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MAGAZINE

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FINANCIAL CRISIS II

HOW TO PREPARE FOR THE INEVITABLE CRASH

PLUS...

SUPER-HIGH YIELDS

ARE THEY TO BE TRUSTED?

INVESTMENT TRUSTS Vs OEICs

WHERE'S THE BEST PLACE TO PARK YOUR CASH?

TEN-BAGGERS

CAN THESE SUPERSTAR STOCKS CONTINUE TO DELIVER?

STERLING IN CRISIS

HAS THE SELL-OFF GONE TOO FAR?

WELCOME

Dear Reader,

We delight in bringing you content that you can't find anywhere else. Most recently, we were able to give our readers access to a video presentation that took place behind closed doors and where we were the only media outlet admitted (on the condition of not revealing any of the other participants).

Our lead contributor, Jim Mellon, spoke to a group of German Plutocrats who had assembled in Munich's best hotel for a day of investment strategy discussions. Jim was the special guest of the evening and he was asked to spend 20 minutes speaking about Brexit, the Euro, and his view of the world.

In the end, he was kept on stage for nearly an hour. He was also heavily besieged at the subsequent dinner, with participants scrambling to get a seat at his table. I subsequently presented a few short sections of his presentation to the audience of TipTV, with whom we are now regularly running a joint show. Please see page 63 for more details and how to find a link to this regular show.

In the end, we released the entire 50 minute video of Jim's presentation on our YouTube channel. Such lengthy, raw footage is not usually that popular. But we received too many emails from readers asking us to give them the whole, uncensored story.

Parts of Jim's presentation were also picked up by other outlets, not least the wildly popular social media and weekly newsletter of Leave.EU, the Brexit campaign outfit turned news operation, who presented it to their 1m+ followers.

Our readers were first to be in the know, and the viewpoints thus presented were up until that point not easy to find anywhere else. We call a spade a spade. Master Investor delights in taking a contrarian view and looking at challenging situations from a different perspective.

On that note, I recommend you pay particular attention to Victor Hill's cover story. Our lead story in today's issue is filled with some alarming facts and stats, and all set into the kind of historical context that Victor's regular readers enjoy so much.

We are nearing the end of an exciting and unusual year. For investors, these are challenging times, but also times of opportunity. Count on us to be at your side with exclusive insights, unusual viewpoints, and hard-to-uncover facts that will help you make sense of the investment and financial landscape.

Best regards,

Swen Lorenz
Editor, Master Investor

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ALL OTHER TOPICS

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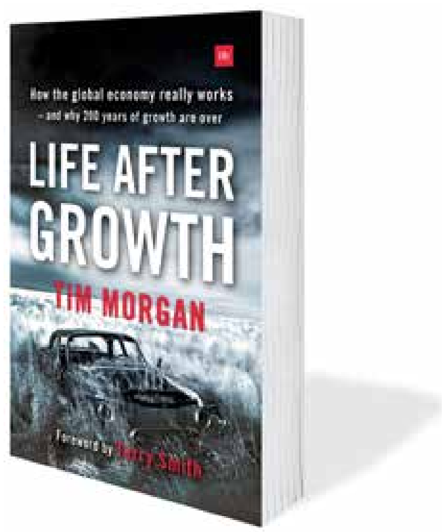

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BY JIM MELLON

MELLON ON THE MARKETS

THE GREAT UNRAVELLING

Another month of the phony war in markets. Equities are range-bound almost everywhere – with the notable exception of Japan, which is performing well and ahead of every other major market. (So it should: it's the cheapest and best bet!)

But don't think for one moment that this quiet period and low volatility will last. I've just been on a trip through the Somme and to the Normandy landing beaches – our journey served as a sobering reminder that phony wars have a habit of turning into something much worse.

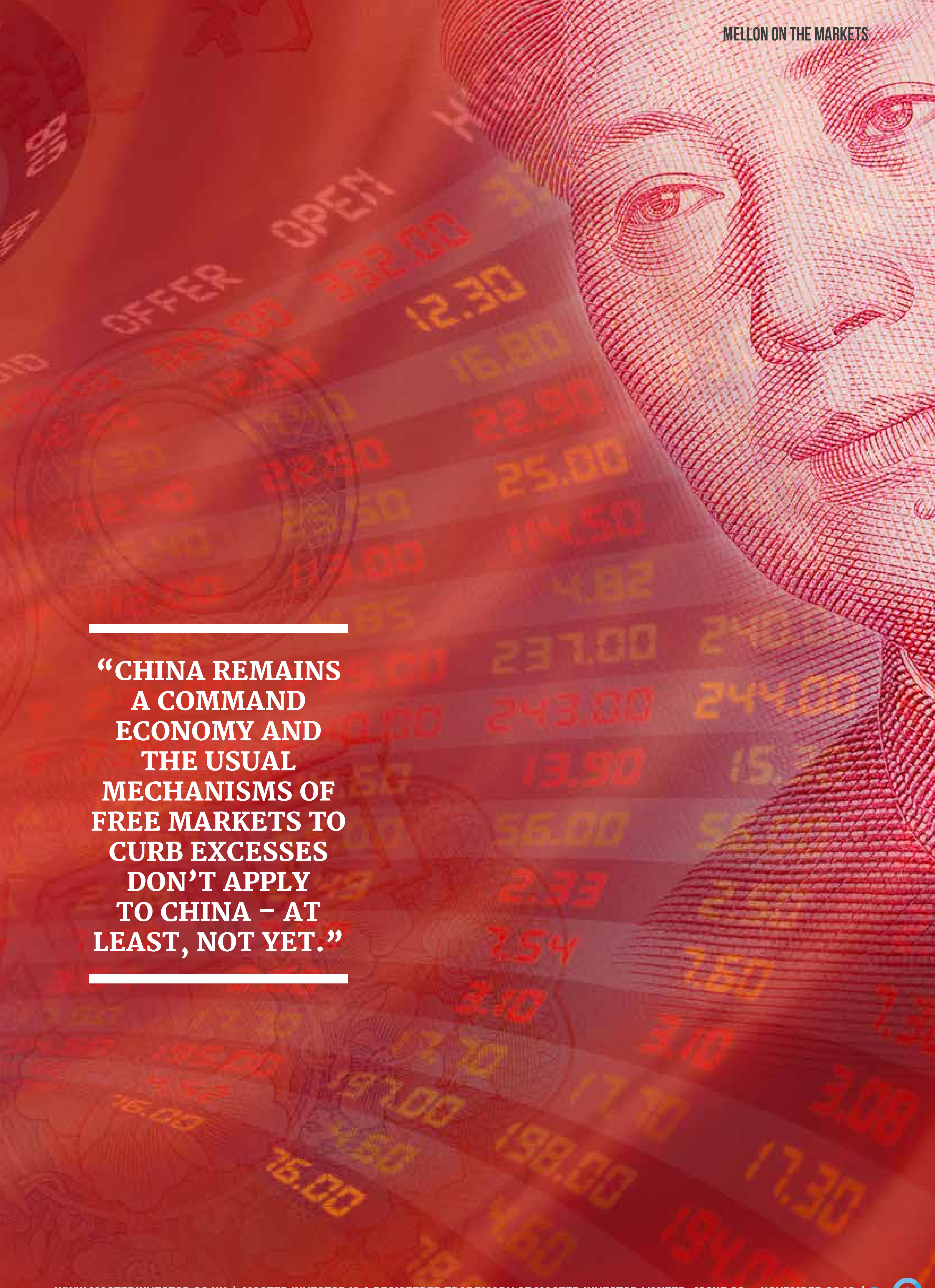
There is something called the Dunning Kruger effect: incompetent people rarely realise that they are thus handicapped. The best demonstration of this is the current crop of central bankers, who are mostly incompetent to the core and are blissfully ignorant of the fact. While the likes of Kamikaze Kuroda and Mark Carnage are congratulating themselves on "saving the world", Gordon Brown style, the signs of a *Great Unravelling* are appearing.

Bond yields are rising (and this could have been predicted by a monkey); the effects of negative interest rates are now generally believed to be pernicious by all except their perpetrators; banks in many parts of the world are beginning to feel the strain – especially in Europe and in China; and corporate cannibalism, otherwise known as share buybacks, is having a progressively smaller impact on earnings, and indeed, on share prices. This is particularly so in the US, where despite $175 billion of share buybacks a quarter, earnings are falling, and valuations remain especially stretched.

Oh, and the strength of the US dollar reveals an underlying cause: a shortage of dollars. US nominal GDP is slowing markedly, and world money supply growth, despite all of the QE experimentation going on, is negligible. This shortage of US dollars is likely to cause problems in the future for highly indebted emerging markets, as most of their debts are denominated in US dollars, and those debts have soared to record levels since 2008.

The most indebted of all emerging markets, however, is China, which is looking pretty perilous. Debt to GDP is now estimated at 300%, which makes Italy look parsimonious. Capital flight from China is proceeding at a rapid rate, depleting forex reserves despite strong trade surpluses. Property speculation has reached absurd levels, with second tier cities in China boasting property prices three times that of Manhattan, and exposing real-estate exposed banks to a future crash.

Meantime, China's capital stock expansion, which has been in double digits for over 30 years, has left it with physical capital stock larger than that of the US. And that isn't a good thing, as China's stock of "soft" or brain powered capital is peanuts compared to that of the US. Instead,



"CHINA REMAINS A COMMAND ECONOMY AND THE USUAL MECHANISMS OF FREE MARKETS TO CURB EXCESSES DON'T APPLY TO CHINA – AT LEAST, NOT YET."

“BREXIT SHOULD BE REGARDED BY SERIOUS INVESTORS AS A SIDE SHOW TO THE MUCH BIGGER PLAY OF THE INEVITABLE IMPLOSION OF THE COMMON CURRENCY.”

China has built too many factories, too much go-to-nowhere infrastructure, and too many inefficient energy plants. Some people have been forecasting disaster for China for what seems like forever, including Jim Chanos and Rob Citrone. They haven't been right yet, because China remains a command economy and the usual mechanisms of free markets to curb excesses don't apply to China – at least, not yet.

But, a crash is coming, and one has to believe that the best China shorts are the banking system and of course the currency, which has fallen to a multi-year low against the dollar. So trade number one of this missive is to short YUAN against the US dollar.

Now, back to those crazy central bankers... Adair Turner, former head of the FSA, has said that we live in a world of *permanent monetisation*. By this he means that although QE has supposedly come to an end in the US and in the UK, the chances of the bloated balance sheets of central banks being wound down, even if only by waiting for bonds to mature, are zero. Reducing the size of the balance sheet of central banks isn't on the cards anytime soon, as it would cause a deflationary bust. If it happened in the US, it would cause contagion in the rest of the world. Not going to happen.

So, what will central bankers do? I am guessing that there will be an American rate rise post the US election, but it will be small and won't be repeated more than twice in 2017. Janet Yellen will be looking to send a signal of rate normalisation, which is to be welcomed. Hopefully Mr Carnage won't do the opposite and cut rates further in the UK. Mr Carnage is determined to prove that somehow he has stabilised the UK economy post Brexit – when the reality is that the recent strength of the economy has ABSOLUTELY NOTHING to do with him. He really is a right Dunning Kroger!

On the subject of Brexit, the legions of worthies, the sobbing artistes, self-styled economists and wise men and women who predicted disaster for the UK (yes, you did!) immediately post a vote to leave are now deferring their timetables. They remind me very much of the religious maniacs who from time to time trudge to the top of mountains to await the Second Coming, only to trudge down forlornly when it doesn't happen. They, of course, have the same resilient hope for disaster as the Remainers – that they just got their timing wrong, and redemption won't be long in coming (in their deluded minds).

Well guess what. Four months on from D-Day (which they would describe as Disaster Day), the UK economy is likely to be the strongest in the G7 for yet another year, leaving the Eurozone trailing in its wake. And I bet it doesn't do nearly as badly in 2017 as the Deferred Disaster Mongers are making out.

Sure, sterling is down, but it will recover, particularly against the doomed Euro, as our auto correct on the current account deficit is much faster than for other countries (because of the translation effect of the huge stock of foreign assets that the UK holds). The stock market has been booming, and possibly too much so.There are opportunities in the UK, but generally I think stocks are pretty fully valued. Especially as what's going to happen in Europe isn't going to be helpful to the UK, whether in or out of the EU.

Brexit should be regarded by serious investors as a side show to the much bigger play of the inevitable implosion of the common currency. Imagine it as a house, and you see fissures and cracks everywhere; the paint is peeling, the beams are exposed and overburdened, and one day – and that day isn't that far off – the ceiling caves in.

Italy and its referendum, Hungary and its pompous populist PM, elections in France and Germany, Portuguese stagnation, Spanish deficits – you name it, the cracks are evident. Oh, and the so called Target 2 balances, the massive overdraft of the feckless southerners at the Bundesbank mediated by the ECB, just keep getting bigger.

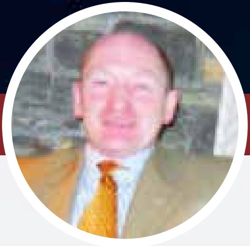
So trade number 2 is short euro against the pound and the dollar. It's going to blow!

Meantime, the usual stalwarts continue to be backed: gold and silver, **Gilead (NASDAQ:GILD)**, **Synergy Pharma (NASDAQ:SGYP)**, short all negative yielding bonds (there are less of them now!), and short the yen and long Nikkei continue to apply. When the Euro blows up EVERY single European bank will be bust, so one might as well short them too!

Happy hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter



BY VICTOR HILL

OPPORTUNITIES IN FOCUS

FINANCIAL ARMAGEDDON? IT'S NOT INEVITABLE, BUT...

Risks in the international financial system have been rising for a while. In recent months bank valuations and some credit default swaps (CDSs – the rates at which banks insure each other) for European banks have reached levels not even seen during the Credit Crunch of 2008. Brexit has created a climate of uncertainty – not just for the UK, but for Europe as a whole. But there is another malign force at work – the relentless rise in debt in a zero-interest world. Even cash-generative China is awash with debt. A crunch of some kind is coming – though what form it will take is arguable. Financial Armageddon over the next two years is not inevitable, but it is beginning to look likelier than not. Don't despair. I've got some ideas on how to survive a possible banking collapse.

Brexit – a climate of uncertainty

On 10 October JPMorgan Chase CEO Jamie Dimon said that Brexit makes *the likelihood of the Eurozone failing five-times higher*. This was at the annual meeting of the Institute of International Finance in Washington[i]. I don't want to argue the pros and cons of Brexit here, but to contextualise it in an increasingly dangerous global financial system.

Europe's banks are in crisis

The decline and probable fall of **Deutsche Bank (FRA:DBK)** over the course of this year has been a slow-motion car crash. If Deutsche Bank fails then a long line of Italian, French and Spanish dominoes could fall in turn.

While Frau Merkel was adamant on 24 September that the bank would not receive German government support, on the basis of capital and liquidity – the two critical metrics of a bank's health – Deutsche has (in theory) a clean bill of health. Its Core Tier 1 capital ratio is at 10.8% and it has €215bn in liquidity reserves. This core Tier 1 ratio is proportionally better than those of banks that got into difficulties during the financial crisis.

The problem for Deutsche, along with other European banks, is profit-

"ON 10 OCTOBER JPMORGAN CHASE CEO JAMIE DIMON SAID THAT BREXIT MAKES THE LIKELIHOOD OF THE EUROZONE FAILING FIVE-TIMES HIGHER."

ability – and the outlook for profitability. This will remain the case regardless of whether the final settlement with the US Department of Justice is $14 billion or a more realistic $5 billion. Q2 2016 pre-tax profits were down 67%, prompting CEO John Cryan to promise to be even more ambitious in the speed and intensity of current restructuring.

Deutsche Bank's shares are trading as I write at around €13 – a level far below the value they retained during the darkest days of the financial crisis – and the bank's long-dated 6 percent 2049 bond trades at around 73% of face value. The bank's five-year credit default swaps hit a fresh multi-year high in October, implying that the market thinks the bank has a significant probability of default.

On 15 October it was reported that the Qatari Investment Fund had lost patience. Qatar bought £1.57 billion of Deutsche Bank stock two years ago as part of a €7.2 billion (£6.5 billion) capital increase, at the time paying €29.20 a share. With the share price having plummeted 45 percent this year, and having lost €1 billion, they are reported to have pulled out of a further £12 billion fund-raising round. The bank was even accused on 07 October of using "unsavoury sales practices" in relation to a private placement. In the second week of October rumours were circulating in the markets that JP Morgan Chase was covering up the degree of its exposure to Deutsche Bank.

"IN THE FAT DAYS BEFORE THE CREDIT CRUNCH, AMERICAN AND BRITISH BANKS HAD A TARGET PRE-TAX ROC OF 35 PERCENT – AND SOME EUROPEAN BANKS EVEN EXCEEDED THAT. DEUTSCHE BANK WILL BE LUCKY TO MAKE 5 PERCENT THIS YEAR."

Many economists – not least Yannis Varoufakis (whose book I reviewed in MI magazine in May) – regard the first Greek bailout of 2010 not as **the bailout of an improvident government, but as the bailout of the German and French banks which were exposed to Greece.** The condition of Europe's banks and the future of the single currency itself cannot be disentangled.

Why are European banks finding it so difficult to generate a satisfactory Return on Capital (ROC)? If they are so well capitalised, why have their share prices bombed? I would say there are five main reasons.

Firstly, traditional retail and corporate lending margins have been squeezed since the crisis. A climate of risk aversion and tighter bank regulation, compounded by a sluggish economy, has wiped out a huge swath of higher-margin lending activity. Second, with a policy of negative interest rates in the Eurozone imposed by the ECB, European banks have to pay to park overnight funds with the ECB. Third, the profitable investment banking business has gone away. Bond underwriting, for example, no longer makes money. Fourth, partly due to internet competition, up-selling of other financial products like insurance is more difficult. Fifth, there have always been too many banks in Europe; but now they are standing on each other's toes.

In the fat days before the Credit Crunch, American and British banks had a target pre-tax ROC of 35 percent – and some European banks even exceeded that. Deutsche Bank will be lucky to make 5 percent this year. That's just not commensurate with the

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"THE TOTAL VOLUME OF ALL THE DERIVATIVES BUSINESS OUTSTANDING WITH DEUTSCHE BANK IS RECKONED TO BE A MIND-BOGGLING €61 TRILLION WITH A NET EXPOSURE (THAT IS, IF ALL THE COUNTERPARTY POSITIONS DEFAULTED AT THE SAME TIME) OF €41 TRILLION."

risks incurred – which is precisely why the market believes that many European banks would be better off dead (their market cap is substantially less than their book value).

No more bailouts – only "bail-ins" are allowed

A bailout is when a government rescues a bank, as the UK Treasury saved Royal Bank of Scotland (RBS) and Lloyds Bank in October 2008. A bail-in is where shareholders, bondholders and depositors are given "haircuts" and the government dispenses kind words.

For the Germans, having lectured the Greeks on the virtues of financial stringency and allowed Greece's cash machines to run dry, any kind of state-backed rescue plan for Deutsche Bank would carry a very high political price – perhaps even Frau Merkel's job.

Moreover, Frau Merkel could not legally bail out Deutsche Bank even if she wanted to. The **EU Bank Recovery & Resolution Directive (BRRD)** of 2014 provides that shareholders and creditors of a failing bank must be bailed-in before any state funds can be mobilised to recapitalise a bank. In July 2015, when a small Italian mutual bank, the **Banca Romagna Cooperative (BRC)** ran into trouble, the Italian government's instinct was to use funds from the national *Deposit Guarantee Insurance Fund* to inject new equity. But this move was vetoed by Brussels. Instead, the entire cost of the recapitalisation was borne by shareholders and junior bondholders. At least one retired depositor committed suicide.

Across Europe banks are beginning to charge retail customers for basic banking services. Commerzbank imposed a swath of charges on current accounts recently. In France, BNP Paribas, Société Générale and LCL are amongst those banks which have significantly raised

Vytautas Kielaitis / Shutterstock.com

charges for both retail and corporate customers[ii]. So people and companies who hold cash balances get zero return and have to pay additional charges. No wonder the amount of so-called *stable funding* from customer deposits is in decline, increasing bank liquidity risk.

Derivative Exposures are at Record Highs

Deutsche Bank was fingered by the IMF recently as one of the most important net contributors to systemic risks in the global banking system. One reason for this is that its balance sheet does not reflect the huge volumes of counterparty obligations that Deutsche Bank has amassed by its activities in the numerous derivatives markets across the world. Back in the '90s Deutsche Bank was one of the innovators in the field of writing *interest rate swaps* which enable corporations and financial institutions to hedge their interest rate exposures. And it remained a leader in exotic investment banking products and in the dubious realm of "structured finance" – mostly undertaken by its London and New York branches.

The total volume of all the derivatives business outstanding with Deutsche Bank is reckoned to be a mind-boggling €61 trillion with a net exposure (that is, if all the counterparty positions defaulted at the same time) of €41 trillion. Actually, astonishing as that is, Deutsche is not out of line with other so-called *Global Systemically Important Financial Institutions* (G-SIFIs).

Under Basel III and the Capital Requirements Directive IV (CRD4) banks have to put up capital against counterparty credit risk using Value at Risk (VAR) models. But there is considerable controversy about the methodological effectiveness of these models. Even if the German government were somehow to find a way to bail out Deutsche Bank by recapitalising it, it is very unlikely that it could guarantee all of its counterparty obligations in the derivatives markets, which amount to a sum many times bigger than the entire German economy.

The European Bank Agency (EBA) "Stress Tests" of August 2016 lack credibility

The markets don't believe that the major European banks are as well capitalised as they (and regulators) claim they are. And with good reason.

The Italian financial journalist Paolo Barnard criticised the 2016 EBA stress tests. *The desperate EU regulators rigged the test to the point of ridicule: they did not even examine lenders from Greece or Portugal, where banks' balance sheets are akin to a warzone,* he said. Moreover, in October it emerged that Deutsche Bank has been allowed to fiddle the stress tests by booking the cash proceeds from a stake it held in a Chinese lender before the deal had gone through.

"IF AND WHEN INTEREST RATES DO RISE, MOST WESTERN GOVERNMENTS RISK GOING BANKRUPT."

At a time when faith in the rating system is diminishing, the credibility of the stress testing system itself is in question. Far from being methodologically rigorous exercises in risk management to quantify the probability of another systemic banking crisis, the real purpose of stress tests is to provide reassurance to the market.

Government Finances are deteriorating everywhere

In the early stages of the financial crisis when **Northern Rock** had to be rescued by the UK government in September 2007 the UK's Debt-to-GDP ratio stood at around 34 percent. Right now, that ratio stands at 83 percent. True, some progress was made in the Cameron-Osborne years in tackling the budget deficit, though this year it will stand at above 2 percent of GDP. **The absolute volume of UK government debt outstanding more than doubled in those years to an astonishing £1.64 trillion[iii].** Under Mr Osborne's regime of so-called "austerity" government expenditure increased to record levels.

UK Chancellor Philip Hammond will deliver his Autumn Statement on 23 November. We have been primed to expect that fiscal policy is to be "reset", which, together with the previous announcement that the budget deficit will not be plugged in this parliament, can only be interpreted to mean that the new government will spend more and borrow more. So, by 2020, the UK Debt-to-GDP ratio could be nudging 90 percent. US economists Carmen Reinhart and Kenneth Rogoff regard anything in excess of 100 percent as *the point of no return.* They have shown that once governments exceed this level they rarely or ever manage to fall below it again without default (of some kind)[iv]. Moreover, very high debt levels, they argue, inhibit growth.

The UK is certainly not alone in being a country whose national finances have never recovered from the financial crisis. It is a similar story in most of Europe, except that the Southern European countries – with the noble exception of Spain – started out with much higher Debt-to-GDP ratios even before the Crisis. With a Debt-to GDP ratio nearing 200 percent everybody knows that the Greek state is bankrupt, but the bailout pantomime continues. And Italy, with a 140 percent Debt-to-GDP has been living in Neverland for years.

And we know that the US Federal debt has continued to rocket under President Obama, despite his good intentions. The figure now quoted is US$20 trillion or more than 90 percent of US GDP. Again, the Japanese government owes debt to the value of around 230 percent of GDP.

I reckon that all of these figures **underestimate** of the true level of debt. This is because there is no globally accepted national accounting standard for measuring national debt. Crucially, debt incurred by different levels of government is often not aggregated. A good example is Spain where much fiscal policy is devolved to regional, provincial and city administrations. Thus the Kingdom Spain can borrow in its own name – but so can the Generalitat de Catalunya (an *autonomous community*), the Provincia de Barcelona and the Ayuntamiento de Barcelona. There are similar problems in Japan where prefectures borrow in their own name.

If and when interest rates do rise, most Western governments risk going bankrupt. Even at a time when 10-year Gilts yield well below one percent, the total interest cost for the UK government was forecast to be £39 billion this year (it will be more) – almost as much as the defence budget. If rates rise to even 2 percent then that cost will double in time and will be more than the education budget.

In 2008 the USA and the UK were able to counter a systemic banking crisis by cutting interest rates and increasing deficits. Now, interest rates cannot go lower (except into negative territory) and state finances could not withstand another systemic crisis.

The rising cost of welfare in the West

In Britain and in many other democracies the welfare state is growing faster than the economy as a whole. This is partly because growth itself has been insipid overall since the Credit Crunch (the Eurozone economy has barely grown in ten years), but also because a higher percentage of the entire population qualify for transfer payments of one kind or another. In the UK, Housing Benefit is a case in point. Initially introduced by Prime Minister Thatcher to assist the most vulnerable tenants, it now costs the Exchequer more than the Royal Navy.

Similarly, the cost of state-provided healthcare has been growing faster than the economy, as life expectancy increases and as citizens' expectations evolve. Founders of the NHS like Nye Bevan did not envisage that it would be required to provide fertility treatment, cosmetic surgery and obstetrics for overseas visitors.

The Cameron-Osborne years were full of promises to reduce the cost of the welfare state. So far, under Mrs. May, we have heard nothing on this theme.

China is awash with debt

On 18 September the Bank for International Settlements (BIS) reported that Chinese debt had risen to "alarming levels"[v]. So it is not just the tired West. The country's *credit gap* is now three times higher than the "typical" danger level. This measure tracks the difference between corporate and household debt as a proportion of GDP and the long term trend, thus highlighting any divergence between current and historic borrowing patterns.

The BIS rates a reading above 10 percent as a *cause for concern.* China's gap hit over 30 percent in March. China's debt is not exorbitant when compared with other large economies. **Yet the speed with which it is growing is unprecedented.** China was not responsible for *The Age of Debt.* But it may turn out to be one of its most spectacular victims.

The Eurozone is inherently flawed

On 19 October Jim Mellon told an audience of German plutocrats in Munich that the collapse of the Euro within five years was "a certainty". What was he on about?

Back in 2012 the European Central Bank (ECB) President, Signor Mario Draghi, pledged *to do whatever it takes* to save the single currency. The ECB became a master practitioner of *Quantitative Easing* (QE). It adhered to a Zero Interest Rate Policy (ZIRP) before becoming a practitioner of the cult of Negative Interest Rate Policy (NIRP). A policy of printing money and zero rates (conjoined with fortuitously low oil prices) has disguised its inherent flaw – which is that huge unsustainable imbalances have built up in the system.

I recently explained how the TARGET2 intra-Eurozone settlements platform has turned the Bundesbank into a bad bank. As of July 2016 the Bundesbank's unsecured overdraft facility in favour of TARGET2 stood at an astonishing €660 billion. This sum of money is, in the words of the German academic

"CHINA WAS NOT RESPONSIBLE FOR THE AGE OF DEBT. BUT IT MAY TURN OUT TO BE ONE OF ITS MOST SPECTACULAR VICTIMS."

Gunnar Beck, *unlikely ever to be repaid... Germany's trade surplus with the Eurozone therefore is little more than a massive accounting trick.*

European QE started by lending cheap money to banks but then proceeded to buy Eurozone government bonds with invented money. Now it has ventured into the deep underworld of monetary black magic – it is buying corporate bonds with invented money, even those of junk-rated companies. This is completely unprecedented. The ECB now holds over €1 trillion of bonds bought at *artificially low* or *negative* yields, implying huge paper losses if and when interest rates rise. A one-notch credit downgrade and the bonds in question will be worthless.

Even Otmar Issing, the eminent German monetary economist who was one of the architects of the single currency, is now saying that the European Central Bank (ECB) is becoming dangerously over-extended and that the entire project is unworkable in its current form. On 15 October he said: *One day the house of cards will collapse*[vi]. He thinks the current *Merkelpolitik* – the strategy of stumbling from one crisis to another – cannot be sustained indefinitely.

ACTION

There are numerous ways to get exposure to gold. You can buy physical gold (coins to bullion); you can buy gold miners (MI recently took a look at Centamin (LON:CEY)); or you can buy a gold ETF such as those offered by ETF Securities.

If you like the idea of buying agricultural land, check out the sites of some leading land agents on the UK Land Agents Directory. Market leaders are Savills and Knight Frank. If you do not already own a pair of wellies, you will need advice. Investors who do not want to get their wellies dirty can instead invest in a farmland fund such as The Farm Fund, the Braemar UK Agricultural Land Fund, and the Brooks MacDonald UK Farming Fund, all of which have modest yields.

Under the *Stability and Growth Pact* of 1997 on which the Eurozone was founded, member states pledged to restrict their fiscal deficits to just 3 percent of GDP and their overall debt burdens to 60 percent of GDP. This has been abandoned in all but name – few Eurozone members have been compliant for years. Add to this the extraordinary reputational risk that the ECB is courting, and you have a risk profile which Professor Issing considers would have been *unthinkable in the past.*

If Professor Issing can be so candid, why is there no action? Because France and Germany, the two central pillars of the Eurozone, have differing analyses of what is wrong and have different prescriptions as to how to fix it. The French want *to mutualise* European Government debt – so that a bond issued by, say, Greece would be guaranteed by all 19 members. And they want to create a European Ministry of Finance that would not only start to harmonise fiscal codes, but would eventually collect taxes. For the Germans both proposals are anathema. The first would require an amendment to the German constitution, which is politically impossible before the elections of October 2017. The second offends the German principle of "budgetary sovereignty" – *no taxation without representation.* (And I am with the Germans on this.)

Global deflation will rebound

Last month's MI magazine predicted the return of inflation, and short-term, I accept that this is likely happen. We will have a shot of inflation in the UK by the end of Q4 2016 thanks to the swooning Pound, which means that the Bank of England might actually meet its inflation target for the first time in years. BoE Governor Carney has already said that he would permit inflation to overshoot the official 2 percent target. According to *The Economist* (which is about as accurate an economic forecaster as the average punter) UK inflation will hit 3 percent in 2017.

> **“THERE IS NO GUARANTEED WAY TO SURVIVE A SYSTEMIC BANKING CRISIS JUST AS THERE IS ONLY LIMITED PROTECTION OFFERED BY A BUNKER IN A NUCLEAR WAR.”**

On 18 October we learned from the ONS that the Consumer Price Index (CPI) had risen to one percent in September. This was even before the latest falls in Sterling. This was mainly because of the recovering price of oil, and because hotel prices rose during a bumper summer for the tourist trade. Food prices fell. But, with base rate at 0.25% in the UK we already have a real interest rate of **minus 0.75%.** Another reason to get your money out of the bank! (Hurry up: the central bankers want to ban cash altogether.)

But, medium-term, the spectre of deflation will come back to haunt us. For its part, the Eurozone has become a generator of deflation. The world has massive overcapacity, global debt is out of control (as we have seen) and global demographics are against us (ask the Japanese). Chronic and persistent deflation is highly damaging to both the finances of indebted governments and corporate borrowers alike – and hence to bank balance sheets.

The recipe for the *bombe surprise*

Add fermenting government debt and deteriorating finances to modest rises in interest rates in the English-speaking world. Simmer gently on a European banking system with zero profits and declining liquidity, and add large chunks of non-performing loan portfolios. Mix in the gloopy marinade of a deeply flawed currency union, in which colossal hidden liabilities have been allowed to brown. Then glaze with a build-up of emerging market debt from countries where bank solvency is obscure. Drizzle generously with post-Brexit hysteria and Italian political soufflé. Season with increased geopolitical risk, and serve to a bunch of demented central bankers who believe in the Prophet NIRP. Et voilà! Bang!

How to mitigate the risk of losing your cash

Unfortunately, there is no guaranteed way to survive a systemic banking crisis just as there is only limited protection offered by a bunker in a nuclear war.

Obviously, depositors should, as far as possible, diversify their holdings of cash so as not to exceed the level guaranteed by the relevant deposit insurance scheme. In the UK the *Financial Services Compensation Scheme* was reduced on 01 January this year to just £75,000 (from £85,000). Note that this only applies to accounts that do not incur a penalty on withdrawal.

Yet in a bank bail-in for European banks, local deposit insurance schemes may not be enforced. Depositors in the Bank of Cyprus, after the bail-in of April 2013, incurred a one-off deposit levy of at least 6.75% on all uninsured bank deposits of over €100,000. Depositors in two other banks were treated even more harshly. As I wrote last year an estimated 48% of uninsured deposits in the Bank of Cyprus – many held by wealthy Russians – were frozen and later converted into equity. Depositors in European banks beware.

What should governments do in *The Age of Debt*?

In the short-term there are honey-pots which lie beyond the reach of the cash-hungry government bears. These are the huge cash piles that have been amassed by Fortune-100 companies which have generated massive profits and hold them in offshore jurisdictions where they remain effectively untaxed. **Apple Inc. (NASDAQ:AAPL)** was sitting on a cash pile of US$231.5 billion in July this year[vii] – a sum beyond dreams of avarice for Western governments.

The reason why this has been allowed to happen is that tax on company profits is too high – especially in the USA where it is 35 percent as against Ireland's 12.5 percent. If governments were collaborative they would club together to squeeze Apple and its ilk. But, even within that paragon of good governance, the EU, governments are gaming the system. In fact, J-C Juncker, when PM of Luxembourg (where Amazon notionally resides), was a master of this game. Clinton or Trump, the next US administration needs to tackle this.

Medium-term, we have to get back to interest rate "normality" so that banks may be allowed to make a decent return on capital. That could mean reversing the trend towards central banks' independence. If the cults of ZIRP and NIRP persist, they may have to be suppressed by the politicians. The twilight of the central bankers is nigh. If that entails a form of default – *c'est la vie*! The end-game of the Euro will involve defaults anyway.

Long-term, the entire international monetary system is in need of a new model. Since, in 1971, the Nixon administration abandoned the Bretton Woods monetary settlement of 1944, under which the US Dollar was pegged to gold, we have lived with a system of floating exchange rates and a world of purely *paper money*. Future economic historians will no doubt call the period from 1971 to 2021 (your guess is as good as mine) ***The Age of Debt*** – for surely it will come to an end before too long. (I'll be writing about what sort of dispensation might replace the current international monetary order in early 2017.)

And investors?

Don't get me wrong – I am not some kind of survivalist getting ready to take to the hills with my gun. But in a world where the entire financial system is creaking in the gale, I can't help thinking that two quite different asset classes are hedges to a banking crisis: Gold, and agricultural land.

Gold might be an asset with no return – in fact there is a cost-of-carry – but it has a long track record as a reliable store of value in times of turbulence. Gold is up about 18 percent year-to-date. Gold has been alluring the human psyche for millennia. Recently the Chinese and the Russians have sought to bolster their gold reserves. I keep hearing investors (Jim Rogers amongst them) talking about a ratio that I had never heard of until recently: gold reserves-to-GDP. This is now brandished as a metric of economic resilience. On that basis, the UK does not come out well.

Agricultural land does generate yield; and its price and yield depend on the quality of the land and its location. An acre of decent cereal-producing land goes for around £8,000 right now in South East England; but an acre of Cumbrian grazing land suitable for sheep might cost you under £2,500. English farmland has risen in value by over 200 percent in the last decade. The real value of the land derives from what you can do with it; and, with global warming, it turns out that growing seasons are getting longer in the UK and there is a wider variety of crops available (not to mention improvements in yield facilitated by GMOs).

I wrote in the spring about the great outlook for Kentish wine, and, with Brexit, the upside for local fizz is even better. Farming is a great business – but it requires a lot of specialist knowledge. Most land investment in the UK is speculative, relating to the granting of planning permission (obviously land with planning consents carries a premium); but when land is used to feed the world it carries unique tax privileges (farmland in the UK is exempt from IHT), and you may even qualify for a government subsidy.

i Reported by The Banker, 11/10/2016. See: www.thebanker.com/Editor-s-Blog/Will-the-EU-and-UK-heed-Wall-Street-s-Brexit-warnings

ii See Le Point, 17/10/2016: www.lepoint.fr/dossiers/economie/special-placements/banques-et-si-vous-trouviez-moins-cher-ailleurs-16-10-2016-2076301_797.php

iii See: www.ukpublicspending.co.uk/uk_national_debt_chart.html

iv See *This Time is Different: Eight Centuries of Financial Folly* by Carmen M Reinhart and Kenneth s Rogoff, Princeton University Press, 2009. Reinhart and Rogoff published an influential paper on this issue in 2010 entitled *Growth in a Time of Debt* but their figures and methodology have been contested.

v See: www.ft.com/content/fc825300-7e44-11e6-8e50-8ec15fb462f4

vi See: www.telegraph.co.uk/business/2016/10/16/euro-house-of-cards-to-collapse-warns-ecb-prophet

vii See: www.cnbc.com/2016/07/26/apples-cash-hoard-shrinks-for-the-first-time-in-seven-quarters.html

BY JOHN KINGHAM

THE DIVIDEND HUNTER

SUPER-HIGH YIELD INVESTING: ONLY FOR THE BRAVE

In recent months I've written about a range of dividend stocks from the high quality end of the spectrum: from Buffett-style stocks to consumer staples and consistent inflation-beaters. But being a dividend-focused investor is not only about buying into these high quality dividend growth companies. There is another side to the search for income – perhaps the dark side – which puts yield first and quality a sometimes distant second.

The pros and cons of super-high yield investing

Super-high yield investing involves buying shares where the dividend yield is close to or above twice the market yield. Of course this means taking on more risk, but the returns can be much greater as well.

Picture this: You decide to invest in a somewhat mediocre company which has a 6% yield. Most investors think the dividend is about to be cut, but what if they're wrong (a not unlikely scenario)? What if, instead of cutting the dividend, the company maintains it and copes admirably with whatever significant problems it was facing? In that situation it's easy to imagine the share price heading upwards as investors become less fearful and more optimistic about the company's future.

If a dividend cut was no longer on the cards then other investors might accept a more reasonable yield of perhaps 4.5% from this mediocre company. For the yield to fall that much the share price would have to increase by 33%, and if that happened over the course of a year then your one-year return would be 6% from dividends, 0% from dividend growth and 33% from capital gains.

> **"IF YOU'RE GOING TO GO DOWN THE SUPER-HIGH YIELD ROUTE, AS I OCCASIONALLY DO, YOU'LL WANT TO KEEP AN EYE ON ANYTHING THAT MIGHT CAUSE THE DIVIDEND TO BE CUT."**

Such rapid gains might seem unrealistic, but it happens all the time; in fact I've been lucky enough to invest in some of these situations myself. For example, when I bought **UK Mail (LON:UKM)** in 2011 it had a yield of 8.6% because the market expected a dividend cut. The cut never came and within a year I sold for a total return of 32%. An even faster re-rating occurred after I bought N Brown in 2012 when it had a yield of 5.4%. Just eight months later the share price had increased by 47% and I sold for a total return of 52%.

However, many super-high yield investments will not work out so well (which is something I have learned from experience). The most obvious risk is that the dividend gets cut or suspended, both of which will decimate the yield and remove the key driver of short-term capital gains. So if you're going to go down the super-high yield route, as I occasionally do, you'll want to keep an eye on anything that might cause the dividend to be cut, including cash hungry demands from debts, pension deficits and capital expenses.

In the rest of this month's article I'll look at three companies that fit the following criteria: 1) Their yields are close to double the market average; 2) they haven't cut or suspended their dividend once in the last decade; 3) they haven't recently announced a dividend cut, rights issue or other major dividend-reducing event:

Brown (N) Group (LON:BWNG)

Share price: 192p
Dividend yield: 7.4%
10-Yr growth rate: 4.6%

N Brown is a leading clothing company with a particular focus on market niches that are not always well served by traditional high street retailers. For example, the company's three main "power brands" and their related niches are: JD Williams (for the over 50s), Simply Be (for women regardless of size) and Jacamo (for men from size S to 5XL).

The company has been around for over 140 years as a mail order catalogue business, allowing customers to buy on credit and pay monthly rather than up front. But that business model is unlikely to thrive in the 21st century thanks to the Web, which is in many ways one giant catalogue. In order to survive for the next 140 years, N Brown is going to have to completely update its business in order to be a successful online-first, multi-channel retailer.

"N BROWN IS GOING TO HAVE TO COMPLETELY UPDATE ITS BUSINESS IN ORDER TO BE A SUCCESSFUL ONLINE-FIRST, MULTI-CHANNEL RETAILER."

That transformation is already underway, but it won't be (and hasn't been) easy, and therein lies the main reason behind its massive dividend yield. The market doesn't like uncertainty, and there is an enormous amount of uncertainty about whether or not N Brown can successfully pull off this transformation. Like everybody else, I have no idea what will happen, so as usual I'll stick to what we do know, which is the numbers recorded in its accounts.

First of all I think N Brown's borrowings of £330m are a little high when compared to its average post-tax profits of just under £80m. This gives it a debt ratio of 4.3, whereas 4.0 is the most I like to see in a cyclical company like a retailer. Capital expenses have also been quite high and in the last couple of years capex has been even higher still as the company invests in back-office systems and physical stores. That high capex is one reason why the company's free cash flow has failed to cover the dividend for most of the last decade. For now that gap is being plugged with rising debts, but that cannot go on forever. N Brown needs to get its operating cash flows up and capex down in order to reverse the trend of rising debt. If it can do that then perhaps the dividend will survive unscathed.

Other than high borrowings, high capex and weak free cash flows, both Brexit and the devaluation of the pound could also turn out to be serious threats. However, I don't like to speculate about the future as there are so many possible outcomes, so I won't go into any Brexit-related "what ifs".

Despite these problems I am currently an N Brown shareholder, so of course I hope it can maintain its dividend, but as with any company there can be no guarantees.

Carillion (LON:CLLN)

Share price: 250p
Dividend yield: 7.3%
10-Yr growth rate: 1.8%

Carillion is a construction and support services business, helping its clients with the finance, design, construction, maintenance and operation of buildings and other infrastructure. Its profits are split about 50/50 between support services on the one hand (facilities management and other services) and construction and public private partnerships (PPP) on the other (PPP is typically an all-in-one contract to finance, design, build and maintain public sector properties such as hospitals).

The company has a long and successful history, but since the financial crisis revenues and profits have declined in most years, although the dividend has continued to go up. As a result, dividend cover has fallen to just 1.4 which is dangerously low. Carillion's revenues and profits must start to increase soon if its record of dividend growth is to be sustained for much longer.

A lack of top and bottom line growth is not enough to cause a yield of more than 7%, so there must be other risks to the dividend. For me, those risks come in the form of borrowings and defined benefit pension obligations.

Both borrowings and pension obligations are a potential risk because they can generate relatively fixed costs: interest in the case of borrowings and (potentially) deficit reduction payments in the case of pensions. These fixed costs are important because Carillion has a significant foot in the construction sector, which can be very cyclical. Generally it's a good idea for cyclical companies to keep their fixed costs low so they can more easily survive the occasional downturns they'll have to face.

In Carillion's case, I think its borrowings and pension obligations are unacceptably high. Currently it has borrowings of just over £660m, while its average post-tax normalised profits are just over £140m. That gives it a debt ratio of 4.7, which isn't insanely high but is a little higher than the 4.0 I'm comfortable with for cyclical sector companies. The scale of these borrowings is reflected in its debt interest payments, which are currently running at £35m or 25% of average post-tax profits (imagine having credit card interest equal to 25% of your post-tax income).

“CARILLION’S REVENUES AND PROFITS MUST START TO INCREASE SOON IF ITS RECORD OF DIVIDEND GROWTH IS TO BE SUSTAINED FOR MUCH LONGER.”

However, an equally significant problem is its defined benefit pension scheme. Unfortunately, the Bank of England's near-zero interest rate policy is increasing the present value of future pension fund obligations (or liabilities). In many cases the result is liabilities that are greater than the scheme's assets, leaving a funding deficit which the company is legally obliged to fill.

This is where Carillion is today. Its defined benefit pension scheme has liabilities of around £2,700m and assets of around £2,300m, leaving a pension deficit of £400m. That is a huge amount given the company's average post-tax profits of £140m. Pension liabilities are about 21-times the company's earnings, which is a truly massive financial obligation.

To close that deficit the company is currently pumping about £50m a year into the scheme, and it has been agreed with the scheme's trustees that these payments can continue until 2027 if required.

I think this combination of £35m interest and £50m deficit reduction payments is a huge drain on cash for a company generating around £140m in post-tax profits. Unsurprisingly, the dividend has not been covered by free cash for most of the last few years.

For me the risks around Carillion are too high, and even if the dividend yield was 10% or 20%, I still wouldn't invest. There is a significant chance that it will have to cut its dividend and/or raise capital through a rights issue if its cyclical end markets suffer another setback.

Connect Group (LON:CNCT)

Share price: 140p
Dividend yield: 6.8%
10-Yr growth rate: 4.9%

Somewhat like N Brown, Connect is another company which must transform itself to survive, in this case away from its historic core business of delivering newspapers and magazines (it was previously known as Smiths News and demerged from WH Smiths in 2006). Since you're reading an electronic magazine you are probably all too aware that physical newspapers and magazines are being replaced by electronic versions, which of course require no delivery trucks.

To escape this structural decline, Connect has diversified both organically and by acquisition. There have been two major acquisitions in recent years: In 2012 the company acquired The Consortium, a leading supplier of products to the education and medical markets, for around £40m; and in 2014 it acquired Tuffnells, a leading B2B next-day parcel delivery business, for around £115m. These two acquisitions now generate about 30% of the company's profits.

On the organic side perhaps the most interesting new venture is Pass My Parcel (PMP), a same-day click & collect and returns service. This is a fast growth area of the delivery market, with more and more people expecting to be able collect or return their online purchases within a day or less. PMP doesn't currently turn a profit as it is focused on building scale, but the venture indicates a willingness to adapt and try new things.

From a financial perspective, Connect has a long and steady history of dividend growth at a reasonable pace, but as is the case with most super-high yield companies, there are risks, and those risks come primarily in the form of large borrowings and pension obligations (again).

Those recent acquisitions were paid largely with borrowed money, leaving the company with £151m of debt, which is four-times its average normalised post-tax profit of £39m. That's right on the limit of what I would describe as prudent, but not enough to stop me from investing.

However, on top of those borderline borrowings is the company's defined benefit pension scheme. With liabilities of £530m, the scheme is almost 14-times the company's average profits, which makes it far too large for my liking. Unlike Carillion though, there is a substantial surplus of around £140m, and that makes the pension far less risky, despite its size.

So far I think Connect is a borderline case, with borrowings and pension liabilities that are risky, but perhaps not excessively so. Other positive factors could still tip the balance in the company's favour. For example, Connect does not require large capital investments in order to grow; in fact capex has averaged just 23% of profits over the last decade. Its free cash flows are also very good and have easily covered the dividend in most years.

"CONNECT DOES NOT REQUIRE LARGE CAPITAL INVESTMENTS IN ORDER TO GROW; IN FACT CAPEX HAS AVERAGED JUST 23% OF PROFITS OVER THE LAST DECADE."

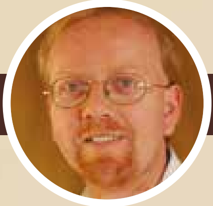
As with N Brown, I think an investment in Connect is basically a bet on the company's ability to successfully transform itself away from a shrinking market, and at today's price that's a bet I would seriously consider taking.

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.



BY NICK SUDBURY

FUNDS IN FOCUS

INVESTMENT TRUSTS VERSUS OPEN-ENDED FUNDS

There are lots of factors to consider when investing in a fund, but it's important not to overlook the way it is structured. An investment trust operates in a completely different manner to an open-ended fund such as an OEIC or unit trust and there are times when this can have a significant bearing on the performance.

With an open-ended investment company (OEIC), shares are created or cancelled every time that an investor puts money in or takes it out. They are open-ended because the number of shares can be unlimited, although the price will always reflect the net asset value (NAV) of the underlying assets.

Unit trusts are also open-ended, although the legal structure is more complicated with the trust divided into units that rise or fall in value in line with the NAV of the portfolio. Units are created or cancelled every time someone invests or disinvests, but unlike the shares of an OEIC, the units don't give you the ownership of the fund, they only entitle you to participate in the assets.

The investments held by a unit trust are protected by an independent trustee and are managed by a fund manager. An OEIC is slightly different as the holdings are safeguarded by an independent depository, while the investment manager is an authorised corporate director.

Investment trusts

Investment trusts are the oldest form of fund in the UK with some dating back more than a hundred years. They are structured as publicly listed companies with their shares quoted on the London Stock Exchange.

When an investment trust floats on the market it issues a fixed number of shares, which raises a set amount of capital for the manager to invest,

"RESEARCH BY THE ASSOCIATION OF INVESTMENT COMPANIES (AIC) HAS FOUND THAT 49% OF INVESTMENT TRUSTS HAVE HAD AT LEAST ONE MANAGER AT THE HELM FOR 10 YEARS OR MORE."

hence the reason they are known as closed-ended funds. Investors can buy or sell the shares whenever they want on the stock exchange in the same way they would for a normal trading company.

The investors are the shareholders and their interests are protected by an independent board of directors that is tasked with making decisions on their behalf including the appointment and monitoring of the fund manager.

Investment trust shareholders are entitled to vote on whether or not to approve the remuneration report, which covers investment management costs and the directors' fees. They can also elect whether to reappoint the members of the board. In theory this makes them more accountable than an equivalent open-ended fund.

Research by the Association of Investment Companies (AIC) has found that 49% of investment trusts have had at least one manager at the helm for 10 years or more. This suggests a welcome degree of continuity, which is less likely to be the case with an open-ended fund where many of the managers seem to move on a more regular basis.

Predictable cash flows

The closed-ended nature of an investment trust can be an advantage because the purchase or sale of the company's shares does not result in any cash flows into or out of the underlying portfolio. This allows the managers to take a longer term view and may enable them to invest in less liquid holdings that have the potential to generate higher returns.

These kinds of liquidity considerations are particularly relevant for sectors such as direct property, private equity, infrastructure and peer-to-peer lending. If an open-ended fund invested in these areas they could run into real difficulties if a large number of investors suddenly decided to withdraw their money.

We saw this a few weeks ago with many of the open-ended property funds. The surprise result of the EU referendum made investors nervous about the prospects for the UK economy, yet they were unable to cash out as the fund managers weren't able to sell the buildings fast enough to meet client demand.

These funds typically hold 10% to 15% in cash to finance client redemptions, but this wasn't enough and many had to suspend dealing for a number of weeks, while also imposing a fair value adjustment to take into account the estimated fall in the value of the assets.

If you want to invest in one of these illiquid asset classes it is much safer to use an investment trust where there are no such problems. They may also have an advantage in more liquid parts of the market.

Open-ended funds always have to react to client inflows and outflows by investing or disinvesting the money. This adds to the transaction costs borne by the fund and will reduce the returns, but the amounts are difficult to quantify, which is why they are not included in the published ongoing charges figure.

Discounts and premiums

Most open-ended funds are priced once a day to reflect the underlying NAV of the portfolio at that time. As long as you put your dealing instruction in close to the cut-off point it shouldn't be a problem, although there is always a theoretical risk that something significant could happen to the markets before it is processed.

The price of an investment trust fluctuates according to the performance of the underlying assets and the prevailing investor sentiment. Unlike an open-ended fund, the shares can trade at either a premium or discount to their NAV, which can make them more volatile.

Investors who get the timing right can use this to their advantage. If they buy when the discount is relatively wide and the underlying portfolio then does well, the share price should move closer to the newly appreciated NAV.

Those who get it wrong could find that the discount widens once they have invested, which is why it is always worth checking to see if the company operates a share buyback programme. Where this is the case, it gives the directors the power to buy back and cancel their own shares when they are trading at a large discount, with the aim of the process being to narrow the gap.

Income and gearing

OEICs and unit trusts are usually available as either income or accumulation shares/units. The latter roll up the income received in the fund and reinvest it, whereas the former will distribute it on a regular basis according to the mandate.

UK domiciled OEICs and unit trusts are legally required to pay out all of the income that accrues in the fund over the course of their accounting year. Investment trusts have more flexibility as they can retain up to 15% of their annual income. This is added to their revenue reserves, which they can use to smooth the dividend payments from one year to the next so as to produce a steadily increasing stream of income for their investors.

The AIC has identified 20 investment trusts that have increased their annual dividends for at least 20 consecutive years. There is no comparative data for the open-ended funds, but it is highly unlikely that any of them will have been able to match this given their relative lack of flexibility and the dramatic market fluctuations over the period.

"THE AIC HAS IDENTIFIED 20 INVESTMENT TRUSTS THAT HAVE INCREASED THEIR ANNUAL DIVIDENDS FOR AT LEAST 20 CONSECUTIVE YEARS."

Another issue that might be relevant is the gearing. Unit trusts and OEICs can borrow a maximum of 10% of the fund's value (on a temporary basis) where their mandate allows and then use the money to invest. In a rising market this can help to boost the returns as long as the gains exceed the cost of debt, otherwise it would work against the fund holders.

Investment trusts are not subject to the same 10% limit, although each will have its own maximum level depending on its mandate. There are times when this could potentially make a big difference, although not at present as the average level of gearing excluding Venture Capital Trusts is just 4% according to the AIC.

Costs and performance

Whenever you buy an investment trust you will have to pay commission to your broker and half per cent stamp duty in the same way that you would for any other UK listed shares. It is unusual to have any upfront costs when investing in an open-ended fund, although a few still levy an initial charge on your investment.

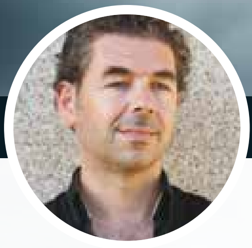
Before the introduction of the Retail Distribution Review, open-ended funds typically had higher management fees than investment trusts. This put investors at a disadvantage and would have eaten into their returns, but it is now a much more level playing field.

Recent analysis by Canaccord Genuity looked at 51 directly comparable investment trusts and open-ended funds. They found that only 45% of the investment trusts had lower ongoing charges, which suggests that the relative cost differential is much less of an issue than it was in the past.

Charges can have a big impact on the returns, so it is worth noting that the Canaccord analysis revealed that 84% of the investment trusts outperformed their open-ended counterparts on a NAV basis over five years.

The position is less clear cut when you look at it on a sector by sector basis. Research by Canaccord Genuity based on the period to the end of June shows that on a one year timeframe the open-ended funds did better in ten out of the fifteen sectors. Over ten years the investment trusts outperformed in nine of the sectors, possibly as a result of their historic cost advantage.

The main structural advantages of an investment trust are the closed-ended nature of the fund and the ability to retain 15% of the income so as to smooth the annual dividends. Beyond this you need to look at it on a fund by fund basis with the key factors being the mandate and the skill of the manager.



BY FILIPE R. COSTA

THE MACRO INVESTOR

STERLING IS DUE A REBOUND

"To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties."

- Paul Samuelson (Sep. 19, 1966), "Science and Stocks", Newsweek, p.92

Armageddon averted

Economists and analysts have always been a gloomy bunch. Every time the economy improves, they are slow to show support; and every time things go wrong, they make them appear even worse by predicting severe crises and financial crashes. Investors, as a group, are even worse, as they move together in hysterical 'herds' which amplify economists' and analysts' predictions. But I am not in a position to blame either, mainly for two reasons.

First of all, the human mind suffers from quite a few cognitive biases, which include the availability heuristic and the availability cascade. In short, we continually overestimate the likelihood of something happening when it is closer to hand and we quickly turn such an ill-formed belief into collective wisdom, which often ends in extreme market movements and, sometimes, crashes. Second, you know the saying "people who live in glass houses should not throw stones"? Well, I'm a part-time economist, part-time investor so... you get the picture...

The infinite behavioural biases that affect our thought patterns together with our resistance to change explain the extreme predictions relating to the Brexit result. Such a massive change would surely impact the way people live in the UK, lead to profound economic changes in the country, and challenge 60 years of progressive European integration.

Many of us were raised within an integrated EU and don't know any other model. For some, leaving the EU is the biggest disruption that could possibly happen. At the same time, we must understand that there's much at stake and for many people. Take London, for example, which is much better off inside the EU because of its financial services industry. Upon leaving the EU, the balance of power could shift. Such expected gyrations and power rebalances explain why some people and institutions have been so bold in the level of doom and gloom predicted.

"SOME BELIEVE THAT STERLING'S DOWNFALL WILL CONTINUE AND THAT WE MAY EVEN BE HEADING TOWARDS A BALANCE OF PAYMENTS CRISIS."

Personally, I believe in the central tenets upon which the European integration has been based; but at the same time, I realise that the current model is completely rotten, to the point that it seems like a hopeless effort to keep the crew onboard a sinking ship that no-one is really willing to fix. Europe has been performing very poorly and inflicting even more damage on itself through self-imposed austerity, at a time when there's no growth and unemployment is high. At the same time, the Union is also failing to deliver solutions to key issues such as immigration.

While London and some other big cities across Europe are big winners from the European project, much of the rest of the UK and many other places in the EU are net losers who pay for the financial excesses of a few, don't benefit from policy measures and yet are expected to contribute to the whole thing. Brexit may therefore be an ugly outcome but an understandable one.

Still the best performer in the G7

Three months after the Brexit vote, it is time for Theresa May to think about triggering Article 50 and negotiate the exact terms of the UK exit in the best way possible for the country. The financial services industry will be closely monitoring her performance, in particular regarding passport rights retention, but so will car makers in Germany. In 2015, the UK exported £223 billion to the EU, but imported £291 billion. While the country depends on the EU market for its exports, the EU market also depends on the UK. And when I say that, I'm not just thinking about trade. EU countries are heavily invested in the UK in the form of direct investment and portfolio investment.

A hard Brexit is certainly an ugly outcome for the UK, but it is also not beneficial for many EU countries, with Germany topping that list. European policymakers love to spread fear across the Union in order to 'encourage' its members to remain. They need to make Brexit appear harder than it really is. But, despite some good theatrical performances, in the end, they will negotiate what is in their own best interests, and that certainly isn't a hard Brexit.

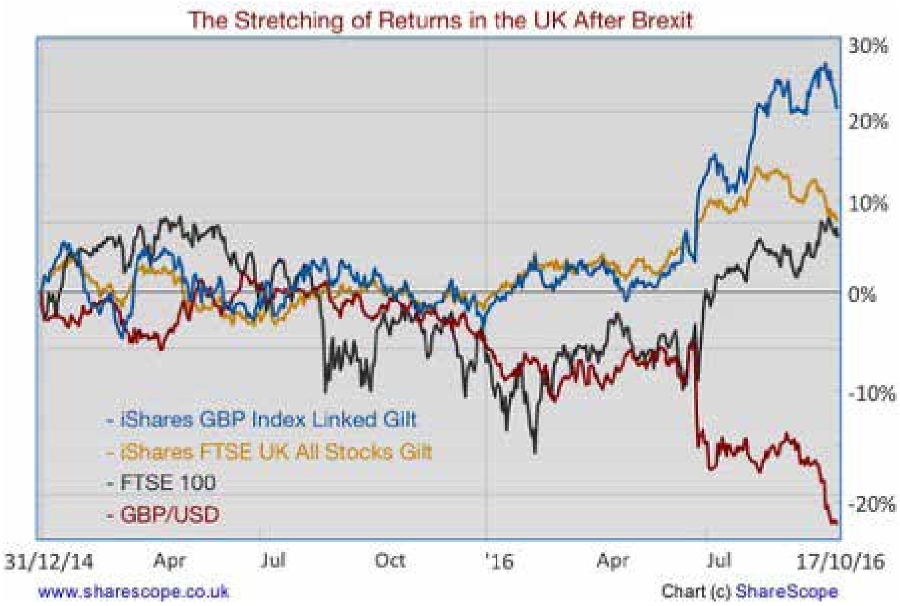
Three months after the referendum, Britain is still growing. Sterling has crashed 16% against the dollar and 14% against the euro, but the FTSE 100 is up 10%, the unemployment rate is holding steady at 4.9% (an 11-year low), and the IMF even had to revise GDP growth numbers for the country to 1.8% (the best expected G7 performance for the year). Such figures aren't exactly consistent with the havoc scenario predicted by many onlookers.

There were big shifts in the market, and divergences in the returns for different asset classes, many of which seemed dormant before the Brexit vote. The FTSE was pushed higher by the big multinationals operating mostly outside the country, which now convert their foreign-currency profits into more sterling than before. Meanwhile, gilts rose on monetary policy easing expectations, while index-linked gilts also advanced due to increasing inflation expectations.

The decline in sterling and the balance of payments

There is one asset that deserves special attention: sterling. The currency has been punished during the last three months, turning it into casualty number one from Brexit. Because gilt yields have been rising at the same time, some believe that sterling's downfall will continue and that we may even be heading towards a balance of payments crisis.

To some extent the decline in sterling has been inevitable and also desirable. Sterling was overvalued against the dollar and the euro, principally because of extensive quantitative easing that has been deployed in the US and the Eurozone. With a current account deficit that amounts to 5.9% of GDP, it would be natural for sterling to lose some value and for the trade deficit to shrink. But the attractiveness of the UK as an investment destination has prevented that from happening, because the financial account has always helped to re-equilibrate the balance of payments. Foreigners have much more investments in the UK – in the form of direct investment and portfolio investment – than the UK has abroad, which allows the country to run such a big trade deficit.



But, with the UK planning to exit the EU, the appetite for UK assets among foreign investors may lessen and thus provide less of a margin to run trade deficits. In the short term, the adjustment should be processed through the exchange rate, which explains the decline in sterling. A depreciated sterling is expected to push exports higher and reduce the appetite for imports, thus narrowing the existing trade gap. At the same time, the downside correction in sterling decreases the price of domestic assets in foreign terms, which attracts more investment. But after an initial adjustment, sterling may very well start recovering again and I wouldn't be surprised if it completely reverses losses against the euro.

Let's take a more detailed look at the balance of payments. The most recent data show a huge current account deficit that comes mainly from a trade gap and a primary income gap. While a trade gap may be a problem, its significance is often overstated and misunderstood. Since the 1980s, the UK has been through a process of de-industrialisation and a *financialisation* of the economy has taken hold. As a result, it imports much more goods than it exports.

However, its trade position in services has benefited from *passporting* rights and other features of the EU open market. Although primary income is negative at first glance, it just reflects the fact the British economy is in much better shape than others. The primary income account reflects employee compensation and investment income received by UK residents abroad less the employee compensation and investment income earned by non-residents in the UK. Ireland, for example, usually shows a huge surplus on this account. That is because the country attracts many outside corporations, which help the economy grow but that ultimately repatriate their profits. In the UK case, British companies have been investing abroad for a long time. Many oil and mining companies across the globe belong to UK residents. At the same time the UK has also been an important recipient of foreign investment and currently many EU residents invest in the UK.

The primary income account has been positive for many years but has slipped into negative territory since the financial crisis. On one hand, there was a huge deterioration in the profits earned by UK-based mining and energy companies overseas. Adding to this sluggish performance in the commodities market is the awful performance in the EU, where British res-

Balance of Payments UK

Data in £ million, not seasonally adjusted

	2Q2014	3Q2014	4Q2014	1Q2015	2Q2015	3Q2015	4Q2015	1Q2016	2Q2016
Current account									
Trade in goods and services									
Trade in goods	-27847	-32520	-33169	-34266	-26407	-32133	-33631	-32758	-32901
Trade in services	23459	19827	25999	24027	21159	17551	25026	23344	22178
Total trade	-4388	-12693	-7170	-10239	-5248	-14582	-8605	-9414	-10723
Primary income									
Compensation of employees	-71	-143	-153	-92	-57	116	-56	-32	-88
Investment income	-5167	-8532	-7031	-7295	-8534	-6233	-13602	-9105	-9789
Other primary income	-132	-232	-223	-210	-252	-353	-311	-313	-192
Total primary income	-5370	-8907	-7407	-7597	-8843	-6470	-13969	-9450	-10069
Secondary income									
Total secondary income	-5335	-4431	-8242	-6804	-5236	-4589	-7985	-6728	-5189
Current balance	**-15093**	**-26031**	**-22819**	**-24640**	**-19327**	**-25641**	**-30559**	**-25592**	**-25981**
Capital balance	**364**	**-333**	**-318**	**69**	**-281**	**-275**	**-564**	**513**	**-248**
Financial account									
Direct investment	-3069	38296	-38068	-74901	24991	-19916	-5394	-70762	-1976
Portfolio investment	-39467	-53825	-32342	-42143	-116566	-34920	-71738	-35168	-105078
Financial derivatives (net)	-22186	9826	-2	-20419	-18064	14243	-7543	35258	-16963
Other investment	52621	-11900	35523	88217	101802	21193	40608	37885	106699
Reserve assets	825	-665	4244	12638	1101	5260	2080	2328	2791
Net financial transactions	**-11276**	**-18268**	**-30645**	**-36608**	**-6736**	**-14140**	**-41987**	**-30459**	**-14527**
Net errors and omissions	3453	8096	-7508	-12037	12872	11776	-10864	-5380	11702

Source: UK ONS

idents also own interests but which have been ever less profitable. On the flip side, foreign investments in the UK continued to generate healthy profits and dividends for their owners.

A large primary income deficit reflects, at least in part, a disappointing global economy when compared to the British economy and not exactly a poor trade performance. While the current account deficit has been huge, overseas investors seem unconcerned, as they have been investing huge amounts in the British economy in the form of direct investment and portfolio investment.

The question that arises here is: ***Will they continue to do so?*** With the UK outside the EU, will the country still be attractive? Or will sterling continue to slide in order to reflect a reduced appetite for UK investments?

First of all, we need to look at the EU, which is the closest substitute for the UK. The European bloc is going through its worst time since World War II. The average GDP growth rate for the last six years (a period of economic recovery) has been 1.2% for the whole EU and 1.0% for the Eurozone, while the UK has been growing at 2.0%. The UK, Norway, Iceland and Switzerland have all performed much better than the EU. The Union has not been able to deal with economic downturns and the whole project seems to be falling apart.

If outside countries seem to be performing better than EU members, it is not reasonable to expect foreign investment in the UK to decline all that much if the UK leaves. After a 15% depreciation in sterling, the country is more attractive in pure financial terms than before, particularly at a time when the European Union appears to be falling apart. Investing in the UK also acts as a hedge against the downfall of the EU and the euro. The continuing deterioration of the Eurozone economy, along with the persistent austerity and the extension of asset purchase programmes by the ECB, will force money out of the EU and in the direction of the UK.

On a medium-term view, I expect the pound to recover every bit against the euro, because there is a rising concern about the potential dismantling of the whole European project, which will favour investments in countries like the UK, at the expense of the EU. Sterling may experience some volatility as negotiations for Brexit unfold, but I believe that most of the major forces pressing the pound lower have been depleted.

> **"STERLING MAY EXPERIENCE SOME VOLATILITY AS NEGOTIATIONS FOR BREXIT UNFOLD, BUT I BELIEVE THAT MOST OF THE MAJOR FORCES PRESSING THE POUND LOWER HAVE BEEN DEPLETED."**

Rising inflation

The latest data on prices show an inflation rate of 1.0%, up from 0.6% in the previous month and at its highest level in almost two years. Economists are predicting an inflation rate of between 3% and 4% in 2018, as a consequence of Brexit. The decline in sterling is pressing prices higher because imports now cost more in sterling terms. If wages don't grow accordingly, the UK may experience a decline in living standards. But Brexit is not the only culprit behind the rise in inflation. Higher inflation isn't a three-month phenomenon but rather a 12-month trend. Inflation had been revived well before Brexit, which is simply accelerating its re-emergence. Let's not forget that the BoE increased its asset purchases and cut interest rates – at a time when the exact opposite should have been done – which contributed to the quick depreciation observed.

For investors, a combination of declining sterling, rising inflation and expected increases in fiscal spending can only mean the 10-year gilt offered at a 1.12% yield is a massive short op-

portunity. The only reason for such a low yield is that Mark Carney is doing his best to foster expectations that he can do more, through further cutting interest rates and increasing asset purchases. But, with inflation rising faster than predicted and the economy in much better shape than in the EU, such expectations are ill-formed. Currently, gilts offer a lot less than is necessary to compensate investors for expected inflation, which means they carry a negative premium which is only shared by other 'safe havens'. But if the UK *is* a safe haven it may well expect large inflows of money from the EU and a quick reversion in sterling movements. UK government debt is currently amongst the most overvalued in the world.

I believe we are at the lowest point in terms of interest rates, which means that government yields will start rising. One way of playing this would be through a long position in db x-trackers II UK Gilts Short daily ETF, but unfortunately Deutsche Bank no longer offers this ETF. An alternative is to short the **iShares FTSE UK All Stocks Gilt (IGLT)** or open a short position in gilts through spread betting. With the government expected to announce fresh fiscal stimulus on 23 November and having already abandoned its target of achieving a balanced budget by 2020, the pressure on yields will be high. Another way of playing this trend is through index-linked bonds (linkers), which have their coupons and principal adjusted to reflect realised inflation. But investors must be careful with linkers as, to some extent, they may be slightly overvalued, as they experienced massive price increases after the Brexit vote. Many of them are trading with negative real returns. However, for those who believe that inflation will move higher than the market currently expects, purchasing long-maturity linkers is the way to go.

The Market For Index-Linked Treasuries

Asset	EPIC	Price % Change Since 23 June	YTD (%)
0 1/8% Index-Linked Treasury 2068	T68	40.74	63.67
0 1/8% Index-Linked Treasury 2065	TR65	38.71	
0 3/8% Index-Linked Treasury 2062	T62	33.48	51.56
0 1/8% Index-Linked Treasury 2058	T58	33.37	50.18
0 1/4% Index-Linked Treasury 2052	TG52	28.01	40.32
0 1/8% Index-Linked Treasury 2046	TR46	23.96	36.07
0 3/4% Index-Linked Treasury 2047	T47	23.41	32.73
0 1/8% Index-Linked Treasury 2044	T44	22.52	31.97
0 5/8% Index-Linked Treasury 2042	T42A	20.88	28.98
iShares GBP Index Linked Gilt	**INXG**	**19.72**	**27.44**
0 5/8% Index-Linked Treasury 2040	TR40	19.05	26.86
0 1/8% Index-Linked Treasury 2036	TG36	17.34	
0 3/4% Index-Linked Treasury 2034	TRTQ	14.75	20.46
0 1/8% Index-Linked Treasury 2029	T29	12.65	16.92
0 1/8% Index-Linked Treasury 2026	TR26	10.04	14.02
0 1/8% Index-Linked Treasury 2024	TR24	8.17	11.85
0 1/8% Index-Linked Treasury 2019	TG19	3.01	4.38

Source: Sharescope

What to expect from financial markets

First of all, the current increase in gilt yields isn't compatible with a continuing decline in sterling –that is a disconnect more typically found when there is a balance of payments crisis, which is not the case in the UK. The rise in yields is not related to any lack of confidence in the country but rather the realisation of higher inflation. This will attract foreign investors and will push sterling higher again. If there is a vulnerable area of the market it is not sterling but rather gilts.

In terms of equities, I believe that the big multinationals that have benefited the most with the currency plunge will now underperform. However, companies related to infrastructure will benefit from additional government spending. It may worth playing the contrarian at this point and picking up a few of those stocks that have been hit the worst since June.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

SMALL CAP SUPER-STARS – CAN THESE 10-BAGGERS CONTINUE TO DELIVER?

"Tenbaggers", a term coined by investment legend Peter Lynch, are often thought of as the Holy Grail of equity investment. Referring to a stock with the potential to increase in value by a factor of ten, these elusive investments, just like winning the lottery or finding buried treasure, can change your life forever.

But if you are lucky enough to have already found one of these rare shares, and your capital has increased in value from £1,000 to £10,000 or beyond, what to do next? Bank your gains and head for the beach or ride your winners and hope for even more riches?

Here follows three companies which over the years have delivered returns beyond many investors' dreams. But now they are becoming more mature, can they continue to deliver?

DOMINO'S PIZZA

One of the success stories of AIM, and indeed the London markets as a whole, is fast food franchiser **Domino's Pizza Group (LON:DOM)**. Having been granted the Domino's Pizza Master Franchise Agreement for the UK and Republic of Ireland (ROI) in 1993, the company set out to repeat the success previously delivered by the original US business.

Listing on AIM in December 1999 with 190 stores Domino's has since grown its UK portfolio to 920, with 47 stores in the ROI. It also owns the Master Franchise for Switzerland, Liechtenstein and Luxembourg, has a minority interest in Domino's Iceland, Norway and Sweden, and, via a joint-venture, has a stake in a German pizza delivery business.

Domino's makes its money in a number of ways

While having a handful of corporately owned stores, where revenues are made directly from selling pizzas, sides and desserts, the vast majority of Domino's income comes from the franchise based model. An initial fee is charged to franchisees when they set up their business and then an ongoing royalty is charged based on store sales. Equipment is also sold to franchisees, as are ingredients, which come mainly from a central commissary in Milton Keynes. A modest amount of income also comes from rent charged on property and from finance leases.

And a lot of money has been made over the years. During its time as a public company Domino's has grown revenues from £20.7 million (in 1998) to £317 million in 2015, representing a compound annual growth rate (CAGR)

of 17.4%. Pre-tax profits grew from £1.47 million to £73.2 million over the same period – a CAGR of 25.8%. Reflecting the operational success, the company's market cap has risen from £25 million at IPO to the current £1.7 billion, with the shares having graduated to the FTSE 250 following a move to the Main Market of the LSE in 2008. Adjusted for a recent 3 for 1 share split, IPO investors who held on to Domino's shares have enjoyed capital gains of over 4,000%.

More dough to be made?

Despite having developed into a mature mid-cap company Domino's still has a variety of growth opportunities. In its core UK market, while store numbers are rapidly approaching four figures, the company still sees "substantial" growth capacity, with a medium-term target of 1,200 pizza parlours being one of management's aspirations. Supporting this, the company is working closely with franchisees in order to improve profitability, increase orders and further drive growth from the digital channels of mobile and online. In the international operations a good opportunity is seen in Ireland as the wider economy recovers and further stores (which are corporately owned) are expected to be opened in Switzerland. A first store in Sweden is expected to be opened before the end of the year.

The strategy seems to be working well, with a recent trading update reporting total system sales (those from all franchise and corporate stores) up by 11.5% to £237 million in the 13 weeks to 27th September (the 3rd quarter). That took overall system sales in the year to date to £731.5 million, which is all the more impressive given some strong growth figures posted in the comparative period.

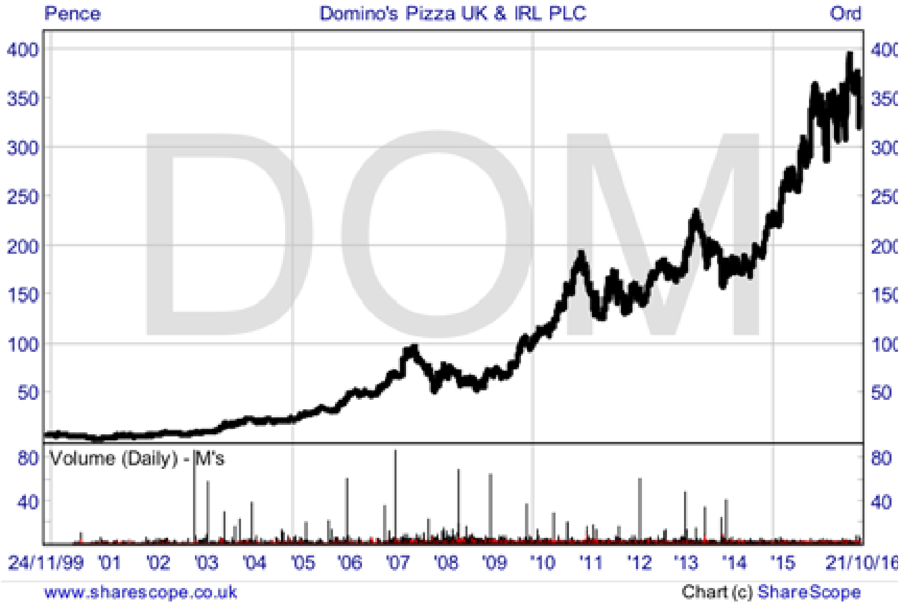
The numbers were driven by a strong performance in the core UK market, where overall sales grew by 10.5% as 21 new stores were opened. For the full year 80 new UK stores are expected to be opened, 10 more than previously expected. Continued investment in digital saw system sales from this channel up by an impressive 18.1%. The ROI delivered sales up by 7.6% and the smaller Swiss operations grew by 16.7%. Elsewhere, in the smaller international operations, system sales grew by 17.5% in Iceland and by 124.8% in Norway, with the German joint-venture said to be performing in line with expectations.

Grab a slice?

Despite its upbeat tone, shares in Domino's fell by a couple of percentage points after the recent trading statement. They have bounced back slightly since but, currently changing hands for 343.4p, are off from their all time high of 396.9p seen at the end of July. At the current price Domino's trades on an earnings multiple of just over 25 times consensus market forecasts for the current financial year.

That valuation may look a bit tasty but looks entirely justified in my opinion given the firm's excellent track record. The balance sheet is sound, with net debt of only £10.9 million as at 26th June and interest payments covered over 200 times by operating profits. Operational cashflow is very good, with £31.9 million coming in net from operations in the first half of 2016. The shares

“IPO INVESTORS WHO HELD ON TO DOMINO’S SHARES HAVE ENJOYED CAPITAL GAINS OF OVER 4,000%.”



also offer modest income attractions, currently yielding 2.2% on expectations for a 7.44p payment in 2016.

Just like its best-selling hot dog stuffed crust pizzas, shares in Domino's are worth taking away.

GB GROUP

If you have ever had to prove your identity online then chances are at some point you'll have come across this next company.

AIM listed **GB Group (LON:GBG)** is a provider of verification services. It uses its range of proprietary software and databases to help a variety of organisations make sure that the people they are dealing with are who they say they are. The company also helps clients to discover other information about their customers which might be important in their dealings with them.

GB Group currently operates via two divisions.

Identity Proofing provides electronic ID verification services for reasons such as combating fraud, money laundering and under-age gambling, employee authentication, screening and risk management. **Identity Solutions** provides software and services that provide accurate and up-to-date customer information which helps organisations to better understand, target and retain their customers.

Driven by the rise in the digital economy since the turn of the century, along with an increasing focus on risk management and crime such as money laundering, GB Group has been an exceptional performer. Boosted by a clutch of acquisitions along the way the company grew revenues from £11.2 million in 2003 (the first relevant set of figures in its current form) to £73.4 million in 2016 – that's a CAGR of 15.6%. Pre-tax profits grew by a CAGR of 20.7% over the same period to £9.3 million and investors who bought the shares at 7.5p on the first day of dealings have enjoyed capital gains of 3,190%.

GBGroup
USING IDENTITY INTELLIGENTLY

Unfortunately, two recent events have caused concern for investors.

Back in April it was announced that GB's CEO, Richard Law, is to retire after 13 years in the job. But a replacement has now been found, with former Experian senior manager Chris Clark expected to take up the role in April next year.

However, having a much more pronounced effect on the share price was a trading statement released in mid-October. The update revealed that for the six months to September revenues grew by 16% to £37.5 million, with organic growth of 9%. But the markets were more focussed on a comment that the roll out of a project with the UK government, GOV.UK Verify, had been slower than originally expected. Despite this, operating profits for the period were still predicted to be in line with expectations, up by 11% at £5 million. The statement added, *"The Board remains confident in the outlook for the full year."*

Nevertheless, GB Group shares plunged by 18.7% on the day of the announcement and by a further 5.1% the following day. This was the largest two-day share price fall in the company's history and in my opinion a huge over-reaction to what was in effect an "in-line" statement.

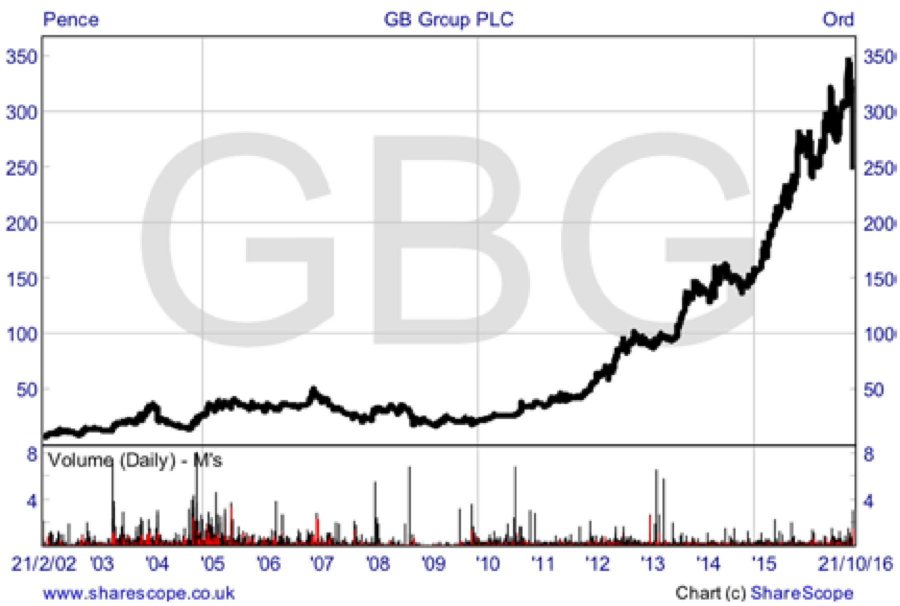
I have several possible explanations for the fall.

Firstly, investors could have been spooked by a profits warning on the same day from industry peer **NCC Group (LON:NCC)**. Secondly, GB has previously announced several "ahead of expectations" trading updates, so the market may have been disappointed that trading for the first half was only "in-line". Thirdly, given the historic share price performance some investors may have been happy to take profits, with the fall below the psychologically important 300p level also triggering price damaging stop losses.

GB = Good Buy?

Following the recent trading statement GB Group shares have slipped to a nine month low of 246.75p, capitalising the company at £331 million. Nevertheless, the shares are still highly rated, trading on a multiple of just over

"GB ESTIMATES THAT THE GLOBAL MARKET FOR ITS SERVICES AMOUNTS TO AROUND £7 BILLION, IMPLYING THAT ITS CURRENT MARKET SHARE IS LITTLE OVER 1%."



25 times market consensus earnings forecasts for the year to March 2017, falling to 22.4 times for 2018. House broker FinnCap reiterated its 350p target after the trading update, which implies upside of 42%. There is also a small prospective dividend yield of 0.9% for 2017.

As I see it shares in GB Group may now experience a period of consolidation in the short term. The markets have removed the company's super-premium rating following the trading update and may want to see what the new CEO has in store for the business before piling back into the shares.

But in the long term there should be further substantial growth opportunities.

GB estimates that the global market for its services amounts to around £7 billion, implying that its current market share is little over 1%. This provides plenty of room for expansion. Also, the recent £37 million acquisition of verification software business IDscan Biometrics is expected to be earnings enhancing in the next financial year. And with net cash of £8.7 million as at 31st March, and the business being highly cash generative, there are resources available to make further earnings-enhancing deals.

For long-term investors GB Group shares are worth checking out.

ACCESSO TECHNOLOGY

According to my research this next company is *the* best performing London listed stock of the past ten years, the shares rising by a huge 8,928%. That means an investment of £1,000 ten years ago will be worth £90,280 now, even outperforming the likes of US listed glamour shares Amazon and Netflix!

Accesso Technology (LON:ACSO) started life on the markets in 2002 as a quirky little business called Lo-Q. As its name suggested, the company had an offering which helped to minimise or even eliminate the time that people spent in physical queues. The Q-bot was a small device which visitors to destinations such as theme parks could pay a few extra pounds/dollars for and it would electronically allocate them a place in a queue for an attraction such as a rollercoaster. This was a win-win situation for all. Customers saved valuable time which would otherwise have been spent standing around doing nothing. And venue operators would enjoy higher income as customers had more time to spend their money on food/drink/whack a mole games etc.

Backed by major client Six Flags, the US theme park giant, Lo-Q trundled on for a few years but really started to accelerate in the second half of the last decade as other clients started to realise the value of its offerings. A step-change in the business then came in December 2012 when US ticketing and e-commerce business accesso (one of those annoying companies with a lower case initial) was bought for £13.7 million. After changing its name to accesso Technology in 2013 the business was further added to by the £8 million acquisition of ticketing and point-of-sale software business Siriusware in the same year and the $33 million acquisition of online ticketing business VisionOne in 2014.

Following the integration of all the acquisitions the group now operates via four business lines, all branded under the accesso umbrella: **LoQueue**, the original queue busting technology, ticketing suites **Passport** and **ShoWare**, and point-of-sale software **Siriusware**. The company can now count over 1,000 attractions and venues across the world as its clients, which range from theme and water parks, live entertainment venues and sporting events. Major leisure industry clients include the likes of Six Flags, Merlin Entertainments, Palace Entertainment and Herschend Family Entertainment.

A rollercoaster ride

From making revenues of sub £1 million and being loss making to the tune of £1.6 million in 2002 accesso grew the top line to $93.2 million in 2015, with a pre-tax profit of $7.2 million. (The accounts were changed from sterling to dollars in 2014 to reflect an increasing US focus.)

The latest set of figures from the company showed another strong performance, with revenues up by 24% at $39.7 million in the six months to June. Noting that trading is heavily weighted to the second half of the year (as the summer months attract more visitors), pre-tax profits were $2.3 million, up from a loss of $1.1 million in the first half of 2015. Accesso ended the period with net debt of $12.5 million, up from $9.4 million six months earlier, again reflecting the second half weighting. Nevertheless, the company remained cash generative with a net inflow from operations of $2.17 million.

Join the ride?

As I write, shares in accesso have gained almost 95% in the year to date. Currently trading at 1,625p the markets have now pushed the valuation up to a multiple of around 42 times forecast earnings for the current financial year. Even for a company as successful as accesso that looks to be somewhat stretched and asking a lot of potential new investors.

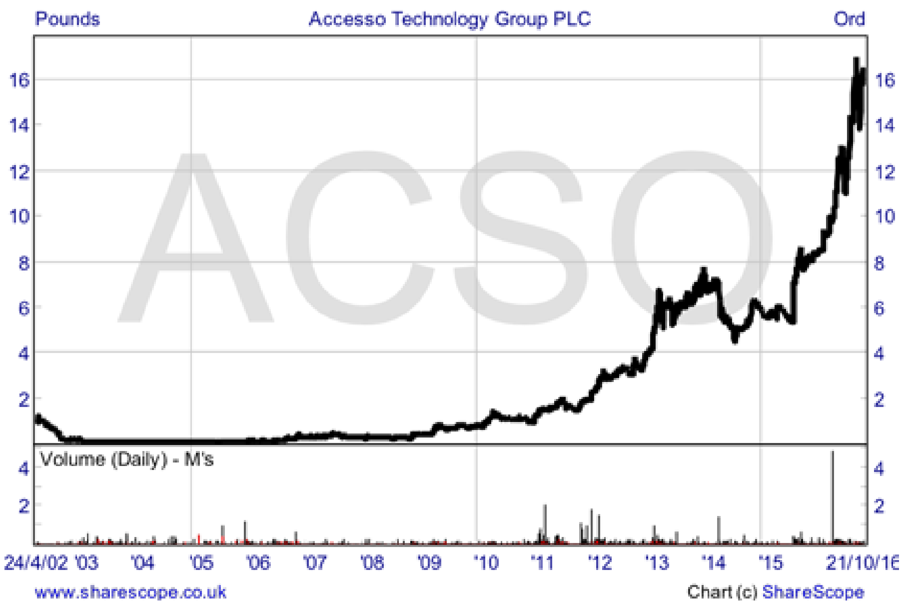
But for those still interested in the shares I note that there should be plenty of growth opportunities in both the short and long term.

In the first half of this year the company saw 57 new business wins and 72 new sites going live, which will boost the numbers in 2017. The next financial year will also benefit significantly from a deal won in 2015 with entertainment giant Merlin. In a major coup for accesso an agreement was struck to provide Merlin, for seven years initially, with its Passport ticketing product across the operator's global portfolio. And providing excellent revenue visibility, major customer Six Flags recently extended its contract for accesso Passport and LoQueue through to 2025.

Income seekers will be disappointed however as the company has stated that a payment is unlikely in the short to medium term, with cash being invested in investment opportunities and potential acquisitions. On that note, accesso has said that it continues to evaluate opportunities for further M&A activity. Given the firm's excellent track record of making acquisitions, in my view this provides perhaps the best opportunity for further long-term growth.

On balance, accesso is a pricey stock, but investors are certainly paying for quality.

"THERE SHOULD BE PLENTY OF GROWTH OPPORTUNITIES IN BOTH THE SHORT AND LONG TERM."



BY FILIPE R. COSTA

HOW TO INVEST LIKE...

MICHAEL STEINHARDT

"The objective of participating in the long-term growth of American equities, willing to suffer through those periods when equities decline, is fine, but it leaves so much on the table in terms of potential professional management..."

— Michael Steinhardt

Buy and (don't) forget

Michael Steinhardt, the man who was once branded *Captain Ahab* because of his fanatical devotion to his firm's portfolio, is different from the previous investors reviewed in this column. Although a long-term investor, he is also a short-term strategic trader; while long on some assets, he is also short on as many others; and although he mainly invests in equities, he doesn't mind taking positions in commodities, futures, bonds and options as well.

Financial markets are a complex animal that often behaves in mysterious ways. There's no strategy that outperforms all the others at all times, and there's no easy formula that is able to render sustained profitability over a long period of time. Instead, investors must adapt to market conditions, make the inevitable mistakes and learn to trade effectively from past experience. While Mr Market misbehaves in the short term, there's no assurance that he will behave any better over the longer term either. Even over long periods of time, average performance largely depends on the start date. Traditional wisdom claims the equity market has returned 7% on average, but had you invested at the peak of the market in 1929 you would still be down 25 years later. Had you invested at the beginning of this century you would have collected less than 3% per year on average, which is a figure that hardly compensates for the risk.

With this in mind, Michael Steinhardt developed his own strategy – one that is neither *buy-and-hold* like Benjamin Graham (issue 13), nor *buy-and-forget* like Warren Buffett (issue 14). He believes in changing markets and periods of decline. But even Peter Lynch's *buy-and-rotate* (issue 15) is too *net long* for him. Steinhardt's strategy is best described as a *long-short* strategy, more typically found amongst hedge funds for whom market timing is everything.

From compulsive gambling to educated risks

Steinhardt acquired an interest in financial markets early in life when he was a teenager and his father gave him 200 shares on his "Bar Mitzvah". Being a curious teenager and a quick learner, Steinhardt often preferred to just hang around the local brokerage office watching the ticker tape, rather than play with other kids his age. He finished high school at 16 and went to the Wharton School of the University of Pennsylvania, where he graduated


NEW YORK STOCK EXCHANGE

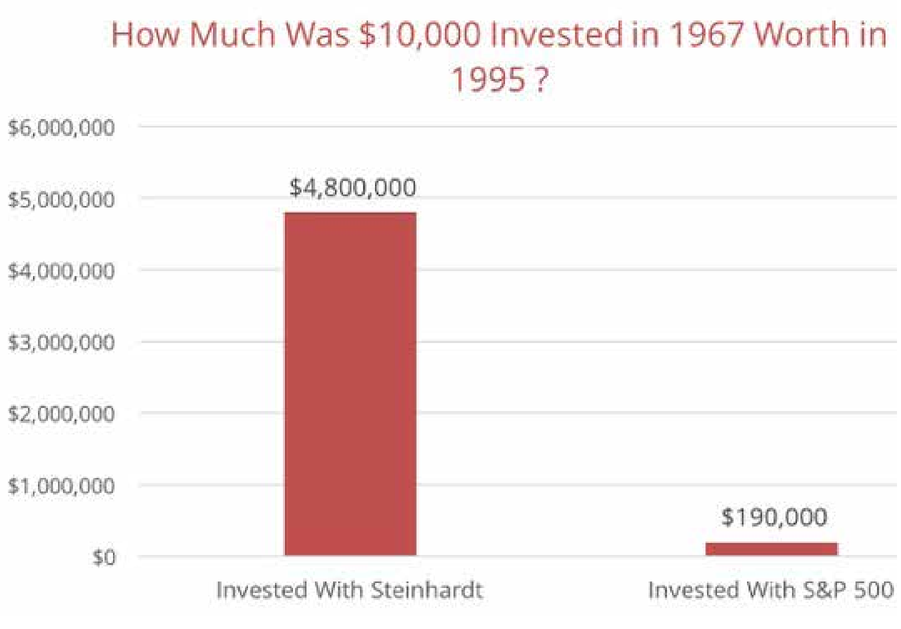
"SOMEONE WHO INVESTED $10,000 WITH STEINHARDT AT THE INCEPTION DATE IN 1967 WOULD HAVE SEEN THEIR INVESTMENT GROW TO $4.8 MILLION BY THE TIME THE FIRM WAS CLOSED IN 1995. THE SAME $10,000 INVESTED IN THE S&P 500 WOULD HAVE GROWN TO A MUCH MORE MODEST $190,000."

in 1960 at the early age of 19. He went on to work on Wall Street as a research analyst and financial journalist. His father, a compulsive high-stakes gambler, gave him regular instalments of money for him to invest, bankrolling his earlier steps into the investment world.

In 1967, along with two partners, he decided to open his own investment firm, *Steinhardt, Fine and Berkowitz*. His experience trading the markets was close to zero, but given that the other partners were better analysts than Steinhardt, he took the trader position. In 1979, the other partners left and Steinhardt renamed the firm to Steinhardt Partners, which he managed for another 16 years. In 1995, after a brilliant year, he decided to return money to his clients and close the business. During 28 years of investment, Steinhardt Partners achieved an average annual compound performance of 24.5%, almost triple that of the S&P 500, with few years registering a negative performance.

Someone who invested $10,000 with Steinhardt at the inception date in 1967 would have seen their investment grow to $4.8 million by the time the firm was closed in 1995. The same $10,000 invested in the S&P 500 would have grown to a much more modest $190,000.

Unlike the other investors reviewed on this column, Steinhardt is comparable to a traditional hedge fund manager who looks for opportunities regardless of asset class, timeframe and directional bias (long/short). Taking a leaf out of his father's book, he has always been bold in the amount of money he places on his views. He is quick to switch from net long to net short if his intuition dictates, and he has always been able to bear the pressure from the market and clients whenever his trades move in the wrong direction. To some extent, his methods have more in common with gambling than with investment, especially in terms of risk management; but, at the same time, he puts the emphasis on exhaustive and continuous research before risking anything.



Variant perception

The most important concept behind Steinhardt's trading strategy is that of variant perception. Steinhardt always tries to develop a view that is different from the market consensus, to then play those variant perceptions until he feels they no longer exist. This means shorting equities that are favourites and backed by a great deal of institutional enthusiasm. To some extent, it is similar to being a contrarian. But in Steinhardt's understanding it is much more than that. A contrarian buys and sells against the crowd, just for the sake of opposing the consensus. The concept of variant perception involves becoming sufficiently knowledgeable about an asset to then take a profitable position on it when there is a disagreement with the consensus. It is about being a contrarian when there's real value to be found.

The variant perception technique rendered Steinhardt a stellar performance, but not without some ups and downs. Trading on variant perception means being in constant disagreement with the market. This almost always means entering the market too soon and incurring high risk. Steinhardt recognises that he almost always starts his positions with losses, which at times can be significant. Steinhardt very rarely closes a losing position and never uses anything like a stop-loss order. In his own words:

"If I short a stock and it goes up a lot, it may skew my exposure a bit, but as long as my variant perception is unchanged, I'll stay short. If I'm wrong, I'm wrong."

"'IF I SHORT A STOCK AND IT GOES UP A LOT, IT MAY SKEW MY EXPOSURE A BIT, BUT AS LONG AS MY VARIANT PERCEPTION IS UNCHANGED, I'LL STAY SHORT. IF I'M WRONG, I'M WRONG.'"

One of the best trades Steinhardt ever conducted was in Treasuries during 1981-1982. At the time, interest rates were flying high, but he was convinced that inflation would settle down and thus so would the FED in terms of its target rate. In the spring of 1981 he started building a large position against interest rates, mainly composed of 5-year Treasuries (as prices vary inversely with yields). But Treasuries only bottomed in September of that year, which meant that, in the meantime, rates still went high enough for losses to accumulate to a painful level. By that time, pressure on Steinhardt was high because he had no experience in trading Treasuries, which made it harder for investors to digest his new ventures. But, as always, Steinhardt had the nerve to hold on with indestructible conviction. The yield on 5-year Treasuries went down from 16% in September to 10% at the end of 1982 and Steinhardt's variant perception was proved right.

But, while variant perception has served Steinhardt well most of the time, there have been occasions when things have gone awry. He usually mentions the episode with Polaroid and the Nifty-Fifty during de 1960s and early 1970s. At the time, the Nifty-Fifty seemed unstoppable. There was a theory that, as long as a company continued to sustain above-average growth, it didn't matter how much an investor paid for it. In fact, equities were trading at very high multiples and the market lost ground. Steinhardt shorted Polaroid shares when they were trading at a price-to-earnings ratio near 60x, just to see that number shoot up to 70x. It was a long period of irrational exuberance, which certainly derailed many "rational" portfolios exploring the return to sanity. Nevertheless, even in cases like this one, when there is a prolonged period of overinflated valuations, Steinhardt stands by his shorts. To alleviate the pressure when the market rises, he sometimes joins the buyers for a while, but while still keeping his portfolio positioned net short for the longer term.

A few trading rules

In a speech back in 2004, Steinhardt mentioned a few trading rules that he believes to be critical to achieving a successful investment performance. They can be summarised as follows:

1. **Make all your mistakes early in life.** Steinhardt is very pragmatic and believes that the most important part of learning comes from one's own mistakes. Investors learn from their bad experiences and become aware of what works and what does not.

2. **Always make your living doing something you enjoy.** This allows the commitment to the whole investment process to be strong, which is a requirement in a competitive world. Basically, investment is about *brain* and *heart*.

3. **Be intellectually competitive.** Investment is a continuous process requiring supervision and action even before some particular asset is selected and added to a portfolio. Constant research is always required to gain an advantage over the market in order to "sense a major change coming in a situation, before anyone else". Sensing the market before all others do has always been a top priority for Steinhardt; it is this that led him to go over his firm's portfolio six times a day, and rendered him the sobriquet Captain Ahab.

4. **Make good decisions even with incomplete information.** It is a good idea to gather as much information as possible before entering any single trade, but the available information will never be complete or perfect. Investors need to be trained to work on the facts, figure out what does matter, and take the right trading decisions before all others gain awareness of the situation. They then need to have the courage to put sufficient money behind the trade to achieve a meaningful outcome.

5. **Always trust your intuition.** Over the years, investors develop and refine an ability to take the best decisions on their intuition. But this intuition doesn't come from a gut feeling or a hunch. Rather, it is a complex process deriving from the investor's cumulative learning over the years. It's wisdom, like that of a fruit seller guessing weights without a scale. It's an educated intuition.

6. **Don't make small investments.** Amazon's stock price climbed from $38 to $820 during the last 10 years, a 2,160% rise. Had you invested $10,000 you would have a respectable $216,000 position by now. But had you invested just $100 you would have missed a potentially life-changing opportunity. After spending so much time and effort researching an asset, investors must make sure that the rewards from the money at risk are meaningful.

A few final words

Steinhardt's variant perception is a contrarian approach to the market, but one under which opposing market sentiment is insufficient. Timing is everything. Just because sentiment is very bullish, which is usually the case near market tops, it doesn't mean it can't be even more bullish the next day (the Nifty-Fifty during the 1960s is a good example of this). Trends often last longer than you can stay solvent betting against them. Investors need a strong instinct for the markets, which takes time to develop and effort to improve. Past experience trading the markets is key, as is knowledge acquired through deep research. Steinhardt doesn't believe in pre-set rules. For him, stop-loss orders, buying on weakness, selling on strength, breakouts and breakdowns, as well as charts and technical analysis, are all superfluous to a successful strategy.

"I look at the stock. It has a fantastic chart. The chart has a base like this, and then if it goes up a little bit more, boy it is a real breakout, blah, blah, blah, blah. They all seem the same to me".

Fundamentals and market timing is what matters the most. And, when the right opportunity surges, investors should embrace it without fear, being flexible enough to be net short as easily as they can be net long, and having the boldness to take on large meaningful positions.

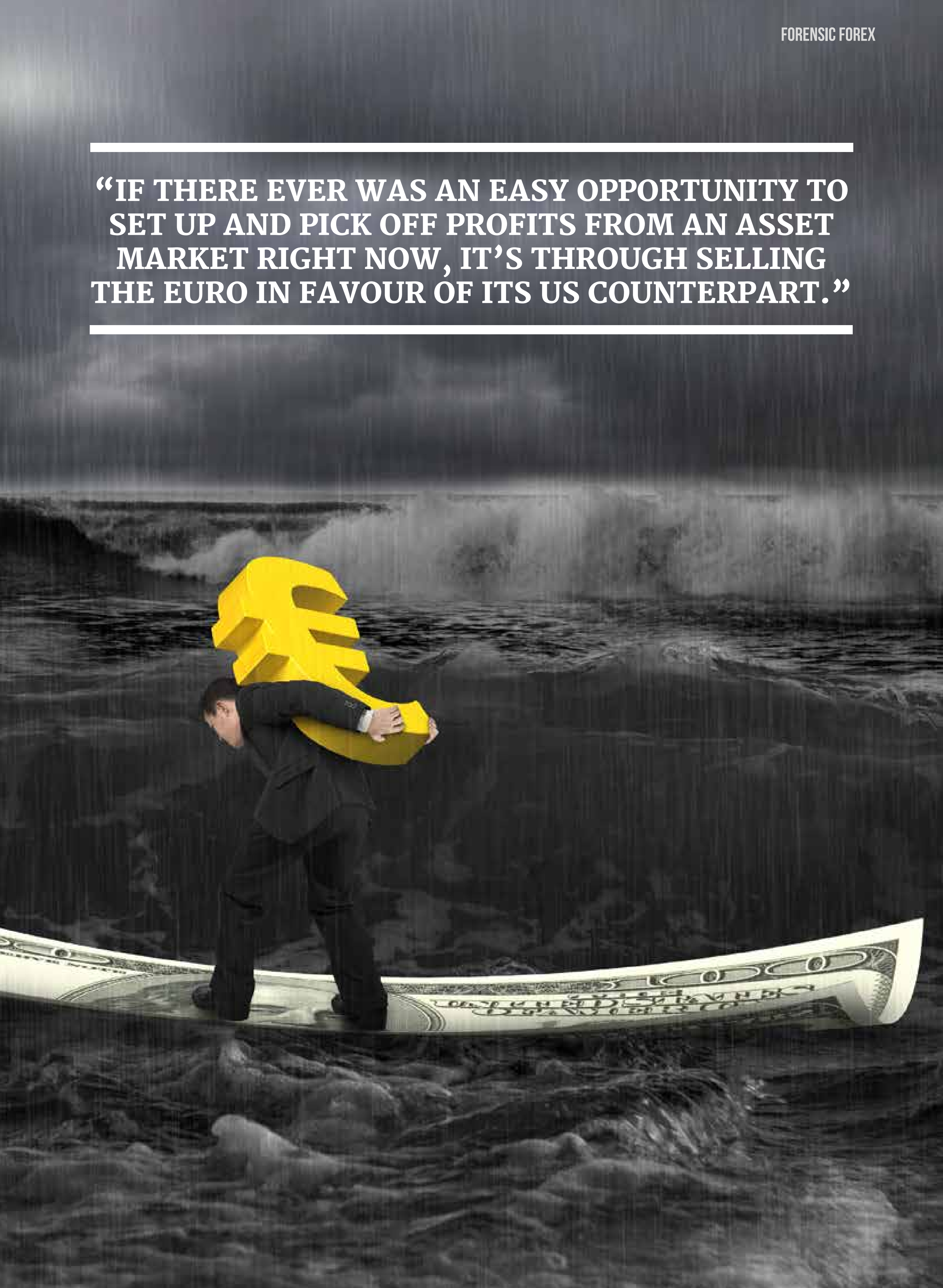
BY SAMUEL RAE

FORENSIC FOREX

HOW I INTEND TO RIDE OUT THE PERFECT STORM IN THE MARKETS

Right now, there is very little anyone is (and can be) certain about in the markets. We've got a perfect storm of global uncertainty about to come to a climax, and holders of pretty much every available asset, financial or otherwise, are wondering if their allocation is the right one.

"IF THERE EVER WAS AN EASY OPPORTUNITY TO SET UP AND PICK OFF PROFITS FROM AN ASSET MARKET RIGHT NOW, IT'S THROUGH SELLING THE EURO IN FAVOUR OF ITS US COUNTERPART."



Perhaps more importantly, this uncertainty isn't rooted in the question of whether the allocation is the right one to maximize gains. Instead, it's rooted in whether or not the exposure can limit losses. This represents a wider fundamental shift in the markets.

In last month's Forensic Forex, we discussed how this sentiment might impact the majors ahead of the US elections. We noted that the US dollar would almost certainly continue to gain strength, and that this would have collateral impact on a number of areas of the US economy. We also noted that Brexit could continue to weigh on the sterling, and as the situation between the UK and Europe played out, we would gain a bit of clarity as to how far sterling might fall in relation to its European counterpart.

It now looks as though the UK currency is set to fall further than anyone seriously expected it to, and this is having (or is set to have) some pretty far reaching implications across the UK and Europe. Imports are getting more expensive for UK businesses, and we've seen this play out with some of the major retailers. Holidaymakers travelling to the continent are getting far less for their money, and in some physical exchange locations, travellers are getting less than one euro for their pound.

Of course, the situation is a two-way street, and the pound sterling isn't going to weaken to nothing, but right now it doesn't look like there's any near-term reprieve. And that's all without even mentioning the US Election, the potential bubble in various consumer sector equities, energy prices and the run for the hills attitude that is pushing up the price of gold.

Last month, I went into quite a lot of detail as to how I expect the US election to play into my bias in the near to medium term, and that hasn't changed much, so I won't go in to too much detail on that. All I'll say is this: I think the dollar is going to rise even without a rate hike, and that this rise is going to continue against each of the majors (sterling, euro, yen, aussie) for at least the next quarter, but most likely two.

Yes, it's looking more and more like Clinton is going to take the election, and this will likely ease sentiment a little from an equities market standpoint (Wall St. will be far more comfortable with a Clinton on Pennsylvania avenue than they will be with a Trump), but not much.

However, there's a real chance of social and civic unrest if Clinton wins, drummed up by Trump supporters feeling they've been underrepresented, cheated or worse. Social unrest is a killer for equities markets, and can be a real black swan if it hits. A post election result flash crash (and we're not talking algo driven here) is a distinct possibility.

Whatever happens, and however things play out, there are only two or three plays on for the next six months, and these are becoming more and more comfortable as risk averse plays every day.

That's the good thing about being a currency trader – it doesn't really matter which way markets are moving. A profit is there for the taking on both sides of price: it's just about picking the right side and waiting it out. In this instance, I'm going to modify my strategy slightly, and trade only in the direction of my fundamental bias – that is, long USD.

“THE DOLLAR IS GOING TO RISE EVEN WITHOUT A RATE HIKE.”

Normally (when things are slightly less certain, from a directional perspective), I'm happy to go at price in either direction, if my price action strategy signals entries, whatever is happening under the charts. With the current situation unfolding as it is, however, there's very little room for error on the short side of the greenback, and plenty of room for aggression on the upside.

So, to bring this all together, my anchor bias heading in to the election and beyond into 2017 is long the US dollar. My trades in the markets will be based on my standard price action breakout strategy, but they will all target a directional bias in line with my long USD thesis. Specifically, I will seek out long positions in the USDJPY, and short positions in the EURUSD, GBPUSD and AUDUSD.

Of these, the EURUSD short is by far the most comfortable. If there ever was an easy opportunity to set up and pick off profits from an asset market right now, it's through selling the EUR in favour of its US counterpart, with a specific target of pullback entry points as shorts unwind and reload.

Happy trading!


EUR/USD
Euro/US Dollar

BY DAVID JONES

CHART NAVIGATOR

THE TREND IS YOUR FRIEND: AN INTRODUCTION TO TECHNICAL ANALYSIS

Too many people seem to have a blind faith approach when investing, and if a share continues to slide they hang on in the hope that one day it will rise. This can tie up money that could be better used for other opportunities and, for me, a major benefit of a trend/charting approach is that it is very clear when my view is wrong. Take the small, manageable loss and move on to pastures new. Whether you are a trader or an investor, the trend really can be your friend – which is why I would argue we should all be paying attention to this most basic part of the chart first of all.

> **"FOR ME, A MAJOR BENEFIT OF A TREND/ CHARTING APPROACH IS THAT IT IS VERY CLEAR WHEN MY VIEW IS WRONG."**

It's more than 20 years since I qualified as a technical analyst. Yes, there is actually a formal examination process that can be taken for squinting at squiggly price lines. In the UK the qualification is run by the Society of Technical Analysts and it is a rigorous test of your knowledge of the many aspects of technical analysis and charting.

When I first started out, charting was still a relative backwater of financial research for many people. Nowadays, with the proliferation of high speed internet connections, sophisticated trading platforms and social media, it can sometimes feel that every man and his dog has an opinion on the trend of the FTSE, gold and the Bolivian Boliviano against the pound.

But let's not be too negative about the proliferation of charting opinions – I think this increased awareness is a good thing. Let's also not forget that charts don't move markets – that's the job of buyers and sellers. But knowing just where you are in a trend

can be useful for all sorts of investment decisions – not least when actually doing nothing at all is the right move.

I think plenty of newer entrants to the dark art of Technical Analysis are misguided as to its potential and ultimately set themselves up for disappointment with just what a chart-based approach can do. There's a tendency for some to feel there must be a "silver bullet" strategy out there – one that calls every twist and turn, every pip and point of a financial market.

This isn't helped by the increased sophistication of software in recent years. Would you like to plot an Adaptive Exponential Moving Average of the price of oil, overlaid on a Zero Lag MACD with a Parabolic Stop and Reverse System mixed in? Within a few clicks your price charts can resemble a surrealist piece of art.

"PLENTY OF NEWER ENTRANTS TO THE DARK ART OF TECHNICAL ANALYSIS ARE MISGUIDED AS TO ITS POTENTIAL AND ULTIMATELY SET THEMSELVES UP FOR DISAPPOINTMENT."

The problem with this approach is that we get further away from what the *price* is actually doing. So for this article we will strip things right back to the bone and focus on that most basic of charting approaches – the trend.

Markets trend. This is an indisputable fact – whether that market is the FTSE 250 index, a commodity such as copper or the price of Marmite over the years. Over all sorts of different timeframes, markets will trend up, down and sideways. At the core of most medium to long term approaches to chart analysis is the idea of identifying and following a trend.

But first let's start from the basics – what actually is a trend? Here is a picture.

That's the last 13 years of FTSE 100 company **British American Tobacco (LON:BATS).** Can you spot a trend? Maybe some moving averages, MACDs and Parabolics might help?

The trend is pretty clear. It has spent much of the past decade and more moving higher. Here's another trend quiz.

You are probably aware of the gyration in the pound/US dollar rate in recent months, but here's a bit of a longer-term view showing the currency pair in decline for the past couple of years.

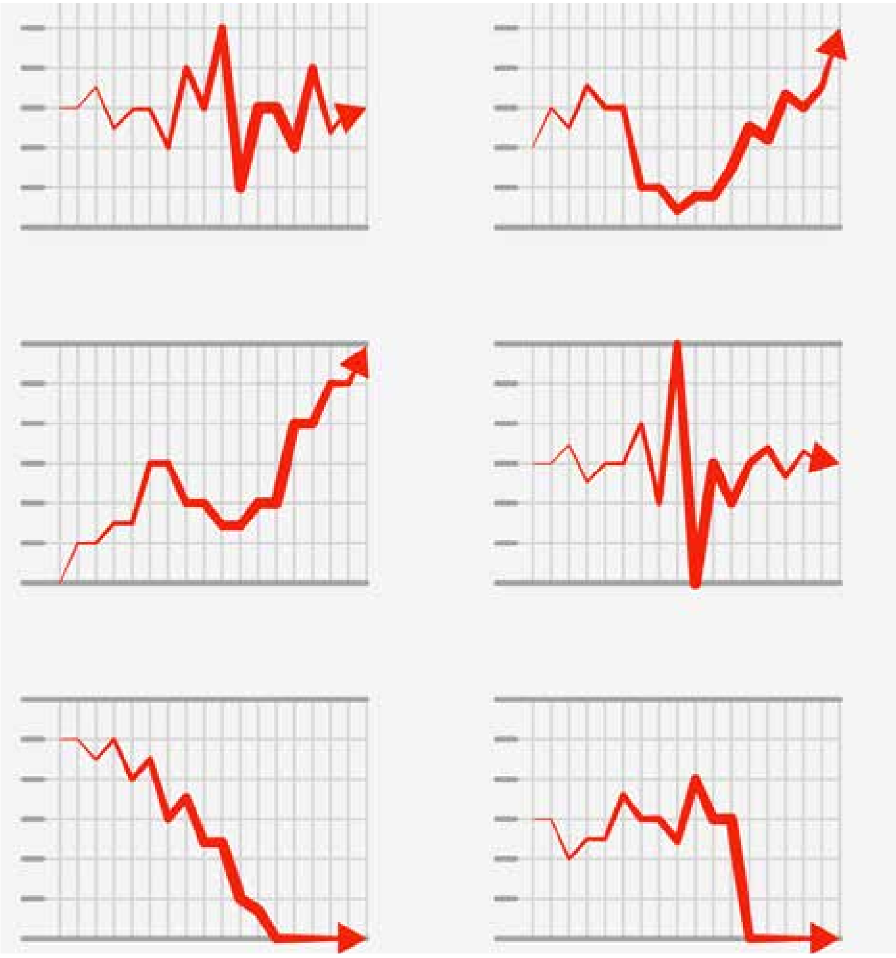
The point here is that major trends should be easy to spot – if you find yourself squinting at a chart looking for a big trend, there probably isn't one there in the first place.

The definition of an uptrend is straightforward enough - a succession of higher highs and higher lows. Not surprisingly, a downtrend is the flip side of this – a succession of lower highs and lower lows. The dedicated chartist is looking to spot a trend, jump on board and ride it until it ends. As the well-worn market cliché goes "the trend is your friend... apart from the bend at the end".

I think the temptation for many of us is to try to predict the bend at the end – and attempt to pick tops and bottoms. This can be rewarding when you get it right but is often a fruitless and financially costly exercise. Far better to try to ride the major trend.

For many of us – in the beginning at least – this is easier said than done. Take the British American Tobacco chart above. By 2010 the share price had more than trebled from its 2003 levels. An investor may have been scratching her chin and thinking "how much higher can it possibly go?" The answer as we now know is: more than double again.

"PLENTY OF INVESTORS CANNOT RESIST THE SIREN CALL OF THE COUNTER-TREND – ATTEMPTING TO CATCH FALLING KNIVES AS A SHARE PRICE CONTINUES TO PLUMMET. BUT WHY NOT MAKE ONE'S INVESTING LIFE A LITTLE EASIER BY GOING WITH SHARES THAT THE MARKET SEEMS TO LIKE ALREADY?"



Plenty of investors cannot resist the siren call of the counter-trend – attempting to catch falling knives as a share price continues to plummet. But why not make one's investing life a little easier by going with shares that the market seems to like already?

There are always plenty of good examples of trending shares – even more so at the moment with the FTSE 100 threatening fresh all-time highs. Here are a couple of examples.

Reckitt Benckiser (LON:RB.) is an interesting one. Like the British American Tobacco example, it is one that has been moving steadily higher for more than a decade. The part of the trend that I have focussed on here has been the last three years.

One thing that chartists will use to help validate the trend is a trend line. You can see this on the chart. From a textbook point of view this is drawn under the lows and the assumption is that any weakness back to here will tempt the buyers back and the longer-term trend will resume. It's only if the price starts to slip below this form of support that our trend follower gets worried that the trend is starting to run out of steam.

Reckitt is a bit of a tricky one at the moment. The trend line is coming in around the 6,000p mark but the price is trading above 7,000p. The more conservative investor may want to hang on and see if the shares dip back, to get in at a better price. That's all well and good of course but the problem is if the trend is still strong then the price may not be inclined to revisit the low £60s and you miss the boat. This is a fact of life in markets and it is up to you to decide whether you are happy to bite the bullet and just buy in, or wait for a better price but risk missing out on the continuation of the trend.

Something that may offer a more favourable entry at the moment is the **BT Group (LON:BT.A)** chart. This one has been in an uptrend for more than seven years but has spent much of this year in decline as the chart below shows.

Clearly markets do not move in one direction all of the time. There will be times in a long-term trend where the price is moving with the trend, against the trend, or within a range. Chartists will view shorter-term weakness in an uptrend as an opportunity to get into the main trend at a better price, and conversely, rallies in a downtrend as better opportunities to get short.

The trends of BT Group are coming to something of a crunch point. There are some early signs that this year's downtrend may be running out of steam and 350p is where the longer-term uptrend for BT would be expected to find support.

Investing and trading is a game of probabilities. For now the assumption would be for that longer-term trend to start to reassert itself. No approach works all the time, but retests of major trends such as the BT Group example do help us identify a level where we should bail out if our view is incorrect.

This article has dealt with the basic building blocks of a chartist approach to investing or trading. Sophisticated indicators such as stochastics, Bollinger bands et al have their place but it does seem to have been the trend (pun intended) in recent years to put far too much emphasis on these mathematical crunchers of price data, rather than what the price is actually doing. They can certainly help refine the buying and selling timing for some of us. But, in a strong trending market, no amount of brightly coloured technical indicators is going to change market sentiment.

About David Jones

David Jones qualified as a technical analyst in 1995 and started his City career as a currency analyst. He then went on to work for trading companies CMC Markets and IG Group as Chief Market Strategist. Since leaving the industry in 2013 he has been a presenter on BBC5Live's Wake up to Money programme and the Chartist for Shares magazine. He is an active trader and private investor.

BY ANTHONY CHOW

OPTIONS STRATEGIES TO ENHANCE PORTFOLIO INCOME

For many investors, the mere mention of options trading strategies and "the Greeks" (Δ, ν, Θ, τ: the measure of sensitivity of the price of derivatives to a change in underlying parameters, as opposed to the people sacrificed economically to keep the EU project from failing) is enough to make one's eyes glaze over. For others such as Warren Buffet and indeed our principal Jim Mellon, derivative instruments have been described as "financial weapons of mass destruction" and heavily implicated in globally disruptive financial events including the collapse of Long Term Capital Management and the Global Financial Crisis from which many economies are still reeling.

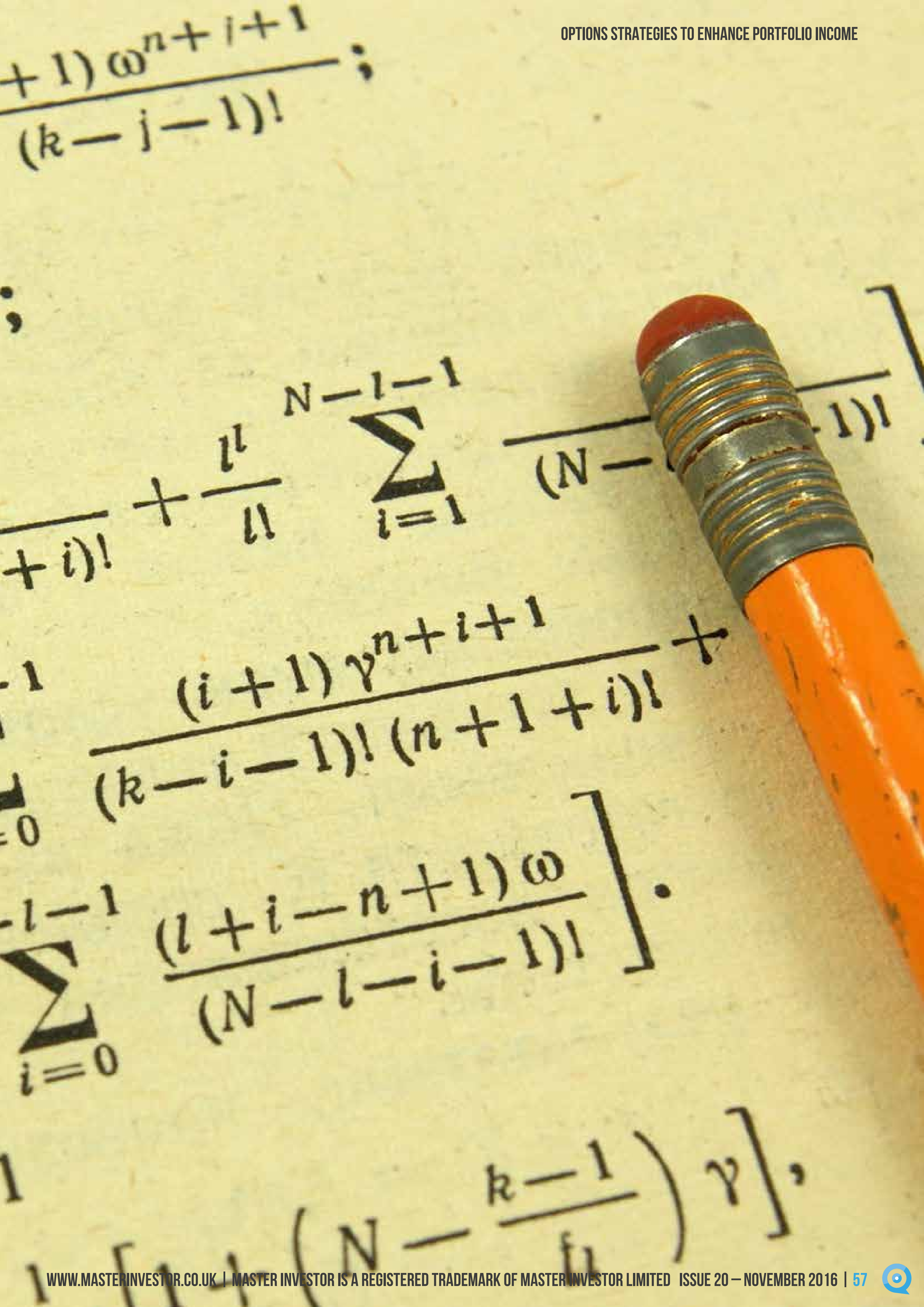
This reputation is not entirely unfounded. When derivatives are used in a particular way they provide access to vast amounts of leverage and the potential for unlimited losses. Deutsche Bank's derivatives book, for instance, peaked at $75 trillion, which is 20 times Germany's gross domestic product, although they haven't suffered unlimited losses, yet...

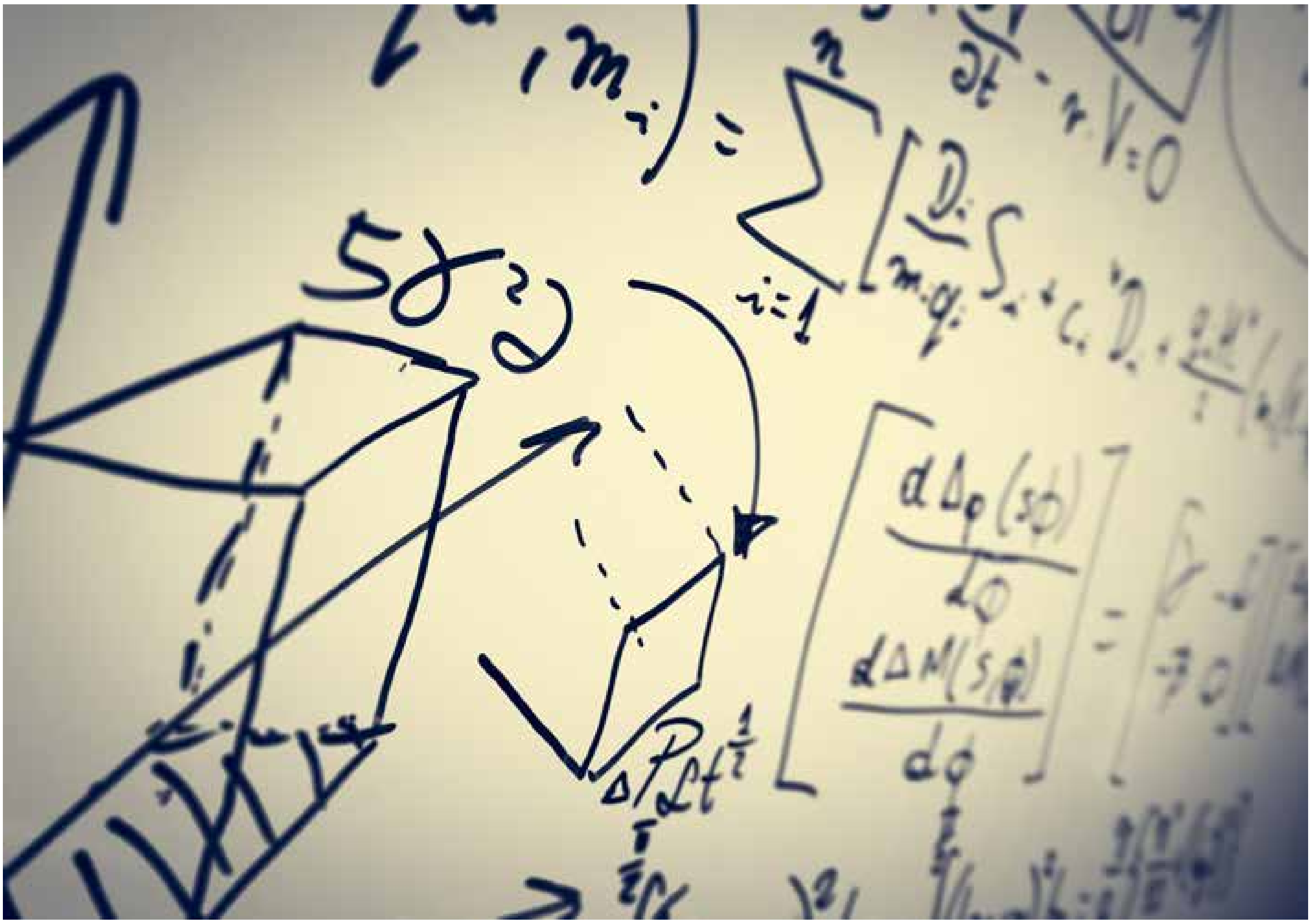
So given their capacity to be so damaging, why would anyone want to use such instruments?

The reason is that there are perfectly sensible ways to use options in order to enhance your portfolio's income. Make no mistake; this is not a way to get rich quickly or the opportunity for risk-free returns. One must be disciplined in the management of exposure and at all times avoid the risk of ruin/a margin call. But in today's zero/negative interest rate environment, even a highly conservative approach here has the potential to generate returns multiples of what you are currently earning in your deposit account.

> **"IN TODAY'S ZERO/NEGATIVE INTEREST RATE ENVIRONMENT, EVEN A HIGHLY CONSERVATIVE APPROACH HERE HAS THE POTENTIAL TO GENERATE RETURNS MULTIPLES OF WHAT YOU ARE CURRENTLY EARNING IN YOUR DEPOSIT ACCOUNT."**

The strategy is simpler than you might think. Write out-of-the-money options and 'bleed' the theta; in other words, write put options on those names you think will go up and call options on those names you think will go down. What this strategy exploits is the relentless force of time and that, all else being equal,



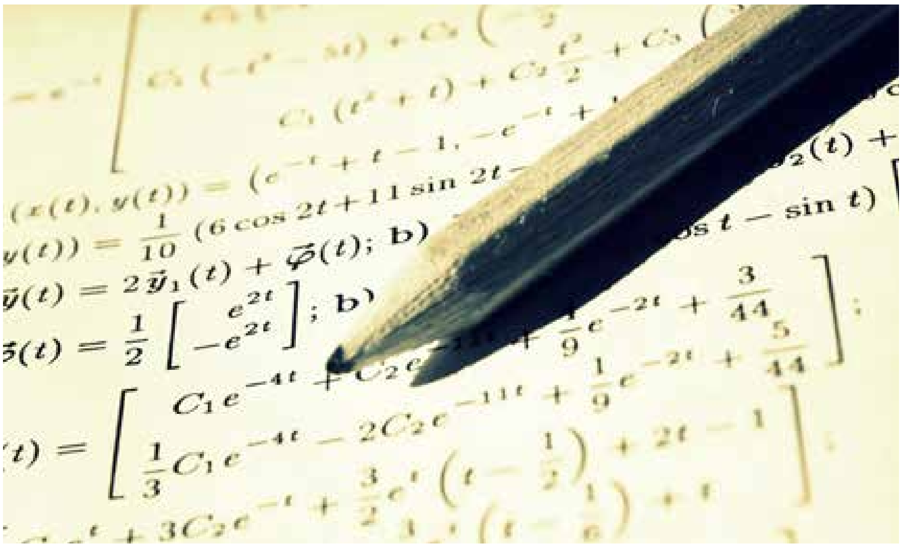


for each day that passes the value of an option decreases.

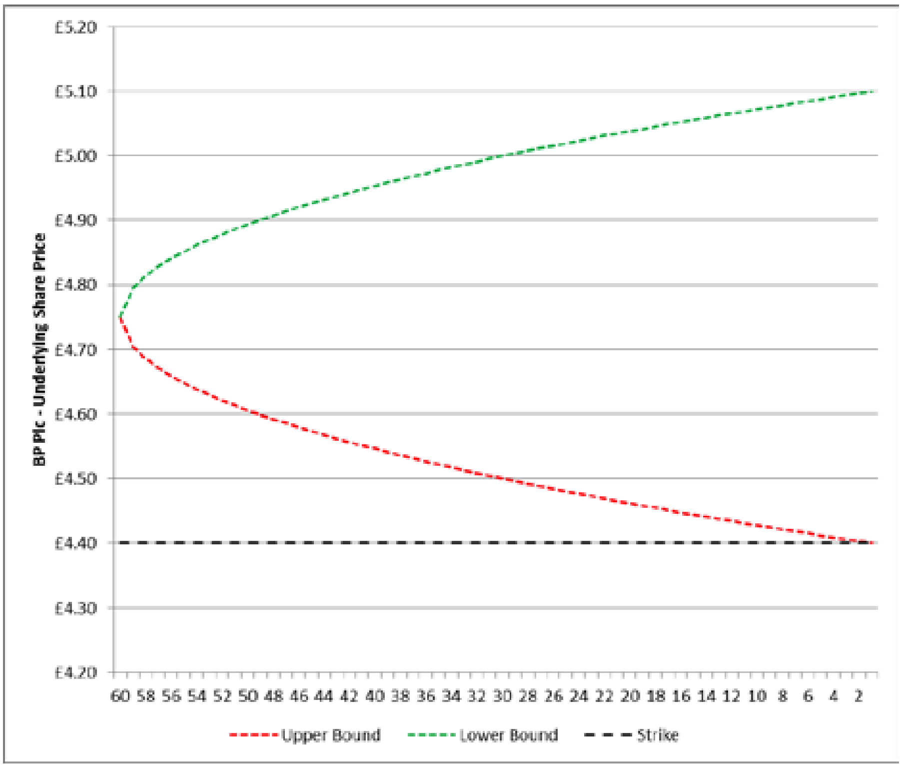
Take for example **BP Plc (LON:BP.)** and assume that you are comfortable it's run by a competent management team, the price of oil isn't going to be decimated in the near term and, touch wood, there isn't another Deepwater Horizon type disaster. If you were to write a put option with the metrics below you could generate a 10.67% gross annualised return with a 7.4% buffer from a decline in the underlying price before your option position would generate a loss at expiry.

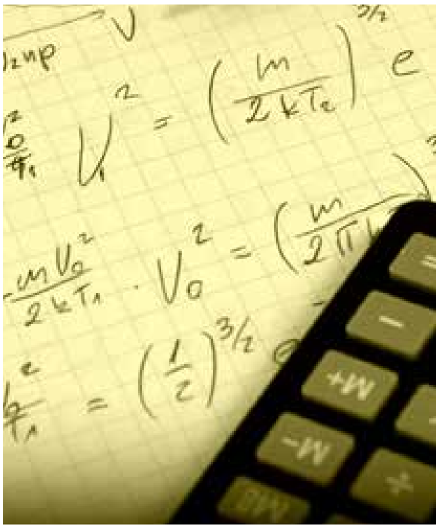
Option metrics:	
Date	1st November 2016
Underlying share price	£4.75
Strike price	£4.4
Implied volatility	24.1%
Expiry	20th January 2017
Premium (bid / ask)	£0.09 / £0.010
Contract size	1,000
Number of contracts	1
Notional exposure at strike price	£4,400.00

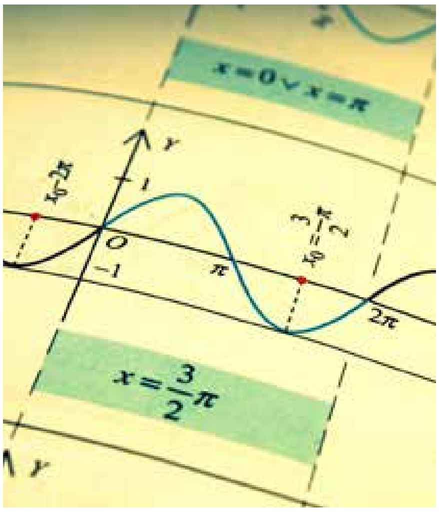
Under this scenario, assuming BP's share price was above £4.40 on 20th January 2017, the option would expire worthless and you would collect £95.00 (assuming filled at mid-price). This is on an exposure of £4,400 which equates to a 2.16% return in 60 trading days, or 10.24% annualised.



Calculating the risk of a position like this with certainty is impossible. However, one should understand what the market price is saying about the risks. Without going deep into the statistics, a normally distributed bell curve is the







best tool for an approximation of risk. With implied volatility at 24.1%, a move in the underlying share price of 0.64 standard deviations would see the option move to being at the money. A one tailed z-test on the bell curve shows statistically there is a 74% chance of the underlying price being above the strike price at expiry. Hopefully with your knowledge you can improve on those odds!

Now, calculating margin requirements for derivatives is an inherently complex matter so make sure you are familiar with your broker's methodology. Saxo Bank, for example, in this specific case requires 10% of the underlying value (number of contracts x contract size x strike price) which is £440.

If you chose to only fund your account with £2,200, this would mean your return on equity would be closer to an annualised rate of 20.48%. However, as you are using leverage and not fully funding the position, you have introduced the risk of a margin call from which you will have a great deal of difficulty recovering. If you chose to only fund your account with £1,100, then your maximum potential return on your equity would be 40% annualised but your risk of ruin has increased further.

While the potential for highly leveraged returns is alluring, it must be stressed that using such high levels of leverage is not an appropriate strategy if all you are trying to do is enhance your income or outperform your deposit rate. Things can and do go wrong in financial markets and margin calls are 'path dependent' which means you could get stopped out and lose your equity from anomalies like a 'flash crash' which seem to be increasing in regularity with the rise of algorithmic traders.

So a couple of points to summarise:

1. This strategy is a stock picking strategy with a larger margin of error than simply being long or short a stock;

2. Don't put all your eggs in one basket to avoid being sunk like a black swan event in a single name;

3. Don't try to shoot the lights out with a highly leveraged account, and avoid margin calls at all costs.

Best of luck!

About Anthony Chow

Anthony commenced his career at ANZ Banking Group Ltd in Sydney, Australia where he worked as an analyst for four years in the corporate banking, leveraged finance and private equity teams.

In 2007, Anthony moved to London to work with Jim Mellon as an analyst where he was responsible for equity research, portfolio construction, risk management and trading a wide range of financial instruments.

Anthony holds a Bachelor of Economics Degree from The University of Sydney and a Post Graduate Diploma in Accounting from Macquarie University. He was awarded the CFA designation in 2010.

BY ROBBIE BURNS

ROBBIE BURNS' TRADING DIARY

THE GOOD, THE BAD, AND THE UGLY

I suspect practically everyone who decides to trade has a gambling streak somewhere inside them. I definitely do. I actually started work in a bookies the moment I turned 18. I loved the thrill of the horses and played the fruit machines in my lunch break.

Those who've read my books know I run a highlighter system for company reports, picking out positive words and negative words. This usually helps me highlight the good, the bad, and the ugly.

I hate words and phrases like "challenging", "below expectations" and the like. The one word I have really come to like to see in a trading update is "exceeding" as in "exceeding expectations". It means the next results are almost certainly going to be decent, unless the company is lying of course (it is possible with AIM stocks) and so you can tend to buy and rest easy for a bit.

My favourite word appeared in two recent trading updates. Indeed one of the updates even exceeded exceeding. Not only was it exceeding, it was "galloping"!

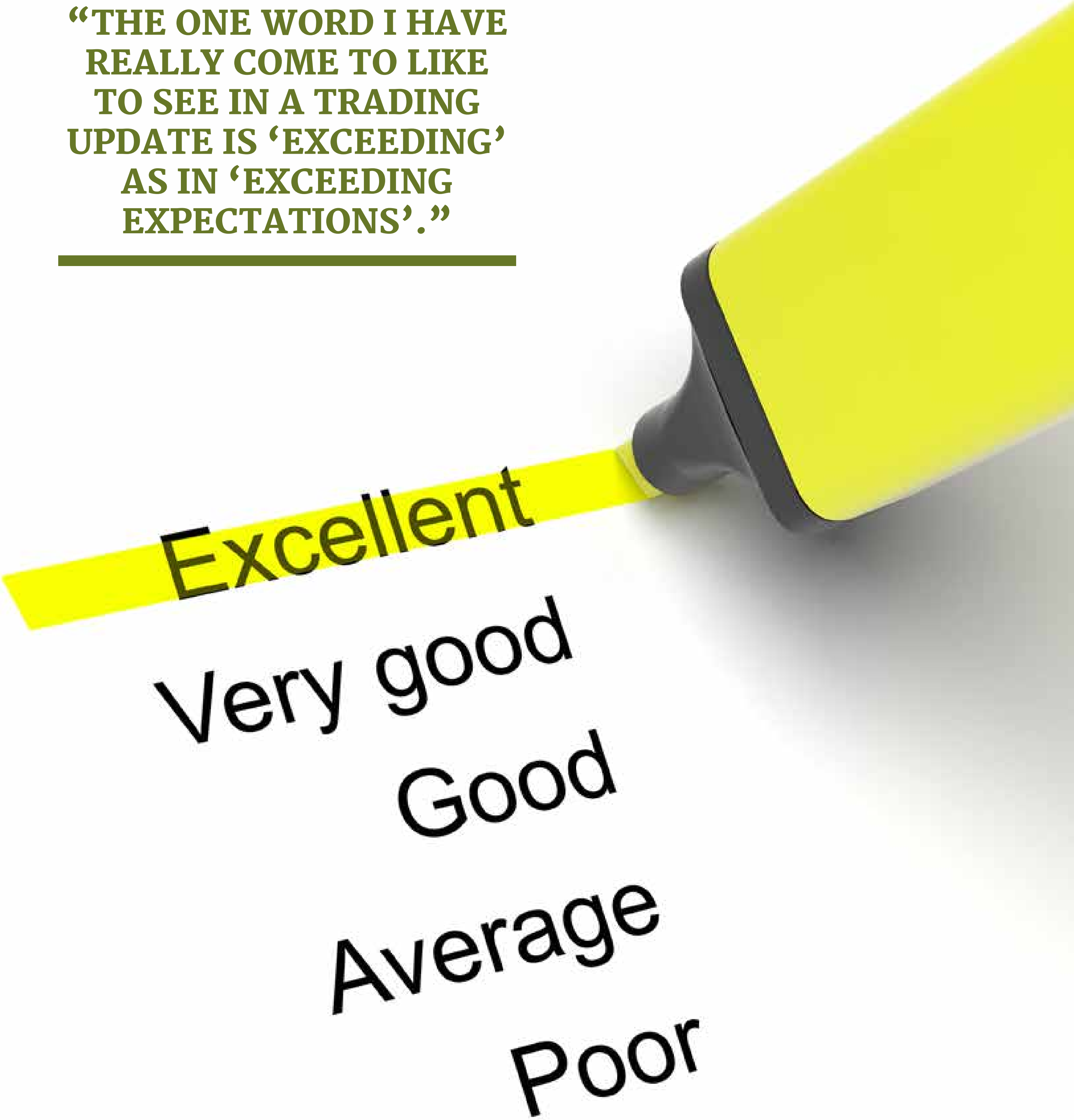
Here's the quote directly from the trading update of tiddler **LPA Group (LON:LPA)**:

"Further to our previous statement which confirmed we entered the year at a gallop LPA is now able to confirm it is still galloping and that current market expectations for the year as a whole are likely to be exceeded."

We also have a "buoyant":

"Order entry and sales output have remained strong and the pipeline of business, on rail vehicle platforms for which the Group has been selected to supply product, continues to grow underpinning future growth potential with delivery from 2017 to 2019 and beyond. The UK market is particularly buoyant and is well supported by export opportunities in Europe, Asia and Australia."

"THE ONE WORD I HAVE REALLY COME TO LIKE TO SEE IN A TRADING UPDATE IS 'EXCEEDING' AS IN 'EXCEEDING EXPECTATIONS'."



And a "successful":

"Following the successful integration of its electro-mechanical activities at Light and Power House in Saffron Walden, the Group is investing to expand its LED based lighting activities in Normanton, West Yorkshire."

LPA is a small company but one that looks like it is going places. Of course you've still got to do your own research on a company and consider whether it has already gone up too much, but I bought some off the glowing positivity of this statement.

Another company also issuing a recent positive word statement is **Fusionex (LON:FXI)**.

We have a "substantial" and the rather nice "significantly":

"The pipeline for GIANT 2016 is substantial. The Group's steady progress has underpinned a strong FY2016 financial performance. The Board anticipates that revenue will be in line with market expectations and, despite the significant planned investment in the marketing and promotion of Fusionex's products, EBITDA is expected to be significantly ahead of market expectations."

You still have to be careful, as both companies are on the lightly regulated AIM segment of the market and both are small, so things can change. But if you are going to invest, always go with the most positive trading updates you can find.

Here are my top 5 positive and top 5 negative words to watch for in statements:

Positive:
1. Exceeding.
2. Excellent.
3. Substantial.
4. Significantly.
5. Transformational.

Negative:
1. Challenging.
2. Difficult.
3. Unpredictable.
4. Lower.
5. Down.

Check Naked Trader 4 for details on how to use my highlighter system on advfn.

Thanks to those Master Investor readers who contacted me after they read my new book *Trade like a Shark*.

I'm very pleased the book has already made some of you more "shark-like" in your approach to trading. Keep up the good work, especially to those of you who have sold some of the more rubbish shares you were holding. Remember to keep your discipline, and if you feel the need for a gamble, use a small "gambling" account.

Before you go, why not get the latest copy of my book *The Naked Trader*, which has just been published! You can get *The Naked Trader 4* only from my website and also from Amazon.

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

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

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BY CAROLINE DREWETT

MILLENNIALS & MONEY

HOW TO BUILD A PROPERTY PORTFOLIO (PART 3)

Corbyn's cronies are back out in force. Listening to PMQs during Theresa May's education shake up, we seem to have turned full circle on New Labour. But one area where their pomposity is particularly hard to stomach is their hostility towards grammar schools. From their contradictory position, they preach to us about their disgust of private schooling, whilst at the same time buying and renting extortionately priced homes in urban catchment areas so that their darlings can attend 'the local comp' rather than being forced to admit they would ever dare send their children to a private school.

For those wealthy enough to get their hands on a one bed, a world of opportunities are opening up, not just for their social circle, but for their children's education and future too. Last month, Lloyds Bank estimated that there is now a whopping average premium of £53,000 to live near a strong performing state school, so choosing where to buy is vital if you want to expect capital growth.

Of course, unless your parents are a part of the wealthy Labour Westminster set, it is likely that you'll have to start on your own and won't be able to settle straight in next door to the London Oratory. The Telegraph recently claimed that without the bank of Mum and Dad, Millennials will be saving for an average of 121 years before they can afford their own home in London. That's right, 121 joyful years. Of course, if you are relying on your own income and savings, you very likely will be saving for eternity.

So what is the best way to get the house of your dreams in a desirable area? The answer, for many, is to buy a house you don't want to live in forever but has potential for capital growth. Only through adding value to a home can we Millennials ever expect to own anything other than a bedsit by the time we are in our 50s.

In order to build a property portfolio, the first home you buy is crucial. Getting your money to work hard for you is vital if you are hoping to expand, as you'll need all the capital you can get if you are making a foray into the buy-to-let market – the ultimate way to get a second or third income. Looking for a starter home and getting on the ladder quickly is very different to looking for a settling-down family residence, or indeed your ideal home. You may enjoy Sunday brunch with your friends of Primrose Hill, and dream of living there one day, but that doesn't mean buying there is a wise option just yet.

Whether your goal is a property portfolio or a dream home, the journey is still the same; buying in an up-and-coming area will be the fastest way

"IN ORDER TO BUILD A PROPERTY PORTFOLIO, THE FIRST HOME YOU BUY IS CRUCIAL."

to becoming a satisfied homeowner. Whilst we all have visions of growing old in beautiful parts of the country, in detached cottages with an Aga and vegetable patch, buying when you're young is all about where will have the biggest capital gains.

My first property was in Brixton, South London, which my mother and her baby boomer friends all told me to avoid like the plague. I received the keys and was so excited to move in, only to be advised to never leave the house without a bullet-proof vest, whilst being struck with horror story after horror story of the days of the Brixton riots.

> **"UNLESS YOU'RE HAPPEN TO BE A DIY GURU, BUYING IN AN AREA THAT IS UP-AND-COMING IS THE BEST WAY TO ADD VALUE TO YOUR HOME."**

What had I done? Had I made a huge mistake of buying in a grimy area? Was it going to be the last thing I ever did? Upon moving in, I ventured to the local pub to celebrate with friends, and on the way home we were horrified to realise there was a lone man walking closely behind us with what we convinced ourselves was a baseball bat in his rucksack. His phone started ringing – it was our chance to run for it. But when he answered, and spoke loudly to Hugo from the tennis club, where they'd just had a smashing game, it struck me that buying in a well-to-do area that traditionally had a bad reputation was possibly the best way to property success.

By the time I had sold the flat, three years and twice the value later, there was a florist at the end of the road, a gastro pub, and a creperie for good measure. All in an area where, the year before I bought the two-bed, the road had been turned into a cul-de-sac to prevent illicit sex workers from being picked up on the main road. Areas change, and in cities, they change quickly. Buying before an area is fully regenerated is the key to capital gains, and sometimes, taking the plunge is the only way.

So, what to look for when buying your first home?

Regeneration of an area

Unless you're happen to be a DIY guru, buying in an area that is up-and-coming is the best way to add value to your home. Of course, it's difficult to anticipate where the next opportunity will be – if it was easy to predict, everyone would be doing it. However, there are key signs to look for.

DrimaFilm / Shutterstock.com

Planned transport links are a good indicator that an area will become increasingly more popular. Whichever city you are in, living somewhere commutable immediately helps your area to improve. Whether it's a new tube station, overground or tram link, as Londoners move away from car-ownership and towards more convenient Ubers, night tubes and Boris bikes, having the tube near your home will add appeal to the area. What follows is usually good nightlife; the more independent bars and restaurants that an area has, the more desirable it will become.

Where Hackney and Shoreditch used to be East End crime hubs, since the arrival of the overground line they're now littered with cafes, bars and converted warehouses which attract thousands of Millennials every weekend. Easy links to the City mean it's no longer the quirky hipsters living there. Instead, City workers own pied-à-terres, and first time buyers have been priced out of the market.

Peckham has become almost as desirable. Its transport links are not yet up to Shoreditch's standards, but it is following suit. You know an area is trendy when an open-air cinema on the roof of an old car park has a month's waiting list for tickets. Look for areas that you wouldn't typically associate with perfection and watch the capital grow so that you can make your next move.

> **"BUYING NEAR WELL PERFORMING SCHOOLS WILL VIRTUALLY GUARANTEE THAT YOUR HOUSE MAINTAINS ITS VALUE, AT THE VERY LEAST."**

Amenities of an area

Although bars and restaurants attract Millennials in their droves, it is education that attracts the 30s-40s with young children. Buying near well performing schools will virtually guarantee that your house maintains its value, at the very least. Of course, this is only true for schools that select on catchment area alone – there is no use buying near a private school or an academically selective school that accepts students based solely on entrance exam results. Usually, successful primary schools go hand in hand with secondary schools. With many schools becoming academies, it is a good chance to buy in an area where the school might be improving, before it starts drawing families in.

The reintroduction of grammar schools will shake things up. Not all grammar schools are open to everyone; some will be based on a combination of catchment area and exam results. When these take effect, parents will be flooding in to ensure their child is eligible to take the exam, and rents and prices will reflect this.

Last year, The Times published a study that claimed that an astronomical 50% of people either sell or stop renting once their child's place is secured at their desired school and move back to a cheaper area. Given that renting a bed-sit in an expensive area – even if it is a second home – is cheaper than school fees for multiple children, the impact of education is not to be underestimated on the value of a town or borough.

Whether an area is almost rejuvenated or only at the very beginning, it is important to ensure that you understand the ways it can improve. Whether through parks, education, restaurants or falling crime rates, each will affect the way that a property gains value and helps Millennials in their quest for a second home.

Living in a home that isn't perfect is far from a life sentence. My first home was lived in for two years before it was re-mortgaged so that a second one could be bought down the road. I never intended to live there forever. A small two bed in Brixton won't serve a growing family, but it generated huge capital gains that I could never have earned through a regular job.

OCTOBER 2016

BEST OF THE BLOG

The UK's Brexit negotiating hand is stronger than you think

In a recent reflection on what central bankers get up to when they meet together for some rest and recreation, I attempted to explain what TARGET2 is. This is the settlements system that, since 1999, has facilitated payments between the various Eurozone countries' internal settlement platforms.

If that sounds boring – it is. So let me tell you something which isn't boring. The unfolding crisis in TARGET2 will have massive implications for the Brexit negotiations. It turns out that the British hand is stronger than we thought because the Germans are desperate to accommodate the UK's aspiration to tariff-free access to the Single Market. Otherwise *they* will be in big trouble.

I have just read an important article by the German academic Gunnar Beck, which should be required reading for anyone in finance and economics who seeks to understand what is

"THE GERMANS ARE DESPERATE TO ACCOMMODATE THE UK'S ASPIRATION TO TARIFF-FREE ACCESS TO THE SINGLE MARKET."

going on right now. Herr Beck is an eminent constitutional lawyer and legal philosopher who hangs out some of the time at the Brussels-based think tank AECR (Alliance of European Conservatives and Reformists). Now even though AECR is partially funded by the European Parliament, what Herr Beck has to say will be very unwelcome to Messrs Juncker, Verhofstadt, Barnier and their ilk.

Despite all the harsh rhetoric in Bratislava that the British can be given no privileged access to the Single Market if they impose immigration controls, behind the scenes, the German political and financial class is worried. They have come to realise, says Herr Beck *how weak Germany's and the EU's negotiating position actually is....*

By Victor Hill

Click here to read the full article

Theresa May's plan is the right one – The UK must seize the day

The IMF has just accepted it was wrong about the post-Brexit Armageddon predictions. After all, since the Brexit-vote the FTSE 100 is up 11%, the services sector has expanded at a faster rate, and the ONS ended up revising its estimates for GDP growth higher in the second quarter, to 0.7% from 0.6% previously. In the end, it was not an Armageddon, not even a small downturn.

On the contrary, the economy seems to be in better shape than before and the IMF was even forced to revise its growth estimates for the UK to 1.8% this year, a figure that places the country at the top of the G7 leading industrial countries. However, the upgrade comes wrapped with a warning, as the IMF predicts postponed difficulties, which will likely materialise into lower growth in 2017.

But, keeping that in mind, apart from the U.S., the IMF is predicting a decline in growth for all other G7 members – i.e. the UK is not alone. Contrary to the first predictions, there may be life outside the EU, in particular away from its austere view and eccentric monetary policy.

The new UK Prime Minister, Theresa May, is determined to advance with the Brexit process, promising to trigger the Union's Article 50 by March 2017. But she is also determined to put an end to the massive over-reliance on monetary policy as an adjustment tool and revert to fiscal spending instead. Infrastructure spending is likely to rise, as Osborne's plan to balance the budget by 2020 has been completely scrapped.....

By Filipe R. Costa

Click here to read the full article

The peer-to-peer investment trusts that pay a 7% yield

Investors looking to tap the peer-to-peer (P2P) lending boom would do well to seek out a suitable investment trust in the sector. Investment trusts are the ideal vehicle to provide exposure to less liquid parts of the market, as investors are able to buy and sell the shares on the stock exchange whenever they want without it affecting the underlying portfolio. The best known examples include property, private equity and infrastructure funds, but it is also relevant for the relatively new area of P2P lending.

P2P has grown rapidly since the 2008 financial crisis as it allows people to bypass the banks with individual investors able to lend to individual borrowers. Cutting out the middleman makes it possible for investors to earn a better return and for the borrowers to pay a lower rate of interest.

"CUTTING OUT THE MIDDLEMAN MAKES IT POSSIBLE FOR INVESTORS TO EARN A BETTER RETURN AND FOR THE BORROWERS TO PAY A LOWER RATE OF INTEREST."

The advantage of investing via one of the funds is that it offers much greater diversification across different borrowers, platforms and geographies. You also benefit from the due diligence of the investment manager in selecting the best loans and don't have to tie your money up as you can sell your shareholding whenever you want.

There are six P2P investment trusts listed on the London Stock Exchange and between them they have a combined market value of just over £1.5bn. Four of them yield over 7% – the other two are just getting started – and they are trading on an average discount to

net asset value (NAV) of almost 5%, which makes them worth a closer look....

By Nick Sudbury

Click here to read the full article

It's a technology bubble but not as we know it

Are tech valuations supported by fundamentals or are we partying like it's 1999? 16 years since the bursting of the dot.com bubble, when the Nasdaq Composite Index fell 37% in the 10 weeks following its peak on March 10, 2000, the continued stellar performance of tech stocks and startups is once again raising eyebrows in some quarters.

Calling asset bubbles is like Paul Samuelson's oft cited joke about markets predicting nine out of the last five recessions. In other words, it's easy to do but harder to identify in real time. Sometimes only hindsight gives us a clear view of past events. Bubbles are also relative. Markets are made by differences of opinion after all.

Caveats aside, there has been extensive recent discourse on internet and technology stocks being or not being (that is the question!) in bubble territory. So, are valuations out of step with reality? Let's start by looking at the **Nasdaq (IXIC)**, the traditional home for tech stocks:

The index is (nominally) certainly way above its 2000 highs and it also looks like a sizeable gap is once again opening up with the **S&P500 (GSPC)**.

Crunching some numbers, the current level of the index pair is 24% above its 18-year average, but crucially, still 32% below peak bubble. We also need to factor in 16 years of inflation – today's 5,000 points would be closer to 3,500 back then – as well economic growth over the period.

By Adam Patterson

Click here to read the full article

BY RICHARD GILL, CFA

READ TO SUCCEED

LIFE AFTER GROWTH

HOW THE GLOBAL ECONOMY REALLY WORKS – AND WHY 200 YEARS OF GROWTH ARE OVER

BY TIM MORGAN

***Life After Growth*'s author Tim Morgan is a popular but controversial figure within the investment industry, and is famous for frequently voicing views against the general market consensus and having built up a reputation for being a bit of a doom-monger. Some of his work has been so pessimistic that he has earned the nicknames "Dr. Gloom" and "Terrifying Tim" from a number of newspapers.**

Cambridge educated Morgan is an energy industry and economics specialist, having worked at investment house UBS Drew Phillips as an oil analyst and then as Head of Research at Tullett Prebon from 2009 to 2013. He has often worked with legendary fund manager Terry Smith, who provides the foreword to this book. Some of Morgan's more popular published work include the Essentials Index, an alternative inflation report which attempts to calculate the real cost of living for households, and Project Armageddon, a critique of the debt laden UK economy. He also runs the popular blog https://surplusenergyeconomics.wordpress.com.

The basic premise of *Life After Growth*, this being the 2nd edition of the book, is that after seeing over 200 years of growth in the global economy we are now experiencing, or at least heading for, a period of stagnation. In other words, growth, and the increasing wealth and prosperity that comes with it, is over. The author argues that while positive growth figures are still being reported by national statistics offices, *real* economic growth has ceased and could even be shrinking.

"GROWTH, AND THE INCREASING WEALTH AND PROSPERITY THAT COMES WITH IT, IS OVER."

Trouble ahead

Going back to the turn of the century, the years before the Great Financial Crisis of 2008/09 did show strong economic growth. But this was mainly driven by debt fuelled consumption and was not real growth at all, merely the spending of borrowed money. If an individual spends £10,000 just because they have borrowed it they aren't better off – in fact they are worse off because they will have to pay back interest on the debt.

On a global basis, between 2000 and 2007 the world's total debt increased by $55 trillion but GDP only increased by $17 billion. If we strip out inter-bank debts then that means each dollar of growth cost $2.20 in new debt. Hardly a good plan for a stable economy, hence the global financial meltdown.

In order to prevent the crisis turning into a total collapse, governments around the world then implemented a range of policy measures including the bailing out of banks, injecting cash into the economy in the form of quantitative easing and reducing interest rates to near zero so that the huge debts became more affordable. But it gets worse. Between 2007 and 2014 global debt grew by a further $49 trillion, with GDP only increasing by $1 for every $2.90 borrowed.

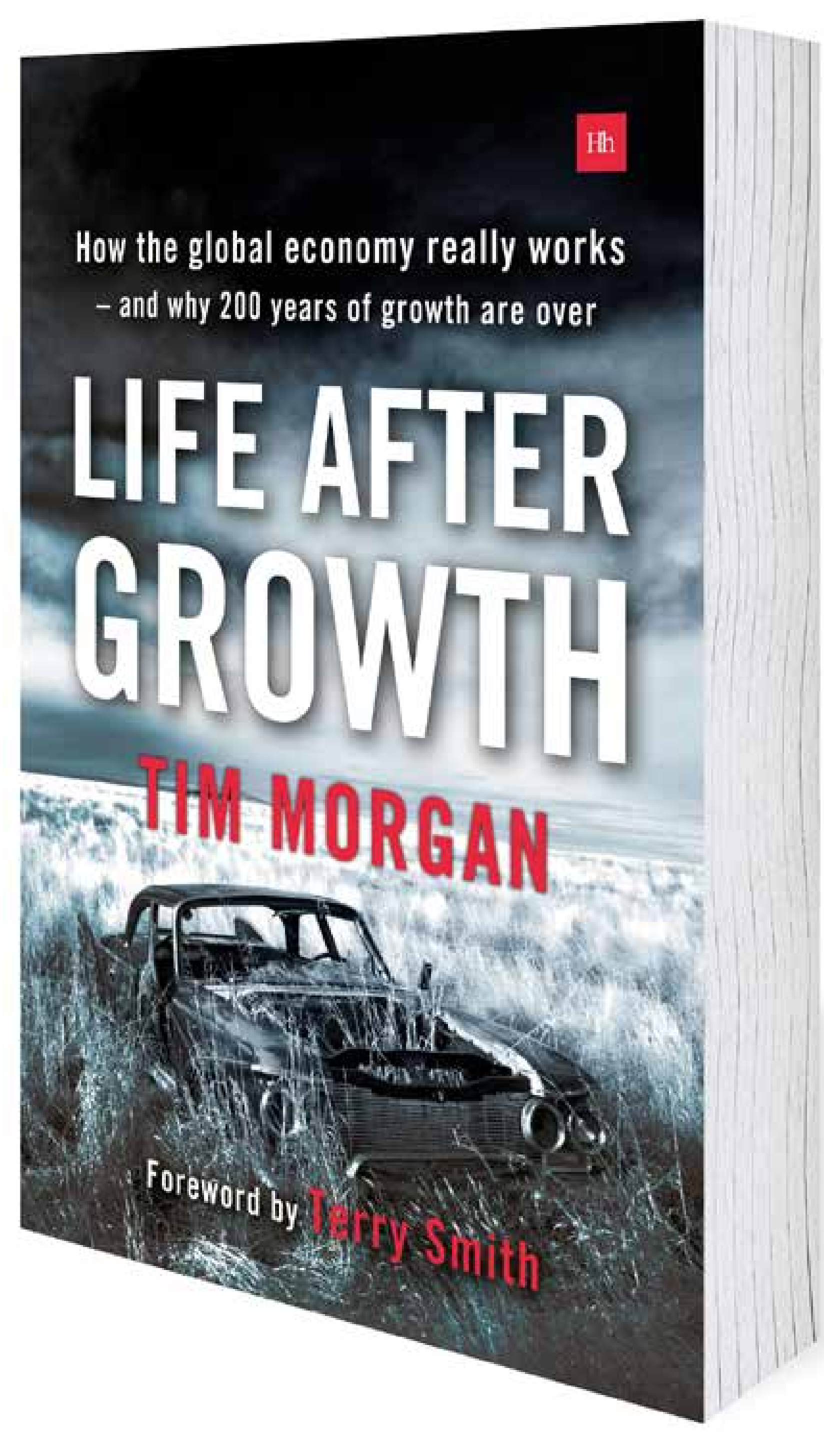
As a result of these government actions we are now in a world with enormous and growing debts, loose monetary policy, artificially inflated markets for assets such as bonds and property, and zero interest rates. But Morgan believes that these features are the *symptoms* of stagnating economic growth, not its *cause*. Instead, he believes that the reason for the lack of real growth is the rising cost of energy, with energy having acted as the primary driver of population and output growth over the past 200 years.

But "cost" of energy doesn't refer to how much your gas and electricity bill is. Instead, Morgan uses the concept of energy **return on energy invested (EROEI)**. All methods of energy production, such as drilling for oil or manufacturing solar panels, use energy themselves. So EROEI is a ratio which measures how much energy is gained for each unit of energy which is used in its production, or in other words, what you get out from what you put in.

So where is the link between the cost of energy and economic growth?

As mentioned above, Morgan is known for being a controversial author and he doesn't do anything to jeopardise that reputation in this book. In it he introduces a new way of looking at the economy, which he splits into two parts. Firstly we have the "real" economy, which includes the goods, services, resources and labour which we are all familiar with. Then we have the financial economy, which involves money and finance.

In an ideal world these two aspects should be closely linked, with the financial economy helping the real economy to prosper. Unfortunately, the two have drifted apart, with the debts issued by the financial economy (which in essence are a claim on future goods and



services) having become far larger than what the real economy can deliver.

Back to energy. **Morgan's core concept is that the "real" part of the economy is and always has been a function of *surplus* energy.** Energy in a financial markets sense is often thought to be things like oil, gas, coal, electricity and so on. But it can include many other forms, such as human labour and the food we eat in order to deliver that labour.

Back in the early days of man there was no surplus energy to enjoy – a hunter gatherer would consume all the food he found in order to provide energy to fuel the search for his next meal. But as agricultural societies developed surpluses began to be created as food production became more efficient. For argument's sake, let's say what previously took a week to achieve before agriculture was developed could now be done in six days, leaving one day of surplus human labour (or energy) to be spent on other things such as building a house, inventing a new machine or learning to play the lute. Hence, surplus energy creates prosperity and *real* growth. The industrial revolution of the 18th century increased this surplus massively as the invention of the heat engine enabled the exploitation of fossil fuels for use in machines which were much more efficient (in an energy sense) than human labour.

But we are now at a stage in the real economy where huge surpluses can no longer be maintained.

The cost of fossil fuels, for example, according to Morgan, has been rising "inexorably" for years. Gone are the days when huge oil fields could be found in the Middle East and cheaply exploited, with most discoveries nowadays tending to be small, and difficult to access and exploit, causing the EROEI to plummet. He estimates that oil fields discovered in the 1930s provided at least 100 units of extracted energy for every one consumed in their discovery, but that the global average EROEI could fall to as low as 10:1 by 2010.

So higher costs equal lower surpluses and thus lower real economic growth. And this could be disastrous for life as we know it. Morgan warns that in a low EROEI economy, with more energy being reinvested in energy extraction, there will be less for not only discretionary activities such as entertainment but also for essential services such as healthcare and food production. He further warns that if EROEI falls materially then our consumerist way of life is over and societies could even be taken back to the pre-industrial age!

"WE ARE NOW AT A STAGE IN THE REAL ECONOMY WHERE HUGE SURPLUSES CAN NO LONGER BE MAINTAINED."

Is there life after growth?

The first three parts of this book reveal a potentially dismal future for humanity. But Part IV suggests that all is not lost and it could be possible for the real economy to be stabilised, albeit at much lower levels of surplus energy than we have been used to in the past.

Morgan advocates the development of energy sources which provide the best available returns, such as solar power, onshore wind and waste heat extraction, and warns against what he sees as less viable alternatives such as biofuels and shale gas. But even if these are successful, he thinks that the biggest challenge of all will be the acceptance, forced or not, of an inevitable shift away from a lifestyle based on ever increasing consumption. Enjoy it while you can!

BY BILL BLAIN

THE FINAL WORD

ARE BREXIT FEARS HIDING SOMETHING MORE FUNDAMENTAL?

By the time you are reading this it's a fairly safe bet that we'll have a good idea who the next US president will be. We'll also be increasingly confident of a modest US Fed hike in December. Based on the whispers I heard during the summer becoming public over recent weeks, my money is on the Bank of England looking for a new Governor as Mark Carney takes the hint and goes back home – no matter what Theresa May is saying publically about his invitation to stay.

"I AM ABSOLUTELY SURE WE DON'T HAVE A CLUE WHAT BREXIT REALLY MEANS FOR THE FUTURE OF THE UK, AND BY ASSOCIATION GLOBAL TRADE."

Although I spend my working day deluged in economic data, and am fortunate to have some very skilled quants and chartists telling me what all the numbers and lines on charts might or might not mean, I tend to take a more pragmatic view on markets. It's instinctive – I've learnt a little from the 30-plus years I've sold, traded and originated bonds, to figure out the likely trends on market action.

I like to think I'm a pragmatist – aware of how markets over-react, under-anticipate, and that it's no-see-ums rather than the blindingly obvious things that cause most trouble. And based on my instinctive approach, I am absolutely sure we don't have a clue what Brexit really means for the future of the UK, and by association global trade.

There are no certainties with Brexit

It's the Brexit outcomes and the way markets are responding to the uncertainty that fascinates me most at present. Lots of people think they know – but they don't, and that's what makes Brexit so deliciously dangerous and potentially tradable.

On one hand we have a bunch of blithely optimistic smilers who reckon departing the European Union will trigger massive growth from a suddenly economically resurgent Britain. They point to rising growth and new factories, and ignore the inflation ogre. On the other side are scowling *bien pensants*, contentedly miserable about their predictions of economic collapse, mass unemployment and the UK's entry to the third world as dialed-on certainties.

The truth, as they say, probably lies between. But I do worry the fixation on Brexit means we're missing a much more fundamental shift in the UK economy.

I've had the misfortune to be stuck at home recuperating last week, which means I've found myself watching perhaps the most annoying day-time TV on the planet. Some of it is absolute tosh – pure filler. There is now nothing I don't know about the fantastic returns generated from buying a pile of bricks at auction in Birmingham and sluicing a tin of paint of over it to create a "desirable residence" yielding 6%.

While most daytime TV is rubbish, clearly the BBC felt a Reithian imperative to balance its output of antique based junk telly with some "educational commentary" – hence the wall to wall news and political analysis on the grown-up channel. Some of it is repetitive, but almost interesting (especially if you are on really good morphine).

Watching one morning, I was struck by the simple fact that no-one talking about Brexit had a clue what they were talking about. It was all unsupported opinion – and most of it badly expressed. On the day the UK announced its strongest jobs and production numbers in years, a "Remainer" was asked if the data meant she'd been wrong. She responded simply: "just wait... the data is wrong", before launching into a Project Fear litany of how jobs will contract, banks will all exit the country, and the UK is going to be impoverished.

She might be right. She might be absolutely wrong. But her comments are a good example of a "Jack's Nappy" – a curious concept a chum of mine invented a few years ago (when our kids were young) to describe any barely rational opinion presented as irrefutable fact. The concept is based on the notion that any father could claim his kid's nappy to be full of freshly pooped gold (mothers know better), secure in the knowledge that few people ever test such assertions. (And yes, my eldest son is called Jack.)

A typical Jack's Nappy might by the "fact" every single banking job in Europe is going to leave London and migrate to Frankfurt, Paris or Dublin. It's irrefutably obvious banks will have to be authorised in the EU to do business in Europe. Numerous factors should be balanced against the argument they need to be there!

In no particular order, the first is the lack of skilled staff, office accommodation, and infrastructure available to accommodate such a shift – it's a well known "factoid" more bankers work in the City of London than people live in Frankfurt. Secondly, no bank has the will (or the cash) to make the necessary logistical moves. Third, banking revenues are being redirected towards simple services which diminishes the attractions of moving. Fourth, it's the

end of the investment banking era as simpler FinTech solutions begin to replace older ways of finance.

Banking exodus?

Moving on to the next assumption: London will likely lose large swathes of its financial business currently located in the finance factories of Canary Wharf, the money and insurance warehouses of the City, and in the bespoke hedgefundery palaces of the West End. But they will lose position as a result of financial evolution – not EU dictat. Financial evolution is occurring at an incredible pace. I reckon Investment Banking in London will have utterly changed and adapted long before the EU and ECB get their hands on it.

Think for one moment of Global Trade – 50 years ago the Port of London was the largest port in the World. Every day literally hundreds of ocean-going trading ships would be unloading on the London docks and wharves. Then someone came up with the idea of Sea-Containers.

Made in 1979, the superb film "The Long Good Friday" was about a successful London Gangster attracting foreign money into London to develop the abandoned docks into his perception of a glorious new future for the UK – more space for development than the rest of Europe combined. The scene on the luxury yacht cruising the lower reaches of the Thames as Bob Hoskins's gangster expounds his vision for the UK is remarkable in its prescient vision of the UK over the next 30 or so years.

"FINANCIAL EVOLUTION IS OCCURRING AT AN INCREDIBLE PACE."

The film was made six years before Big Bang deregulated the City, and before plans to build Canary Wharf started the financial explosion that's characterised the last 30 years of UK growth. And in that is perhaps the real reason for worry.

In the last 30 years I've not only watched the markets rise and fall; I've watched London thrive and drive the UK economy. It's gone from a distinct second place to New York, to becoming the most diverse city on the planet. The Evening Standard tells us there are 270 different nationalities in London – all of them looking for a share of the wealth, and more arriving every day.

The emperor's new clothes

I started counting cranes as a proxy for economic activity in the 1980s. In the boom times of the Big Bang it was all about more and more office space in the City – principally Bishopsgate and Broadgate. In the 1990s I moved to Canary Wharf and watched a single tower become a forest of bank headquarters. A few years ago I moved back to the city, into a new building that had just replaced the former HQ of a US investment bank.

Today I'm back in Canary Wharf, and I'm looking at more cranes from my 20th floor office than ever before. But they aren't building more office space for an ever-expanding financial sector. 90% of the cranes I can see are building luxury residential towers, to be sold off plan to the modestly well off middle classes in Asia who look for the prestige of a London address or somewhere for their kids to stay while they attend university. Very few native workers will ever be able to afford any of the new builds.

"NEARLY ONE THIRD OF LONDONERS WERE BORN ELSEWHERE. WHY DID THEY COME HERE? BECAUSE OF OUR SUPERB WEATHER? OR THE OPPORTUNITIES?"

The numbers are striking. Nearly one third of Londoners were born elsewhere. Why did they come here? Because of our superb weather? Or the opportunities?

It's no secret London's streets are literally paved with gold. That's why every financier, fin-techer, entrepreneur, con-man and otherwise-hopeful makes their way to London. That's why the boom will go on forever... right until the moment it doesn't.

The moment when paradigm-smashing FinTechs realise they can do the same business out of Estonia with a handful of people, or the next web-app unicorn prefers to be based on the coast rather than Chelsea.

The world is constantly changing. Let's just assume for a moment that fears about the UK versus Europe and the decline of banking means London's residential boom isn't going to be funded by banker bonuses, or that Asian off-plan buyers get cold feet about the crashing value of sterling.

Fear not, say my chums in the property sector. They assure me London Property will never crash. Even in a recession, the longest the UK property sector has been down before recovery is 18 months.

But what if the vision of London opportunity so eloquently made by Bob Hoskins in the Long Good Friday has already played out? What if the glory days are over? Maybe the last 30 years of apparent UK growth was just a bubble of financial over-exuberance.

What if the Brexit vote just happens to have coincided with the end of the financial era and a looming emptiness as to what comes next?

And on that happy thought, it's time for inflation linked bonds and wondering about housing stocks.

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

MARKETS IN FOCUS

OCTOBER 2016

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
Bovespa	11.2	49.8	
Nikkei 225	5.9	-8.5	
IBEX 35	4.1	-4.2	
DAX Xetra	1.5	-0.7	
CAC 40	1.4	-2.8	
FTSE 100	0.8	11.4	
Euronext 100	0.0	-2.7	
Russian Trading System	-0.5	30.3	
Dow Jones	-0.9	4.1	
NASDAQ 100	-1.5	4.5	
Hang Seng	-1.6	4.7	
S&P 500	-1.9	4.0	
S&P/ASX 200	-2.2	0.4	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Iron Ore	12.5	47.9	
Coffee	9.3	30.5	
Soybean	6.2	17.3	
Natural Gas	3.1	27.4	
Copper	0.9	3.5	
Cocoa	-1.5	-15.3	
Crude oil (Light Sweet)	-2.4	26.5	
Crude oil (Brent)	-2.4	30.8	
Gold	-3.2	20.4	
Platinum	-4.9	9.9	
Sugar (No. 11)	-5.5	43.3	
Silver	-7.1	29.3	
Palladium	-14.1	10.3	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
EUR/GBP	3.5	21.7	
USD/JPY	3.4	-12.8	
USD/CAD	2.2	-3.0	
USD/CHF	1.8	-1.2	
EUR/JPY	0.9	-11.9	
EUR/CHF	-0.6	-0.3	
AUD/USD	-0.7	4.4	
EUR/USD	-2.4	1.0	
GBP/AUD	-5.0	-20.2	
GBP/USD	-5.7	-17.0	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	Nov 03	Dec 15
ECB	0.00%	Dec 08	Jan 19
FED	0.50%	Dec 14	Feb 01
BOJ	-0.10%	Dec 20	Jan 31
SNB	-0.75%	Dec 15	Mar 16
BOC	0.50%	Dec 07	Jan 18
RBA	1.50%	Dec 06	---
RBNZ	2.00%	Nov 10	Feb 09
BOS	-0.50%	Dec 20	Feb 14
BON	0.50%	Dec 15	Mar 16

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
KAZ Minerals PLC	29.5	179.7	
Evraz PLC	27.4	180.0	
Vedanta Resources PLC	22.4	159.3	
Glencore PLC	17.8	176.3	
Petra Diamonds Ltd	17.1	73.6	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Laird PLC	-54.3	-59.1	
NCC Group PLC	-45.9	-36.8	
Senior PLC	-23.9	-24.1	
Keller Group PLC	-22.5	-18.4	
Berendsen PLC	-22.3	-10.5	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Industrial Metals	27.4	180.0	
Mining	9.6	89.7	
Food & Drug Retailers	8.8	24.6	
Banks	7.5	0.6	
Oil & Gas Producers	6.7	37.8	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Tech. Hardware & Equip	-54.3	-24.5	
Oil Equip, Services & Dist	-7.8	12.9	
Real Estate Inv. Trusts	-6.0	-15.4	
Pharma & Biotech	-5.0	7.0	
Software & Comp Serv	-5.0	18.9