance on nuclear energy in the 1960s.

Nuclear power plants currently operate in 31 countries with France having the largest share of electricity generated by nuclear power. China has the fastest growing nuclear power programme, with 28 new reactors under construction. Numerous new reactors are also under construction in India. Russia and South Korea. Though right now at least 100 older (so-called Generation I and II) reactors are in the process of being decommissioned.

Before the Fukushima nuclear disaster of 2011, it was estimated that an average of around 10 nuclear reactors were expected to become operational every year. But according to the World Nuclear Association, of the 17 civilian reactors destined to become operational between 2007 and 2009, only five actually came on stream.

To be sure, Fukushima brought about a change of sentiment. Over 2014-16, Italy closed all of its nuclear stations and Belgium, Germany, Spain, and Switzerland announced a policy of phasing-out nuclear power. The Netherlands, Sweden, and Taiwan have signalled the same intention. Lithuania and Kazakhstan have shut down lone its lone nuclear plant in the 1990s but then re-opened it with Russian help. Due to financial, technical or political reasons Austria, Cuba, Libya, North Korea, and Poland have never completed the construction of their first nuclear plants. As a result of adverse sentiment, nuclear electricity generation in 2012 was back to its 1999 level.

There are now signs that at last nuclear power production is trending back upwards. In fact, this industry has a great

Pros and cons of nuclear energy

Proponents of nuclear power argue that it is the cleanest and most reliable way to generate electricity on a massive scale. What the original proponents of the 1950s did not know, but which is critical for contemporary advocates, is that nuclear power generation, which uses no fossil fuels, produces zero CO2 emissions. This is crucial at a time when we are obliged to reduce emissions in order to avoid catastrophic global warming (or so the scientific consensus claims). Even some dark-green climate gurus like Professor James Lovelock (still happily with us at 97) and Mark Lynas have changed their minds and are now strong advocates of nuclear power. Mr Lynas believes that reliance on renewables is "delusional".

Opponents of nuclear power emphasise its dangers. There are two aspects to this. The first is the issue of what to do with nuclear waste - the radioactive material left over when the reactors

prone to accidents with devastating consequences - the most recent being at the Fukushima plant in Japan after the earthquake and tsunami of 2011.

We have now had nearly 70 years to solve the nuclear waste problem, but it is still a source of controversy. Companies like British Nuclear Fuels Limited (BNFL) which was liquidated in 2009 partly because of its notoriety, developed highly sophisticated technologies to dispose of nuclear waste. The issue is sensitive because people naturally do not like the idea of radioactive material, which will remain a threat to human and animal health for thousands of years to come, being stowed away near where they live. Even in France, where nuclear power has widespread public support, there have been violent protests against the disposal of radioactive canisters in underground caverns near the town of Bédarieux in the Haut Languedoc.

are upgraded. The second is the fact

that, supposedly, nuclear facilities are

The basic approach to the treatment of high level nuclear waste such as spent fuel rods is to transport it, treat it and vitrify it – that is, encase it in glass. The glass canisters are then sealed inside







In terms of nuclear accidents, there

have actually been very few over the

last sixty years or so, but when they

have occurred they have been devas-

tating. Three Mile Island (Pennsylva-

nia, 1979), Chernobyl (Ukraine, 1986)

and Fukushima (Japan 2011, operated

by Tokyo Electric Power Company

(TKY:9501)) are names that conjure

fear even for those who know nothing

about nuclear power.

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Main nuclear reactor

Nuclear fission reactors currently in commercial use are of two kinds. Almost all reactors now in service are thermal reactors which use slowed or thermal neutrons to sustain fission. Fast breeder reactors do not have neutron moderators, and use less moderating coolants. The fuel for fast breeder reactors has to be about 20 percent more highly enriched. Fast breeder reactors have the potential to produce less nuclear waste but they are more difficult to build and more expensive to operate. Current thermal reactors are known as Generation III reactors, while the fast breeder reactors under development are deemed Generation IV and are not likely to be widely in service un-

Nuclear reactors can be further classified by the type of fuel phase they use, by the type of coolant and by type of moderator material. For example, Pressurised Water Reactor (PWRs) are cooled and moderated by high pressure liquid water. Gas Cooled Reactors (GCRs) are generally moderated by graphite and cooled by CO2. Molten Salt Reactors use fluoride salts for coolant.

The leading manufacturers and operators of nuclear reactors worldwide are overwhelmingly state-owned. But we can find some notable players whose shares are traded. Areva SA (EPA:AREVA), which is 86.5% owned by the French government, currently produces Pressurised Water Reactors and Boiling Water Reactors. EDF (EPA:EDF) is of course the operator of 58 nuclear reactors in France across 20 locations with a total annual output of more than 120 gigawatts of electricity. E.ON (ETR:EOAN) operates six nuclear power stations in Germany which are soon to be operated under a separate division known as Preussen Elektra. Germany's Siemens (FRA:SIE) also designs and builds nuclear power plants and components. Ansaldo Nucleare, a subsidiary of Italy's Leonardo-Finmeccanica (BIT:LDO) specialises in nuclear waste management and engineering. Korea Electric Power Corporation (KEPCO) (KRX:015760) is building four units of the APR1400 reactor in the UAE. Japan's Hitachi Corp. (TYO:6501) now owns Horizon Nuclear Power which plans to build an Advanced Boiling Water Reactor (ABWR) at Wylfa B in North Wales and also prospectively at Oldbury, Gloucestershire. Hitachi also has a joint venture with General Electric (NYSE:GE) in the USA.

technologies in use today

steel cylinders which are in turn enveloped in concrete. The material is then buried in deep final repositories - often boreholes in geologically stable areas. til the 2030s.

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Hinkley: What's the Point?

Although the economy of the UK continues to grow, electricity consumption since 2005 has been falling. In 2014 it fell by seven percentⁱ. This is because energy efficiency measures - from smart meters to loft insulation - are reducing demand even as our usage of electronic devices and appliances increases. When we break this down we see that a fall in electricity consumption by industry has been accompanied by an increase in electricity consumption by the transport sector. As electric cars become more common, no doubt electricity demand in the transport sector will continue to increase. Despite the overall fall in demand, *energy security* – the risk that one day the lights might go out because of inadequate generator capacity – has become a major headache for government.

The previous generation of UK nuclear reactors are all scheduled to be taken out of service by the early 2020s, having reached the end of their lifecycles. Little of this capacity can be replaced by renewables – wind turbines and solar panels – which are, in any case, less reliable. (The wind doesn't blow constantly; and in the UK the sun has been known not to shine.) Gas powered generators still have an important role but coal and oil powered facilities are out because of the government's commitment to reducing our CO2 emissions.

Unlike France, the UK has consistently adhered to a diversified power strategy, using a range of different types of power station. In fact, nuclear power has never accounted for more than about 30 percent of national demand. So it seems logical to replace nuclear capacity going out of service with new, improved nuclear technology. Supposedly, Hinkley Point C will be the first of a new series of nuclear facilities, with a second to be built at Bradwell, Essex in the 2020s.



However, the Hinkley Point C project was controversial well before incoming Prime Minister Theresa May put the project on hold. This was for three main reasons.

The first is the issue of national security. The facility will be built by a consortium led by **EDF (EPA:EDF)** and China General Nuclear Power Group (CGN). EDF is 84.5 percent owned by

the French state – a friendly power (for the moment, at least), while CGN is 100 percent owned by the People's Republic of China and is considered by analysts to be a part of China's *military-industrial complex*. In the USA CGN is facing charges of industrial espionage. In April this year Allen Ho, a US citizen and CGN employee, was indicted for conspiracy to produce nuclear material outside the US without the required authorisations from the US Department of Energyⁱⁱ.

The fear is not just that the Chinese might steal British secrets – after all the technology is largely Chinese – but that the Chinese state might use its privileged access to the power station's software system for nefarious ends. Remote computer hacking by Chinese state-sponsored entities is already well documented. In the event, the Prime Minister and her team decided that "additional safeguards" could mitigate any real or imagined security risks.

The second reason for controversy concerns the cost of construction and the price of electricity produced. While the consortium will technically finance the construction themselves, the UK government will have to provide an estimated £18 billion of subsidies - and some say this will rise to more like £30 billion. Then EDF stroke CGN are guaranteed a price of £92.50 per megawatt hour of electricity produced at Hinkley C. This is considerably higher than the baseload price of wind and solar power. The plant, when fully operational in 2025 (if indeed it is completed in time), will contribute seven percent of all Britain's electricity flowing in to the national grid; so it is likely to push up the cost of energy for the nation as a whole.

The third point of contention is the technology itself which some have claimed is untested. The reactor destined for Hinkley C is EDF's Evolutionary Power Reactor (EPR), which was developed in collaboration with Areva and Siemens. Two EDF EPRs are already under construction: Olkiluoto 3 in Finland and Flamanville 3 in France. Both have been facing costly construction delays. Construction commenced on two Chinese EPRs in 2009 and 2010. They were scheduled to start operation in 2014 and 2015 but are now not expected to come on stream until 2017.

Ultimately, at a time when Britain is facing at least two years of tough Brexit negotiations with an uncertain outlook, it would have been untimely to sour relations with China. In any case, the deal was simply too far advanced to have been cancelled without massive repercussions. What is clear is that the plant will have the most advanced specification of any built to date.

"A NUMBER OF EXPERIMENTAL REACTORS ARE EITHER IN OPERATION OR UNDER CONSTRUCTION WHICH ASPIRE TO REPLICATE WHAT HAPPENS INSIDE THE SUN WITHOUT CREATING MUSHROOM CLOUDS."

Hot fusion is cool

Nuclear fusion is the nuclear reaction that physicists and cosmologists tell us powers the sun and stars. The reaction releases energy by joining up light atomic nuclei such as those of hydrogen and helium atoms at unimaginably extreme temperatures. Nuclear fusion requires that the hugely powerful repulsion between two atomic nuclei be overcome and that they actually merge. This is what happens when a hydrogen bomb goes off.

A number of experimental reactors are either in operation or under construction which aspire to replicate what happens inside the sun without creating mushroom clouds. One is the International Thermonuclear Experimental Reactor (ITER) located in Bouches-du-Rhône in southern France. ITER ("the way" in Latin) describes itself as the world's largest magnetic confinement plasma physics experiment.



ACTION

Consider EDF (EPA:EDF) in your portfolio. Its share price performance has lacked lustre of late (and there have been convulsions in the boardroom, not least over Hinkley) but it pays a decent dividend - a bonne bouche that la République Française uses to tickle the palettes of foreign investors. It is likely to be around for some time to come and is not going to change hands, so consider it as a long-term holding.

One of the beneficiaries of Hinkley Point C is likely to be Kier Group PLC (LON:KIE) the British infrastructure specialistviii. Its shares jumped on 22 September when it announced a 17% increase in its dividend on the back of increased profits of £150 million, up 44% on the previous

year^{ix}. Kier Group already has 350 workers in Somerset building access roads and excavating the site. (Kier Group may also benefit from the new runway at Heathrow or Gatwick - but that's another story.)

The S&P Global Nuclear Energy Index is comprised of the largest publicly-traded companies in nuclear energy in both developed and emerging markets. The index is equally distributed between two segments: nuclear materials, equipment and services and nuclear energy production. This index is tracked by the iShares Global Nuclear Energy ETF* (NASDAQ:NUCL), offering a one-stop shop for exposure to the future of nuclear power.

ITER's member states are the EU, India, Russia, China, South Korea, Japan and the United States. One assumes that the UK will become a member state in its own right after it leaves the EU but, unfortunately, this is just the kind of issue that will be subject to haggling.

"MONEY IS NOW **POURING INTO** A NEW FIELD OF **RESEARCH RE-**LABELLED LOW **ENERGY NUCLEAR** REACTIONS (LENR)."

The march of the tokamaks

For the technically minded, ITER is an experimental tokamak nuclear fusion reactor. The word "tokamak" comes from the Russian токамак - an acronym of the Russian words for toroidal chamber with axial magnetic fields. It is a device that uses powerful magnetic fields to confine plasma in a torus-shaped chamber. In a tokamak, an electric current is induced inside the hot plasma by means of a complex choreography of electromagnets. Construction began on ITER in 2010 and the first plasma was projected to be generated by 2020. But, as usual, there are rumours of delay. Some fear that the facility may not be fully operational until the 2030s and it is already apparently over budget.

There is another tokamak located at the Culham Centre for Fusion Energy, Oxfordshire, operated by Tokamak Energy Ltd in collaboration with the Joint European Torus (JET) project. T25(HTS) - for so it is called - was the first tokamak to have all magnetic fields formed from high temperature superconducting magnets, yet this facility dates back to 1984. Once again, the future of the Culham facility is subject to post-Brexit uncertainty, but it seems likely that its role will be usurped by the new ITER facility in France anyway.

The Department for Atomic Energy of India began the construction of the SST-1 tokamak reactor in Gandhinagar, Gujarat, India in 2005. This project has engaged some of India's most prominent physicists. Land has already been acquired for SST-2 which will be, so the Indians claim, a fully-fledged fusion reactor capable of producing electricity using deuterium-tritium plasma.

Clearly, India has high ambitions for this technology.

Other countries with functioning tokamaks include the USA, Russia, China and Japan. This is a perfect example of where state-funded pure science preempts commercial exploitation - just like the atom bomb.

Cold fusion - the heat is on

In 1989 two chemists at the University of Utah by the name of Stanley Pons and Martin Fleischmann announced that they had achieved nuclear fusion in a laboratory – at room temperature. The idea of cold fusion was born. What they had done was to take a palladium rod and to immerse it into water enriched with deuterium (a form of "heavy" hydrogen found in seawater) and pass a low current through a platinum coil immersed in the water. The "theory" (if that is what it was) was that the low current loads deuterium onto the lattice of palladium atoms so forcefully that the deuterium nuclei fuse together, releasing energy in the form of electricity.



Unfortunately for the professors, the experiment was never replicated elsewhere and they ended their academic careers under a reputational cloud. Yet a lot of scientists have never given up the dream. And money is now pouring into a new field of research re-labelled Low Energy Nuclear Reactions (LENR). Indeed, this emerging technology has been noticed by the Armed Services Committee of the US House of Representatives which earlier this year observed that the field had "strong national security implications". For that very reason China, Russia, India and Israel have commissioned studies to investigate the current state of playiii.

If LENR really worked then it is estimated that a cubic metre of seawater could release energy equivalent to that contained in 10 barrels of crude oil. But then, if something is too good to be true, it probably isn't true. And

"THE SHARE OF ELECTRICITY CONTRIBUTED BY NUCLEAR WILL GROW AS FOSSIL FUEL POWER GENERATION IS DISPLACED."

there is the argument that the idea of cold fusion has been around so long that if it was going to happen something would have happened already.

And yet... money is pouring into LENR-oriented projects. Institutions which are working on LENR include the US Naval Research Lab in Washington DC, backed by the US government. Cherokee Investment Partners, a North Carolina based private equity outfit with an estimated US\$2.2 billion of assets has set up a firm called Industrial Heat LLC which invests exclusively in LENR technologies. Woodford Investment Management LLP based in Oxford, UK, better known for its portfolio of biotech investments, has invested £35 million in Industrial Heat. Be aware, however, that a US\$10 million investment that Industrial Heat made into an Italian entity called Leonardo Corporation is now the subject of acrimonious litigationiv.

According to Industrial Heat's website^v, Bill Gates, founder of Microsoft, recently made a US\$5 million donation to the Texas Tech Foundation which is involved in LENR research. Bill Gates has been linked to LENR research before. During a recent trip to Italy he visited the Italian National Agency for New Technologies, Energy and Sustainable Economic Development (ENEA)vi where scientists claim to have made progress

towards a working design for low energy nuclear fusion using a palladium core. ENEA is supplying equipment for the ITER site in France.

The real problem with the cold fusion approach – unlike hot fusion which physicists understand at a theoretical level, even if the engineering challenges are monumental – is that physicists don't agree on the underlying science. Cold fusion is still such stuff as dreams are made on^{vii}.

Conclusions and predictions

The global nuclear power industry, despite controversies over safety, is set to become the key technology in generating electricity in the era of climate change. The Earth's glaciers are melting - and this is overwhelmingly likely the result of anthropomorphic carbon emissions. As the technology evolves, the economics of nuclear power will improve. Nuclear power will always be more expensive than renewable energy, not least because of decommissioning and waste management costs; but it is much more reliable and consistent. (And the accounting methods used to evaluate renewables may well be flawed.) Energy policies like Britain's, based on diversity of supply, is logical; but countries like Britain and Germany which have procrastinated

about nuclear power over a long period have failed to incubate global industry leaders.

There are and will remain a small number of dominant players which have the clout to design, build and operate these incredibly sophisticated installations. These are, because of the massive barriers to entry, a select group of ultimately state-sponsored entities of which EDF is the global benchmark. British Energy, which operated eight nuclear plants in the UK, was taken over by EDF in 2009, so EDF was already the leading player in the UK nuclear market even before Hinkley Point C came along. CGN is also likely to become a global player: its interest in the UK is based on a strategy to challenge EDF's position globally. In years to come you can be sure that CGN will be building reactors like the one at Hinkley C across Chinese-controlled Africa.

Global electricity consumption will not grow as fast as the global economy because of increasing energy efficiency; however, the share of electricity contributed by nuclear will grow as fossil fuel power generation is displaced. True, a number of advanced countries, amongst them Australia, are opposed to nuclear power. But negative perceptions towards nuclear power could change if global warming accelerates.

Hot fusion might work – theoretically – but is, at present, at the very limits of human science. Keep your eye on India – they have invested heavily in this and have the capacity to surprise. Cold fusion is, for now, the cow that jumped over the moon. On the other hand human history proves that many ancient dreams – like human flight – eventually come true.

- i See: http://www.districtenergy.org/blog/2015/02/27/uk-energy-demand-falls-7-in-2014/
- ii See: http://www.scmp.com/business/companies/article/2002539/china-general-nuclear-power-accused-espionage-its-adviser-us
- iii See: In from the cold, by Michael Brooks, New Scientist 17 September 2016, page 34.
- iv For details see: http://ecat.org/tag/industrial-heat-llc/
- v See: http://ecat.org/2016/bill-gates-reportedly-funds-lenr-research-at-texas-tech-university/
- vi See: http://old.enea.it/com/ingl/New_ingl/research/energy/nuclear-fusion.html
- vii Shakespeare, The Tempest, Act IV Scene 1.
- viii See: http://www.telegraph.co.uk/business/2016/09/17/questor-hinkley-boost-for-brexit-hammered-construction-group-kie/
- ix See: http://www.proactiveinvestors.co.uk/companies/news/166304/kier-lifts-dividend-by-17-as-acquisition-boosts-profits-166304.html
- x See: https://www.blackrock.com/ca/institutional/en/literature/fact-sheet/nucl-ishares-global-



HOW TO INVEST LIKE...

PHLIP FISHER

"Great stocks are extremely hard to find. If they weren't, then everyone would own them. The record is crystal clear that fortune-producing growth stocks can be found. However, they cannot be found without hard work and they cannot be found every day."

— Philip Fisher in Journal of Portfolio Management (2011)

A bet on innovation before Silicon Valley

One of the biggest and most challening questions Philip Fisher ever dared to ask a corporate manager was "What are you doing that your competitors aren't doing yet?" While being relatively crude, such a question is often disregarded by those involved in business, who often can barely give a convincing answer when confronted with it. In a similar fashion, those involved in investment should ask a similar question: "What am I doing so different from the crowd?" The lack of a proper answer entitles an investor to average returns, at most, in which case he would be better off investing in passive index funds (see last month's Invest Like... John Bogle column) while enjoying the free time elsewhere. Superiority in business is achieved by anticipating the future, by pledging resources to develop innovative products that allow a company to gain market share over time and to enjoy a high growth rate. By the same token, a successful inves-

"FISHER
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tor needs to commit his time and effort to researching the market to uncover what others don't: the young companies of today that will turn into the biggest companies of tomorrow due to their outstanding growth prospects.

Philip Fisher, the focus of this month's column, was always seduced by innovation, well before Silicon Valley was created. But, from the very beginning of his career, Fisher believed that only through innovation could a company outpace its competition, and this way grow faster than the market and provide superior returns to investors over the long run. Together with Thomas Rowe Price, Fisher is considered one of the fathers of growth investing, a strategy that is often opposed to value investing. However, Fisher himself was not one to discard the tenets of value investing. The "scuttlebutt" strategy

"WHILE A STATISTICAL BARGAIN CAN SOMETIMES DELIVER 20%-30% RETURNS, A WELL SELECTED GROWTH STOCK, WHOSE **INTRINSIC VALUE GROWS STEADILY** OVER TIME, WILL TEND TO APPRECIATE 'HUNDREDS OF PER CENT EACH DECADE'."



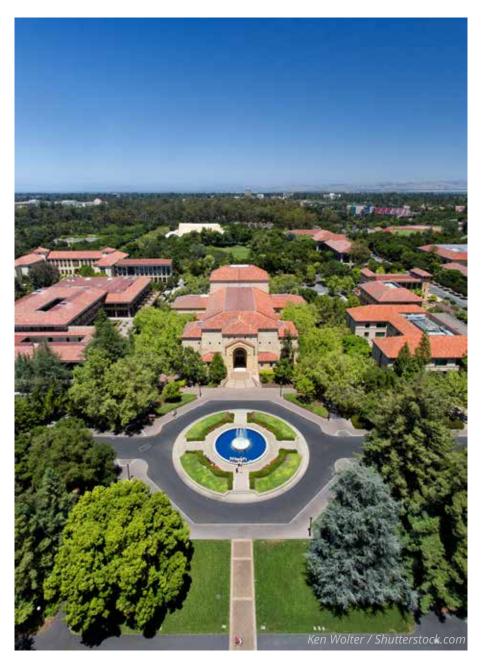
he developed to uncover the best investment opportunities is part of a refined value seeking strategy, aimed at buying outstanding growth prospects based on an intelligent appraisal of the underlying business's characteristics – that is, buying growth at reasonable prices. He always believed the growth strategy to be far superior to the traditional value strategy, which seeks out "statistical bargains" – that is, shares that appear cheap based solely on accounting characteristics.

While a statistical bargain can sometimes deliver 20%-30% returns, a well selected growth stock, whose intrinsic value grows steadily over time, will tend to appreciate "hundreds of per cent each decade". Instead of price-to-book and price-to-earnings ratios, which hide a few headwinds that don't appear in financial statements, Fisher relied on all pieces of quality information he could get about a company to thoroughly evaluate its future prospects.

A rising star

Phil Fisher was born in 1907 in San Francisco, where he lived for most of his life. Unlike the high-flying hedgefund stars of today, who work from expensive offices and are certainly more likely to be found commuting by helicopter or limousine than driving their own car, Fisher was an insecure man who always avoided the spotlight and was more likely to be found walking on the street when commuting than using a taxi or anything more fancy. The two offices he occupied during his career were always modest; and instead of a portfolio management team filled with securities analysts and quant geeks, Fisher was a one-man band for most of his long 70-year investment career. That is, except for a part-time secretary.

Fisher came from a Jewish family, mainly from Prague and Germany, which settled in San Francisco during the early 1850s. His father was a successful orthopaedic surgeon, who had no particular care for business or money. When his practice patients couldn't pay, he cared for them anyway; and when the bills invoiced went unpaid, he just ignored any re-billing or collection attempts. Due to his father's

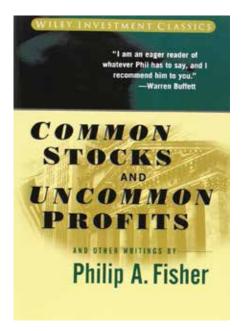


"SCUTTLEBUTT IS ABOUT FINDING OUT FROM MAIN STREET SOURCES IF A FIRM IS STRONG OR WEAK, INSTEAD OF COLLECTING RUMOUR-BASED NOISE FROM WALL STREET."

generosity, it was an uncle that, behind the scenes, helped pay Fisher's education expenses and helped buy him a car. He never knew about it.

Fisher went to the *University of California Berkeley* but later transferred to the smaller *Stanford University* where he felt more comfortable. He graduated at Stanford and remained there for

one year on the then brand new *Stanford Graduate School of Business*. At that time, the business school had no class on investment, but it at least had a class that travelled to visit and analyse local businesses. This contact with real businesses would be pivotal in the development of Fisher's investment strategy, giving him awareness of the need to go beyond the numbers and to get





the real feel from Main Street before investing in anything. In 1928, Fisher dropped out of the Graduate School to work as a securities analyst with the Anglo-London Bank in San Francisco. He later switched to a stock exchange firm, but remained there only for a short time. By then, the US was heading out of the Great Depression and he thought that "there was a magnificent opportunity on the West Coast for a specialised investment counselling firm". The big money management businesses would at that time always relocate to New York upon growing and there were not very many investment advisory firms in San Francisco.

In 1931, Fisher founded Fisher & Co, an investment counselling firm that he would manage until retiring (for health reasons) in 1999 at the age of 91. His business was always very selective and stable. He worked with only a dozen clients at a time, most of whom had the patience to keep their investments with him over the long run. Ultimately, that small structure may have been part of the reason for his huge success.

It was in 1958 – when Fisher published a book based on his past experiences about investing, which made its way to become the first investment book in the New York best seller list – that he became a rising star. The book "Common Stocks and Uncommon Profits" is about Fisher's investment strategy, explaining how he successfully chose his investments. Fifty-eight years later the book is still in print and one of the best references in investing. The main

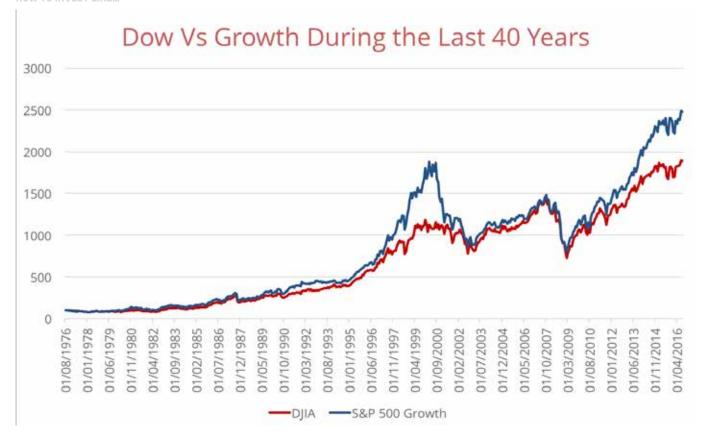
principles taught in the book are still valuable today and successfully used by his younger son Kenneth Fisher in his money management business Fisher Investments. In the book, Fisher explains the scuttlebutt technique, which consists in gathering information and perspective on prospective investments. Scuttlebutt is about finding out from Main Street sources if a firm is strong or weak, instead of collecting rumour-based noise from Wall Street. While it may be nearly impossible to get detailed information from the target company (such information is often kept in relative secrecy), investors can go a long way by collecting information from competitors, customers, and suppliers. These are real people with vested interests in the target company, who will express their fear, respect, and feelings about the target company. As Fisher points out, in doing that, an investor would never have invested in Enron or WorldCom, because he would quickly discover how lousy the underlying performances of these companies was, no matter how great their financial statements were or how highly Wall Street rated them.

A 15-point plan for a growth strategy

The worst part of any investment strategy is to figure out what to buy and what to sell. But, according to Fisher, if investors follow his 15-point plan to select the best equities, then selling becomes a lot less important, as most of the selected companies will virtually be kept forever. Fisher himself selected a

few investments that he kept for many years. He purchased Motorola's shares in 1955 and held it until his death in 2004. His average number of portfolio holdings was around 30 stocks, carefully selected using his 15-point plan and with many of them remaining in the portfolio for many years. Only towards the later years of his life, when he was plagued with dementia, did he change his mind and start selling a few holdings to reduce portfolio size (as reported by his son Kenneth). Such a change in strategy was unfortunate, but a consequence of Fisher not being in the best of health. He saw his father die from dementia and believed the reason for his death was lack of work. He was so scared of retiring that only after 1999 did he accept working from home, until he quit working completely due to his deteriorating condition. But by then Fisher was already more than 90 years old, which is quite enviable. Still, in May 2000, aged 93, he appeared at Stanford Graduate School for a lecture.

Fisher specialised in innovative companies driven by research and development and focused on the long run. For him, the short run was quite unpredictable and just a "mere tactical tool to get to [the] long-term future". Fisher believed that his strategy could be applied by any investor no matter what the focus. Fisher's 15-point plan is where he sets out how investors should choose their holdings. It is about selecting firms with huge product and market potential, and for which management is determined to exploit such poten-



tial beyond the current generation, by deploying a plan to keep and improve productivity and profitability.

Let's take a look at Fisher's plan. The first point is about checking that 1) the company has an existing product portfolio and an expected pipeline of new products to feed a large and expanding market. It's not only about the present but (much) more about the future. Apple, for example, currently accounts for a large share of the smartphone market due to its stunning iPhone product. But with it on its 7th generation (or even more if counting all models), the question would be whether Apple still has products in its pipeline to continue feeding this market for the time being or not. Another point is about recognising that products have cycles, and that when they mature, they're no longer able to provide the same market potential as before. At that point, it is key to understand if 2) management is determined to develop new products to replace the mature products and maintain the company's high growth. Looking at Apple, the company has recently shown interest in the electric car market and has been rumoured to be in talks to buy McLaren to make its debut into this new market. This is an example of management determination to keep the high growth of the past by replacing mature products by new ones. The next point in the plan requires making sure that 3) the company's R&D efforts are effective in relation to its size. It is from R&D that innovative ideas, which are crucial to giving the company an edge over the competition, spring forth.

While innovative, stunning products should sell easily, (4) the company needs to have an above average sales force. The reason is because competition is always fierce in markets where profit margins are great. Only a very few products "are so outstanding that they will sell to their maximum potentialities [when not] expertly merchandised". Because the efforts to sell make a difference, some companies devote a substantial amount of time to improving the skills of their sales force. This kind of data comes from the scuttlebutt process, as it is not reported in the financial statements of the company. But when the sales force is good, the competition would certainly know about it. The task of a prospective investor is to go to Main Street and ask questions.

Another crucial point, which can be easily extracted from financial statements, is that (5) the company must show a worthwhile profit margin. Companies cutting profit margins in the face of competition will most likely engage in price wars and detract value from shareholders. Low profit margins make it difficult to deal with the business cycle and are a sign that the company has not been able to get an edge on the market. Apple, for example, is currently facing a choice between cutting the price of its iPhone or investing in further innovation in its portfolio of products to renew its edge.



With the profit margin being so important and a company being managed as a going concern, then it is natural to ask whether we should concern ourselves only with current profit margin or with the future expected profit margin too. Fisher believes that it is key that (6) the company retains the ability to keep or improve its profit margins over time. When margins are high, so will be the future competition attracted by it, which will press profit margins down. Brand name recognition would certainly be key at that point. There are many Colas out there but just one Coca-Cola. When competition increases, Coca-Cola can retain its margins while other brands can't. This may also come as the result of cost inflation, which increase production costs and must be passed to the final consumer. Under a fiercely competitive environment not all companies will be able to do that.

Fisher always said that he would never invest in a company where high profit margins come from low salaries, because he believes that above-average profits should be connected with above-average salaries. Then, (7) a company should have outstanding relations with employees. It is not only about salaries but also about the attitude of top management, working conditions and the settlement of past grievances. Happy employees

are more productive and engaged in achieving long-term performance for the company they work for. In a similar fashion, (8) a company should also have outstanding relations with executives. Additionally, (9) the company should have depth to its management. A growing company will, at least at some point, need to have a few layers of management and delegate tasks across them instead of running the mill with just one man. Interestingly, Fisher & Co. was most of the time a one-man business, as Fisher always felt reluctant in delegating tasks. While that may have worked for a money management business where one man was managing the money of a relatively stable clientele, it doesn't work for companies growing fast.

To avoid being caught in a situation like Enron, investors should (10) look for companies with good cost analysis and efficient accounting controls. Everyone engaged in a business should keep a good track record of goings-on to be able to understand where money comes from and where things can be improved. At the same time, for accounting to be useful it must be reliable, and this way based on reasonable assumptions.

The next point is one of the most important and related to a key question Fisher always loved to ask company managers: "What are you doing that competitors aren't doing yet?" The answer to such a question allows us to (11) identify how outstanding the company is relative to the competition.

Like we learned from the value investors - Benjamin Graham (issue 13), Warren Buffett (issue 14), Peter Lynch (issue 15), and John Templeton (issue 16) – the only time that really matters for serious investors is the long term. For all of them the focus of their investments is the long term. For Fisher, the focus on the long term is not only related to the investment itself but also to the company's projects. He believes that investors should always (12) favour companies that take a long-range view of profits. Just avoid those companies that are too concerned with meeting quarterly earnings estimates and replace them with companies that focus on their long-term objectives. In addition, the short-term focus acts as an incentive for aggressive accounting practices, as companies attempt to manage their earnings to meet expectations. This makes the business more risky and less valuable for long-term investors. So, the long term should not only be the focus of an investor but also of the company he is investing in.

Every company needs to finance its projects, particularly a company with high growth prospects. Investors must then (13) be wary of a potential dilution of benefits. Companies without enough cash or borrowing ability to finance growth will opt for equity offerings, which will end up diluting the interests of existing shareholders. The next point in Fisher's list regards the way management deals with disappointment. A (14) good management team should not hide disappointment and troubles from shareholders. Trouble will likely occur at some point and investors need to trust management to disclose it without masking it. The remaining point in Fisher's strategy relates to management integrity. Investors should only consider an investment in (15) companies that are headed by management teams of unquestionable integrity. Staying away from questionable integrity avoids Enron and WorldCom outcomes. The scuttlebutt tool comes in very handy here. Fisher believes that an investor



"FISHER **ALWAYS LOVED TO ASK COMPANY MANAGERS: 'WHAT ARE YOU DOING THAT COMPETITORS AREN'T DOING** AEL5,,,

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may build some kind of ranking for his 15-point scheme, but "if there is a serious question of the lack of a strong management sense of trusteeship for shareholders, the investor should never consider participating in such an enterprise".

A different view about diversification

While developing a 15-point investment plan, Fisher also advised investors about a few 'Don'ts'. The first of them is to always avoid following the crowd, something all value investors know about. Wisdom comes from the Main Street and not from Wall Street. A successful strategy requires deep research and scuttlebutt. A second point worth mentioning here is that when the time to buy comes, investors shouldn't "quibble over eights and quarters". The main plan is to find growth stocks for life. If a stock is great at \$45.00, it will most likely continue that way at \$45.60. When trying to time the entry, sometimes all that is achieved is a cost that comes in the form of lost profits.

The last (and main) reference goes to diversification, which Fisher sees as a problem while investors are, most of the time, taught otherwise. While diversification reduces the idiosyncratic risk of a portfolio, it may also lead investors "to put far too little into companies they throughly know and far too much in others which they know nothing about", just for the sake of diversifying risk. For that reason, Fisher believes that risk mitigation comes rather from a thorough selection plan and long-term ownership and much less from the number of assets owned at each time. While we are aware of the role of diversification.

Fisher's arguments certainly have their own merits, in highlighting the fact that sometimes diversification just turns above-average potential into average returns. That's certainly something to think about...

An Invaluable Legacy

Phil Fisher always believed that investment is about departing from the crowd and being patient, as profits are only unlocked when an investor hits Main Street instead of following Wall Street rumours, and may take

time to show up. But, when properly selected, a growth company can provide above-average returns forever, thus eliminating the problem of when to sell. Fisher's *scuttlebutt* process and his 15-point plan are invaluable tools, not only for growth investors but for every kind of long-term focused investor. His shared experiences in "Common Stocks and Uncommon Profits" served as main guidance in the investment course at Stanford Graduate School of Business, a place where Fisher returned in 1961 to teach such a course.



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CHART NAVIGATOR

ARE YOUR TRADES REALLY PROFITABLE?

I've been vocal at many a presentation and seminar when even some of the seasoned players that you may read in magazines like this one ignore the cost of trading and the cost of time when they calculate risk/reward, and ultimately gains/losses on closed trades. Trading is not free and it's important to calculate the actual amount it's costing you to trade. Otherwise you're just living in a dream world. I bring this up and it is often dismissed by the presenter as inconsequential. But that attitude is one of a raging simpleton. It seems to stem from the idea that any strategy that is available to the retail trader (i.e. you and me) is going to work on any time frame. Well that little theory is blown right out of the water the moment you introduce the cost of trading. It's also too complicated for their tiny minds to incorporate into their presentation in a bite-sized way, so they deny it completely because it would completely destroy their sales pitch.

Of course, these costs will vary from one method to another. For example, it's a different calculation to ascertain the cost of being in a spread bet as opposed to owning actual shares with no leverage. But the principle is the same, if not the principal (couldn't resist that one). But even before we get into that, you have to include the cost of any services you use, any training you've done, any books you've bought, and other subscriptions. Let's say you

spend £100 per month on the FT and ShareScope plus odds and sods. Where is that £1,200 in your annual Trading P&L? It starts to become clear that a scratch trade – i.e. one where you neither make nor lose money because you close the position at the entry price – is actually a loss. If you make 12 trades per year in this example you have to make £100 on each of them to negate your subscription costs. One way of dealing with this is to divide the cost into

a daily figure and split that as a cost for each of your open positions.

And so on to the cost of trading itself. Probably the two most popular methods are spread betting (CFDs are calculated in the same way as the pricing structure is more or less the same), and buying actual shares, for example in an ISA/SIPP or stock trading account. Knowing how these impact your position is helpful in knowing which way to approach and



"A SPREAD BET IS A CHEAPER VEHICLE TO TAKE ADVANTAGE OF A SHORT-TERM MOVE, BUT POSSIBLY NOT SO GOOD IN THE LONGER TERM."

manage a trade. Share purchases are what you might call 'front-end loaded', which is to say there are costs up front. Whereas a spread bet is more Pay-As-You-Go. So a spread bet is a cheaper vehicle to take advantage of a shortterm move, but possibly not so good in the longer term. Having said that, we don't have the same ease of borrowing shares to short them as they do in the US. As a result, a short trade will usually be best served by a spread bet. Unless, that is, you are shorting something for which an ETF exists. For example, indices and such markets are often accessible through a short ETF, sometimes with leveraging options too (2x, 3x etc.).

With a spread bet there is no cost to exit the trade except the spread, and possibly a bad fill (one where you don't get any or all of your position filled at the selected price, perhaps due to price volatility). With shares you have to pay a dealing cost so that has to be factored in, and since it's possible to calculate the cost from the current price, were you to take it, then this can be at least approximately known. However there is another wrinkle, which is tax. This is going to vary from product to product and from individual to individual. So you'll have to factor that in yourself if it applies to your situation. Tax is another thing readily dismissed by so-called trading experts in their little presentations, the Flip Chart Pilots that they are.

I'm almost 700 words in and still laying the foundation to illustrate the cost of trading, which gives you some idea why they want to stay off the topic at seminars and particularly sales pitches, which is ultimately what a majority of so-called seminars and training sessions actually are in the UK today.

Now we've established what costs we have, here's a little table showing them for the main trading vehicles:

Cost	Spread Bet/CFD	Share Dealing
Bid-Offer spread	✓	✓
Dealing Cost	×	✓
Stamp Duty	×	✓
Financing Charge (overnight)	✓	×
Guaranteed Stop Loss (some brokers will charge)	?	Your risk
Margin Call	✓	×
Dividends	lost	gained
Futures Rolling Over (varies)	?	×
Dealing Charge to Sell	×	✓
Tax	?	?



Aside from that don't forget your own costs, like the £100 per month from my example. Remember, the only money in the market is yours. No one else is adding to your capital, but they all want a piece of it. A long-term spread bet on an AIM stock with a large bid-offer spread and poor liquidity can actually wipe itself out guaranteeing a loss in real terms surprisingly quickly! And we haven't even allowed for inflation. Ignore the NSO (National Statistics Office) lies. Inflation for most of us in

practice is not close to zero, but more likely around 6%-8%, especially if you buy meat, fish, train tickets for commuting, drinks (both alcoholic and soft) etc. This presents an unusual dilemma: it may be the best course of action to simply spend the money today than save or invest it if you can't beat 6%-8% with a fair degree of certainty. And of course if you're in stocks and under-performing the market then you could easily treat that as a loss. That's more the approach of an investment



bank, but don't forget your money could be in an investment with a fixed return. If you don't beat that then that's a loss too. You need to be realistic about what your costs are, but it is a very personal calculation, and something you should be aware of, and able to put a number on at any time.

So what do these costs look like in practice? Let's look at a couple of illustrations, one for spread bets/CFDs and one for share dealing. They are based on the following assumptions: £5,000 capital exposure, no tax to pay on profits, £100/month on subscriptions (252 trading days in 2016 so 1200/252=£4.76 per day), spread bet exposure based on £5k capital and City Index margins on xyz plc. Hypothetical position taken on Fri 30th September at 160.60 (spread 1.3), which is the price of the last Buy trades at 16:29:45. 3113 shares bought. Charges on top: (using Redmayne-Bentley Stockbrokers' tariff) £59.99 Stamp duty at 1/2% £25. Breakeven requires Bid to be 163.33. Spread 1.3 so mid-price + 0.65 = 164. Selling costs at current price = £60 dead. 83 trading days remain this year. Financing on the spread bet is at 2.5% over LIBOR (0.7565 on 30th Sept).

This also affects your risk/reward. You have to factor making a real profit into that or you are really pissing in the wind and your trading will likely be an expensive hobby. You can see how the cost of simply being in the trade and covering your trading costs has a real impact on your profitability. Over a portfolio you'd be able to spread the cost of your subscriptions, for example, but the cost of financing and dealing costs would be per trade. Do also bear in mind that in the examples I've

"CONTRARY TO THE DISMISSIVE ATTITUDE OF PRESENTERS OF TRADING STRATEGIES, COSTS ARE A HUGE DEAL."



used I've not allowed for inflation or any taxes that might be levied on some individuals.

So, contrary to the dismissive attitude of presenters of trading strategies, costs are a huge deal. Next time you see one, insist they factor them in and see how their little world falls apart. Imagine spending, as you certainly can, thousands on a trading course. How on Earth would you realistically ever make it back?

What this exercise has done, hopefully, is to illustrate the importance of being

honest about what your cost of trading really is, and also setting a time horizon on your expectations. Staying in a trade costs money and a scratch trade after a few months is not the opening price but instead could be close or even higher than your original reward target, which has since been ante'd away like in a card game. In other words, to remain justified in continuing to be invested your reward target must be rising daily, just like the cost of being in the trade, otherwise you'll be all risk and no reward and you won't even know it.



FORENSIC FOREX

HOW I'M POSITIONING MYSELF FOR A TRUMP WIN

Summer is now officially over, and with Wall St back at its desk, things are about to heat up in the financial asset markets. Autumn is traditionally an active period across the full scope of assets, and the currency markets are no exception. Combine this increased volume with the political situation in the US and the uncertainty about what's likely to unfold over the coming quarters, and there's plenty of potential for volatility.

It's looking increasingly unlikely that the Fed is going to raise rates in the near term, despite what the leading news media might like to have us believe, and so my near- to medium-term directional bias is slightly less fundamentally driven (and slightly more technically driven) than it might otherwise be. However, the aforementioned political situation in the US is what I'm focusing on.

With this said, here's how I intend to interpret what plays out.

First up, it's important to note that none of this interpretation is influenced by personal political opinion. I do have a personal preference (yes, I'm UK based, but just because I can't vote in the US election doesn't mean I don't have a vested interest), but

I'm not going to bring it into this discussion.

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By the time this is published, Clinton and Trump will have already taken the stage to go one on one against each other in a debate. At time of writing, they are yet to, but I have my own idea of what's going to happen. Whatever your opinion of Trump may be, I believe there's a very real chance he will outperform Clinton one on one. Yes, she's far more experienced (and knowledgeable) than he is when it comes to the issues that will be discussed, but I think political rhetoric will hinder her connection with the viewers. Trump may reveal a little weakness when pushed on specifics, but I think his frankness will set him apart from Clinton.

Carrying this forward into outcome, I think there's about a 60-75% chance that Trump will win the Presidency. Tying this into impact, I think a Trump will be incredibly damaging for the US equities markets (at least





in the short term – longer term, it may eventually translate to a domestic win). Note that this isn't a reflection of what Trump's policy might do to markets, more of how I think wider market participants will view a Trump win, and in turn, what this view will do to 'risk on' attitude.

So Trump gets elected, sentiment shifts to negative and a 'risk off' attitude comes to the fore. What does this mean for my trading strategy?

Well, it means I'm very bullish US dollar for the next six to eight months.

Risk off sentiment translates to a rush towards safe haven assets, of which the US dollar remains one. Again, news media will have you believe that this is no longer the case, but you just have to look what happens to the dollar when some geopolitical or military shock takes place to see that they're wrong. Yes, eventually much of this dollar shift will - in turn - shift towards precious metals, and long term I'm also very bullish gold (and, for those interested in equities as well as currencies, miners), but the wave flows through the dollar first, and it's this wave I intend to take advantage of.

Looking at price specifically, I always wait for the break of a key (predefined) level and get in according to the break. In the EUR/USD, I'm watching 1.11 to the short side as key near-term support. A close below this would put me



in towards 1.10. In the USD/JPY, I'm looking long on a break above 105 resistance, with an upside target of 110.

So that's about it for now. I'm focusing on these two majors as I think that any fundamental driver will likely impact these two the cleanest. The cable is a bit murky right now given the concurrent political uncertainty in the UK, and its relationship with the Eurozone. Yes, mainland Europe is equally unstable right now, but I think its currency fluctuations are less representative of the underlying geopolitical situation than that of the UK.

Of course, I may be completely wrong with my political theory, and the Fed

might raise rates way sooner than I expect.

If the former materialises, and Clinton takes the top seat, then my bias is probably invalid. If the latter rings true, however, my bias is very much valid, and it just means my target support and resistance in the respective majors is set to break earlier than I currently expect

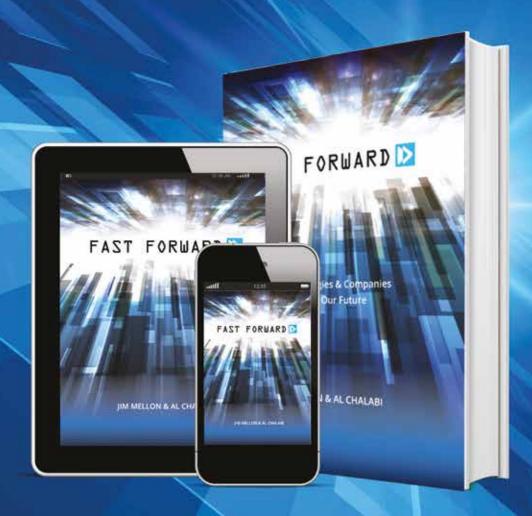
Whatever happens, it's going to be an interesting fourth quarter, and one that looks set to lay the groundwork for the dominant bias during the three subsequent to it.

Let's see how things play out...

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MILLENNIALS & MONEY

HOW TO BUILD A PROPERTY PORTFOLIO (PART 2)

END OF THE ROAD FOR HELP-TO-BUY — HOW MILLENNIALS CAN STILL GET ON THE PROPERTY LADDER WITH CONFIDENCE AND SECURITY

Becoming a home owner is an obsession of British Millennials. Unlike many Europeans and Asians who are happy renting throughout their twenties and thirties, most Brits chase the dream of owning a home as soon as possible. Commentators may never agree why it has become such a huge milestone; some suggest overbearing rental pressures, while others believe the limit on houses in the UK to be the reason. But whatever it is, we can't get enough of new ways to get onto the property ladder, and the government cashes in on Millennials' struggles with every campaign. Sadiq Khan was deemed to win this year's Mayoral race due to freezing TFL fares and his pledge for affordable housing. Cameron won over everyone with his controversial Help-to-Buy scheme. But with the news that Hammond and May have decided to scrap the scheme beyond 2016, what will buying a home look like in future for Britons?

Given the pressures Millennials are under, it is no surprise that in the desperate rush to buy, the whole process can become overwhelming for many. It is not simply a case of any home is better than none; anyone willing to endure the emotional rollercoaster of buying their first home should at least do some research into what to look for to ensure the house is the best possible find, both on a personal level and financially. After all, *Which?* found that

20% of British homeowners regretted their home purchase in some capacity, so what should be considered before taking the plunge?

New build or traditional home?

Before considering anything else, consider which type of home you're looking to own, in order to narrow down your search early on. Buying a house is time consuming, so there's no point wasting valuable research and hours on houses that simply don't suit your tastes. I won't consider new builds for investment purposes for example; growing up in London, I have always loved the tradition and style of older flats; they ooze history and character. Part of



their rental appeal comes from their beauty, and as their numbers are limited, they will always be in demand. There is a finite number of Edwardian and Georgian homes in Britain, unlike new builds. By the time you have signed on the dotted line for a new build, there will likely be another one popping up next door. A newer, fancier neighbouring home. The difference in rental yields might not be too noticeable, but the real differences come when it's time to sell. Having an older home allows for wear and tear - you never expect a 100 year old home to be completely perfect. By contrast, buyers want a new build because they can choose the interior design from a catalogue, and it's totally tailored to your tastes - it will be brand spanking new.

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However, that won't be the case when you come to sell it on. The perfect finish that you fell in love with will be slightly worn, and the perfect design that you spent hours detailing, might not be the perfect combination for the new buyer.

Square footage versus number of bedrooms

Don't be lured in by the number of bedrooms, but rather focus on the square footage. The floor space of an apartment is the key – box rooms have very little potential, unlike a large bedroom which could have an en suite added to it in future, or if rented out, split into two bedrooms with a simple wall. A simple way to work out the value of a home is by its cost per square foot. Areas in central London will go for up to £1,500 per square foot, and finding your local area's rough guide only takes a quick search on Zoopla or Rightmove, which have all the information you'll need when house hunting.

Depending on the area you choose to buy in, the bedrooms' values can vary considerably. Some areas have two-bedroom flats at a premium, whereas others hold one-beds in demand. For instance, Westminster, in central London, requires one-beds everywhere. The high number of MPs, weekly renters and young couples mean there isn't much scope for family homes, unless you're extremely wealthy. More suburban areas which are popular with sharers and families with young children, such as Brixton and Clapham, are valuable as two-beds.

One thing to consider is that the square footage value fluctuates as the house gets bigger. As every flat needs a kitchen, bathroom, and living room, it might not cost you much more to get a slightly larger two-bed than a one-bed. Consider the pros of having a two-bed which could earn you extra income, either with a long-term tenant, or if you want flexibility, with alternatives like Airbnb. Even though your current scenario might lend itself to a particular arrangement, it's vital to have flexibility for the coming years, so try to think of the future, and not just now.

Safety

Buying a home for a family brings a huge number of considerations. If you own a detached house, the area is the most important aspect. But if you are buying a flat in a city, there are multiple,



"TRY TO AVOID BEING LURED IN TO HOW NICE THE PROPERTY LOOKS DURING YOUR FIRST VIEWING."

finer details to iron out. For instance. buying a ground-floor flat is often the only way to have a garden. However, the higher up you go, the safer you are from burglaries. The dilemma between safety versus garden space is an interesting point of contention for potential buyers and something that's vital, especially if there are children to consider. Ground-floor flats, although statistically less safe than second floor flats, are significantly cheaper, which means that you might be able to afford a flat in a more affluent and safer area, even if it is on the ground or lower ground floor.

Final considerations

Try to avoid being lured in to how nice the property looks during your first viewing. I normally make a beeline for the boiler, bypassing the vase of flowers, the luxury throw on the sofa and the dimmed mood lighting. None of these will be there in years to come, or even on completion day. An apartment having an old and battered boiler usually signals a pay out in the near future of £1,500. Windows and natural light in an apartment are very difficult to adjust; unless you are a DIY specialist and fancy numerous planning permission applications to change the exterior of the property, you'll have to grin and bear whatever you've bought. Unlike furnishings and appliances, very little of the fixed fittings will be changeable once you've moved in.

Buying a home gives Millennials the freedom not to be stuck in the rental trap forever. It's a promising step towards financial stability for so many, and should be an enjoyable experience. Try not to rush into it, and be firm with your decisions; arm yourself with as much information as possible and you'll know that you have given yourself the best possible chance of buying the most profitable house possible.







What the European bank stress tests don't tell investors

European bank stocks have fallen to historically low multiples. The earnings outlook is uncertain and the banking environment is in flux. Tighter regulation, coordinated at the EU level, and challenging market conditions have forced banks to refine their business models and strategies – but all this has impacted their Return on Capital. European banks are now subject to systematic

regular "stress tests" by regulators and the results of such stress tests are all put into the public domain. But what do these stress tests really tell investors?

As everybody knows, in the fallout from the collapse of Lehman Brothers on 15 September 2008, the entire global banking system went into convulsions. In the USA and the UK direct government intervention in the financial system averted systemic banking collapse – every economist's ultimate nightmare. Economists argue as to whether the financial crisis resulted from a shortage of bank capital (technically a solvency crisis) or a shortage of liquid funds to sustain bank activities during stressed market conditions (a liquidity crisis). In reality these two concepts are intimately related.

Then, by early 2010, it became clear that European financial markets, and by extension the European banking system, were under severe stress. The most obvious manifestation of this stress was the explosion



in government bond yields in the most financially vulnerable countries across Southern Europe (plus Ireland). This secondary crisis became known as the *European Sovereign Debt Crisis* – although that epithet downplays the danger in which the European banking system found itself. Because European banks traditionally hold large volumes of government bonds (they were, in days gone by, an easy and low-risk source of yield) the fall in bond prices directly impacted their capital bases and their liquidity positions.

The European Sovereign Debt Crisis was finally alleviated after a series of massive government bailouts (Greece, Portugal, Ireland and – in a different form – Spain and Cyprus) over 2010-13 and by a late herecomes-the-cavalry intervention by the ECB. In July 2012 Mario Draghi, the new President of the Central Bank announced his intention to do whatever it takes to save the Euro. This signalled the beginning of a pro-active monetary policy involving the provision of additional liquidity to the European banking system....

By Victor Hill



Law Debenture: Steady income at a double-digit discount

The majority of investment trusts that offer a relatively steady source of income have been bid up well beyond their underlying net asset value (NAV) with investors willing to pay a premium for the secure yield.

One fund that has not yet been caught up in the bidding war is the Law Debenture Corporation (LON:LWDB), an unusual investment trust that the stockbroker Killik & Co has recently flagged up as offering an attractive entry level.

"WHEN MEASURED IN TERMS OF ITS **NAV THE LAW DEBENTURE CORPORATION IS ONE** OF THE STRONGEST **PERFORMING INVESTMENT TRUSTS** IN THE GLOBAL SECTOR, BUT ITS SHARE PRICE HAS LAGGED BEHIND."

It is a unique proposition that consists of two distinct components: a portfolio of UK and international equities, and a wholly owned Independent Fiduciary Services (IFS) business that provides a range of financial and professional services.

LWDB is an independently run investment trust that was created in December 1889 and that aims to achieve longterm capital growth in real terms and a steadily increasing level of income. The £822m fund provides exposure to UK and overseas shares with the goal of generating a

higher total return than the FTSE All-Share index.

The investment management function has been outsourced to James Henderson of Henderson Global Investors, who has been running the fund since June 2003. He has a contrarian, value-orientated approach and has built up an impressive track record.

When measured in terms of its NAV the Law Debenture Corporation is one of the strongest performing investment trusts in the global sector, but its share price has lagged behind and is only up 76.5% over five years. This has resulted in the fund moving from a premium to a significant discount.

At the end of August, 71% of the portfolio was invested in the UK, with 12% in the US, 8% in Europe and most of the remainder in the Pacific Rim region. About a third of the fund was allocated to industrial companies, with financial stocks making up an additional 15.3% and health care 9.4%, with the rest more evenly distributed across the other sectors.

It is quite a diversified portfolio with 84 separate holdings, of which the top ten only account for 18.4%. These include the likes of Royal Dutch Shell, BP, GKN, Rio Tinto, HSBC and Glaxo....

By Nick Sudbury



Why and how to invest in

Born and brought up in India, and now a British citizen, I keep a tab of developments and changes on the ground in India every time I visit. Visitors will be pleasantly surprised by the pace of development, yet less impressed with the increasing income inequality and wealth gap. I am going to focus on India as an investment opportunity and explain how the average investor outside of India can get exposure, and could generate a good return over the medium to long term.

Since February, the Indian market has been advancing at a steady pace as Indian companies thrive under a more-favourable investment climate locally and a lot of liquidity globally. The Indian Government has recently adopted a pro-investment stance when tackling economic issues, and has implemented many initiatives to improve investment accessibility in India and reduce economic burdens faced by companies operating in India. On June 20th, 2016, the government announced sweeping reforms to rules on Foreign Direct Investment (FDI), opening up its defence and civil aviation sectors to complete outside ownership and, for example, clearing the way for Apple to open stores in the country. This pro-investment stance has been emphasised repeatedly over the past year, as the government claims that it wishes to make the Indian economy "the most open in the world."



As you can see in the graph below, the main Indian Index, NSE Nifty, has significantly outperformed the S&P 500, FTSE 100, and China's composite in terms of overall return. Similarly, you can see the reduced volatility of Indian markets when compared to those of other emerging markets, such as China....

By Ruzbeh Bacha



Why British American Tobacco is the perfect Brexit play

It's three months since the UK voted to leave the EU. In that time we have in place a new Prime Minister, a looser monetary policy and sterling is the weakest it has been versus the US dollar in over a decade. All in all, it's been a dramatic quarter. While the FTSE 100 has risen by over 10% since 23 June, investors are nervous about the future for the UK economy. All of this plays perfectly into the hands of tobacco stocks such as British American Tobacco (LON:BATS).

According to the Bank of England, the UK economy is about to flirt with recession. Unemployment is forecast to increase and economic growth is due to flat line for much of 2017. In response, the Monetary Policy Committee has

cut interest rates by 25 basis points and will implement further QE. It has also hinted at further stimulus should it prove necessary over the coming months.

This plays into the hands of British American Tobacco. It is wholly unsurprising that the company's share price has risen by 15% since the EU referendum. That's because a looser monetary policy will exert downward pressure on the value of sterling. It already trades at £1/\$1.30 following the referendum and a fall to \$1.20 or lower is on the cards. As British American Tobacco reports in sterling and yet relies on non-UK sales for the vast majority of its top line, a weaker sterling will boost its reported profitability.

Concern about the macroeconomic outlook is not limited to the UK. Brexit could cause challenges for the EU as well as further afield. Although talk of a global recession caused by Brexit may be premature, the vote has left Central Banks feeling more nervous than they perhaps otherwise would have been had the UK voted to remain in the EU. This has been a factor to at least some degree in the Federal Reserve's

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decision to keep interest rates on hold. Rises in future are almost inevitable, but for now at least they are adopting a dovish stance.

This is a great help to British American Tobacco. That's because its balance sheet is heavily leveraged, as evidenced by its net debt to equity ratio of 299%. A lower cost of debt for longer will mean improved profitability. It will also mean that investors who had been becoming increasingly concerned about heavily indebted companies will adopt a more relaxed viewpoint on their valuations. This could allow British American Tobacco to trade on a higher multiple than at present....

By Robert Stephens







READ TO SUCCEED

TRADE LIKE A SHARK

HOW TO EAT AND NOT GET EATEN IN THE STOCK MARKET

BY ROBBIE BURNS

Robbie Burns is the epitome of a successful trader. For over 15 years now he has been successfully playing the markets and, as a pastime, has written a number of books about his experiences. He is very well off, being part of the UK's 250-strong list of ISA millionaires. He owns two properties outright in London worth a seven figure sum each. He has a large following of private punters who read his blogs and diaries and attend his training seminars. And, if you're into that kind of thing, he trades from home in his pants while watching Deal or No Deal and eating Twix bars.

His latest book, *Trade Like a Shark*, is all about trading psychology. Although Robbie has no formal qualifications in this complicated discipline he has something a lot more valuable – experience. Because of that, his advice is well worth listening to, much more so than that given out by spurious "Chief Market Strategists" of spreadbetting firms you've never heard of.

Eating fish

The premise of the book is that investors should exhibit "shark" like behaviour while trading the markets. Sharks are ruthless and focused, so they win

pretty much most of the time. Fishes, on the other hand (a metaphor for bad traders), quickly get gobbled up as they have no focus or direction. In the ensuing chapters Burns teaches investors exactly how to get their teeth out and be nasty.

"HE TRADES FROM HOME IN HIS PANTS WHILE WATCHING DEAL OR NO DEAL AND EATING TWIX BARS."

What's the secret to being a shark?

After examining the trading records of hundreds of his seminar attendees Robbie concluded that the best traders aren't mathematical geniuses. Neither are they fully trained research analysts or accountants. Instead the secret lies in the brain. It's all about psychology. The best traders treat their investments just like a business, making rational, efficient and logical decisions

totally unaffected by emotion – a bit like Mr Spock. In other words, to make money in the markets you have to take the feelings out of it and be as boring as watching John Major watching paint dry.

Part One of the book covers The Way of the Shark, or in other words the characteristics and behaviours that successful traders exhibit. An important point here is that trading should be treated not as a hobby but as a business. In business those that survive and prosper are ones that are ruthless. Robbie thinks that Alan Sugar would make a good trader because of his cold-blooded and shark like attitude to firing people on his show The Apprentice. He argues that the same should be done with underperforming investments. Some other people he thinks would be good traders are Tony Blair (slimy and scheming but ruthless) and James Bond (cool and calm under pressure). But you don't want to be like Gordon Brown, selling gold at the bottom of the market, prone to temper tantrums and having a new calamity occur every other week.

The eight deadly emotions

After giving some useful advice on the basics of trading and how the profes-

sionals do it, the next section, and my favourite part of the book, covers Robbie's own version of the seven deadly sins.

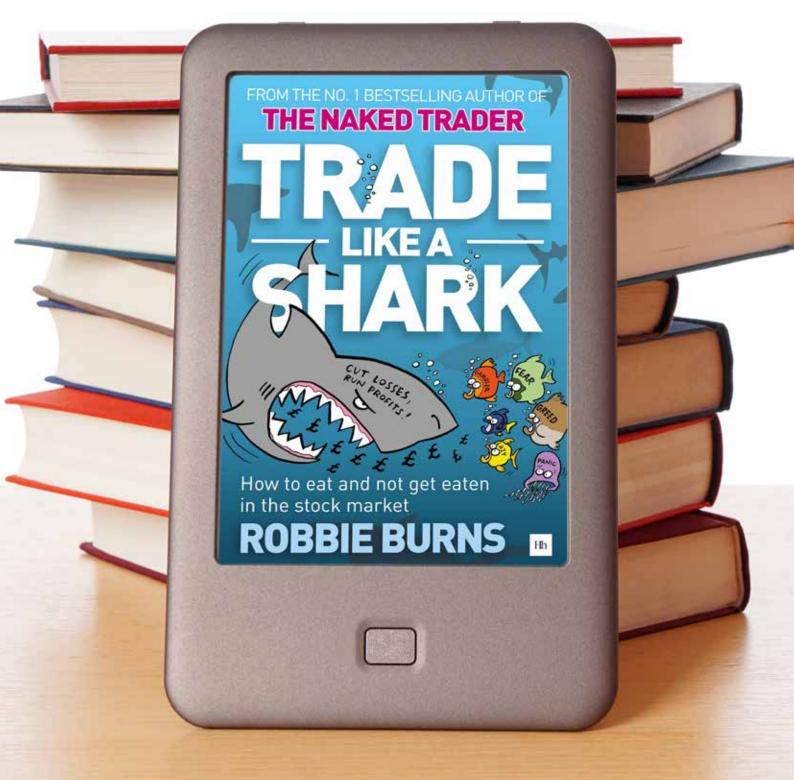
The Eight Deadly Emotions are particular feelings and sensations which generally cause investors to make bad trading decisions. By interspersing the text with examples of real people who have exhibited these emotions in their trading the book highlights the dangers of fear, greed, desperation, egotism, anger, excitement, stubbornness and regret.

"TRADING SHOULD BE TREATED NOT AS A HOBBY BUT AS A BUSINESS."

Take Barry for example. He had a pot of £200,000 to trade the markets with, not a small amount by most measures. Driven by greed and lured by the excitement of a long-shot stock he put the whole lot into Coms, the AIM listed telecoms business, at a price of 12p per share. The shares quickly dived, however, and Barry refused to sell. It's

not known whether he ever exited his position but with the remnants of the company currently trading at sub 2p it is highly likely huge losses were made here.

More usefully, Robbie explains how to eliminate the impact of emotions on your trading and describes in detail



what the traders in the case studies should have done in their own unique situation.

"OVERALL, A FIN-TASTIC AND JAW-SOME READ!"

Of course it is difficult, if not impossible, to completely remove emotions from trading. We are human after all and not from the planet Vulcan. Robbie recognises this and comes up with a solution for traders who want to get their fix of excitement. He suggests taking 5% of your trading pot and putting it into a separate account. From this you can invest in anything you want: oil stocks with dodgy CEOs, Illiquid penny shares pumped up by bulletin board posters, My Aunt Sally in the 2:15 at Doncaster... anything. After all even Mr Spock let his emotions run

wild on occasion – or was it only that one time when he breathed in some strange pollen on an alien planet and fell in love with a blonde girl?

Careful now

The third and final part of the book discusses a number of dangers and traps which can often have a sneaky habit of exploiting the brain. These classic dangers include misconceptions such as "this stock can't go any lower/ higher", "it's bound to come back" and "blue-chip stocks don't fluctuate much". Burns cautions against paying too much attention to other people's advice and warns against the dangers of following so called financial "experts" such as tipsters, brokers, bulletin board gurus, even the bloke down the pub with a "hot tip". He is also very wary of the role which technology currently plays in the financial markets, with instant access to the markets tempting people to over-trade, a gluttony of financial information creating

too much noise and addictive social media sites conjuring up questionable trading ideas from anonymous and egotistical alpha males.

Just to make sure you have been paying attention, the last few pages of the book contain a quick quiz on the ways of the shark, as well as a brief list of 13 rules which shark like investors should always apply to their trading. Number 13 is definitely the most important – never smear jam on your keyboard!

A book to get your teeth into

Robbie Burns has done it again with *Trade Like a Shark*. Like all his other books it is written in the same unmistakable humorous and entertaining style. Experienced and amateur investors/traders alike will learn a lot from it and should always have it on standby in case they are tempted to make an emotion driven trading decision. Overall, a fin-tastic and jaw-some read!





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THE FINAL WORD

THE MARKETS— THE ONLY TRUE DEMOCRACY

We talk a lot about democracy in the West. How we in the UK created the model upon which modern democracies are based. But we don't really have democracy at all. We have an elected dictatorship whenever there's a majority government, which is most of the time. They can more or less do what they wish, without so much as a by your leave, for the term of office. Of course, making democratic decisions about every single issue will suffer from the law of diminishing returns. I know a group that meets in a bar every month for a social. Their monthly missive said "hopefully we'll sit at our usual table unless someone else is sitting there". I suggested they just phone the bar and reserve the table. They said they'd put it to the committee. What a monumental waste of time! So, you have at the one end of the scale a democracy which is in fact a dictatorship, and at the other a complete abdication of responsibility and initiative for even the most inconsequential of decisions.





"THE GREAT THING WITH SHARE PRICES IS THAT, UNLIKE REAL LIFE, THE OUTCOME IS A BINARY DECISION."

Thankfully there is one place where you will find a genuine democracy that works and where someone takes responsibility for every decision that is taken. But it's more of a consensus than what we think of as a democracy. Our form of political democracy is in fact mob rule with impunity. There's a fascinating book called The Spider and the Starfish. It centres around the contrast between what has been the model for business, society and government for centuries - a hierarchy and some sort of committee based decision making. This is the spider. You cut off one of its legs and the whole organisation suffers. The contrast to this is the starfish organisation. It features a decentralisation, where functions are controlled and made efficient by the very people carrying out those functions. This can be done, for example, by having a suggestion box, and each suggestion is then adopted, save for the physically impossible ones posted by the disaffected. If it creates another inefficiency, then that will feature in the next round of suggestions. Efficiency is created by the very people carrying out the function making themselves efficient. If a leg of the starfish gets cut off it doesn't affect the whole organisation in such a detrimental way. In fact, locally, things carry on and evolve to efficiency in the new paradigm if required.

The reason democracy is flawed is that it relies on all problems and issues being polarised. As people are finding out here after the Brexit Referendum, and in the US with the Trump election, you can't judge people, and certainly not friends, on one issue after another, and a polarised choice is no choice at all. Luckily that is not applicable to price, which is happily polarised. Whereas politics is in fact a multi-dimensional landscape, not a left to right scale (no matter how much politicians want to tell you it is), a price scale is just that. Politics is

all about people getting demented over how to treat the symptoms, and never the root, of the problem in question. Price is all about a consensus between buyer and seller. It's constructive and it works.

To make money you need to find disparity – a situation where the voters (i.e. the market participants) have got it wrong. You're looking for a 'Leave Win', just like the EU Referendum. Interestingly, the Colombians after 52 years of war with FARC, voted in a referendum on a negotiated peace just this weekend. They said FARC Off and voted against peace, and instead for more war. Another curve ball. It puts to bed the Utopian notion that everybody in the world wants peace. They don't. Get over it.

Everyone has a different agenda, but the great thing with share prices is that, unlike real life, the outcome is a binary decision. Of course that decision may last only a moment before someone else votes by buying or selling and the price moves again. But it's an ongoing litmus test of sentiment. Human sentiment about the price of a stock or financial instrument. And that's as pure as democracy gets. In fact it's better than democracy: it's ongoing consensus. There's no reason we can't do that





in politics too though. The Swiss base their system of government on public decision making. Most western democracies are not far past the dark ages.

Basically, this democratic consensus is why charting and Technical Analysis work. A chart is not some set of random numbers as some think, like the scores on a dice or a roulette wheel. It's a real crowd trend indicator. That said, there are big players and they can 'gerrymander' the markets, for want of a better word - but not forever if the instrument is highly liquid, like a currency. In order to manipulate that sort of price effectively you need the help of a regulatory body. A good example of that is the FSA's creation of a perfect scenario for banks to fix LIBOR for years without detection while the FSA looked the other way.

One thing worth noting is that when investment banks buy or sell into a market they will often use algorithms that start off by doing the precise opposite of what they intend to do - sell to bring the price down before they make a big purchase, for example. Watch out for that. It's easier to see on the NAS-DAQ than the FTSE as they have more transparency available to retail (and all) participants there. You can watch the investment banks as they execute using various transparent and not so transparent ECNs (electronic communication networks). A curve ball in that department though is the recently introduced Tick Size exercise that will, for two years, use a group of shares and three control groups whose shares will be guoted and trade in different tick sizes in order to see if it makes markets more stable. I'm generally against



market manipulation, especially by regulators, as the law of unintended consequences has a habit of ballsing everything up. However that's what we have to deal with.

So the next time you trade remember that your 'vote' does count. No matter how small, it is counted. I'd just like to say a big thank you to my regular readers. I'm going to take a bit of a break from writing now and focus on trading. I think it's going to be an interesting winter. If you want to know what's still coming up then read my last few months of articles. For example, in May I predicted that Bon Marché (LON:BON) would be following BHS down the pan. They issued a profit warning a week or two ago and blamed it on low clothes sales in the summer. Their shares dropped 21% on that news. That summer season hadn't even begun when I wrote "There's a Bon Marché in many towns where people will struggle to pronounce the name properly. In any case they're a clothing store and wow does their chart spell failure."



I'd wish you luck but of course I want to take your money as much as anyone else's. Trading isn't a sport and I'm not a sportsman. And you know what they say: never interrupt your opponent when they're making a mistake.

MARKETS IN FOCUS

SEPTEMBER 2016

Last		
Month %	YTD %	Proximity to 52w High*
4.3	30.9	
2.2	6.2	
1.7	10.5	
1.4	6.3	
0.8	34.6	
0.7	-8.0	
0.6	-2.7	
0.2	-4.1	
0.1	2.6	
-0.1	6.1	
-0.5	5.1	
-0.8	-2.2	
-2.6	-13.6	
	Month % 4.3 2.2 1.7 1.4 0.8 0.7 0.6 0.2 0.1 -0.1 -0.5 -0.8	Month % 4.3 30.9 2.2 6.2 1.7 10.5 1.4 6.3 0.8 34.6 0.7 -8.0 0.6 -2.7 0.2 -4.1 0.1 2.6 -0.1 6.1 -0.5 5.1 -0.8 -2.2

COMMODITIES				
Commodity	Last Month %	YTD %	Proximity to 52w High*	
Sugar (No. 11)	16.2	51.6		
Crude oil (Light Sweet)	7.1	29.6		
Palladium	7.0	28.4		
Crude oil (Brent)	6.1	34.0		
Copper	5.4	2.6		
Silver	2.5	39.2		
Coffee	2.1	19.4		
Soybean	1.3	10.4		
Natural Gas	1.1	23.5		
Gold	0.5	24.4		
Platinum	-2.2	15.6		
Iron Ore	-2.4	31.5		
Cocoa	-4.3	-14.0		

FOREX		
Last Month %	YTD %	Proximity to 52w High*
2.0	17.5	
1.8	5.1	
0.8	3.5	
0.1	-5.1	
-0.5	0.4	
-1.2	-12.7	
-1.2	-11.9	
-1.2	-3.0	
-1.9	-15.7	
-3.1	-16.1	
	Last Month % 2.0 1.8 0.8 0.1 -0.5 -1.2 -1.2 -1.9	Last Month % YTD % 17.5 1.8 5.1 0.8 3.5 0.1 -5.1 -0.5 0.4 -1.2 -12.7 -1.2 -3.0 -1.9 -1.5.7

Central Bank	Key Rate	Next	After
central bank	ney nace	ITCAL	Aitei
BOE	0.25%	Oct 13	Nov 03
ECB	0.00%	Oct 20	Dec 08
FED	0.50%	Nov 02	Dec 14
BOJ	-0.10%	Nov 01	Dec 20
SNB	-0.75%	Dec 15	Mar 16
BOC	0.50%	Oct 19	Dec 07
RBA	1.50%	Oct 04	Nov 01
RBNZ	2.00%	Nov 10	Feb 09
BOS	-0.50%	Oct 26	Dec 20
BON	0.50%	Oct 27	Dec 15

FTSE 350 TOP				
Sector	Last Month %	YTD %	Proximity to 52w High*	
JRP Group PLC	36.7	-19.3		
KAZ Minerals PLC	29.0	116.0		
Evraz PLC	25.8	119.8		
Anglo American PLC	24.1	223.1		
Glencore PLC	21.9	134.5		

FTSE 350 BOTTOM			
Sector	Last Month %	YTD %	Proximity to 52w High*
Capita PLC	-35.3	-44.5	_
CMC Markets PLC	-30.7	N/A	
Mitie Group PLC	-29.1	-38.3	
McCarthy & Stone PLC	-18.3	-34.3	
Countrywide PLC	-17.4	-45.8	

FTSE 350 SECTORS TOP				
Sector	Last Month %	YTD %	Proximity to 52w High*	
Industrial Metals	25.8	119.8		
Mining	15.5	73.1		
Oil Equip, Serv & Dist	7.4	22.4		
Food & Drug Retailers	6.4	14.5		
Industrial Engineering	4.9	38.1		

FTSE 350 SECTORS BOTTOM				
Sector	Last Month %	YTD %	Proximity to 52w High*	
Food Producers	-8.9	-10.1		
Mobile Telecom	-3.8	-2.7		
General Retailers	-3.5	-14.0		
Aerospace & Defense	-3.2	7.8		
Support Services	-2.9	3.5		



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