



# MAGAZINE

# masterinvestor

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## FIDELITY'S TOM STEVENSON

### KEEPING THE FAITH WITH MARKETS



## PLUS...

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ALAN STEEL EXPLAINS THE  
POWER OF PENSIONS

### **OIL MAJORS GO GREEN?**

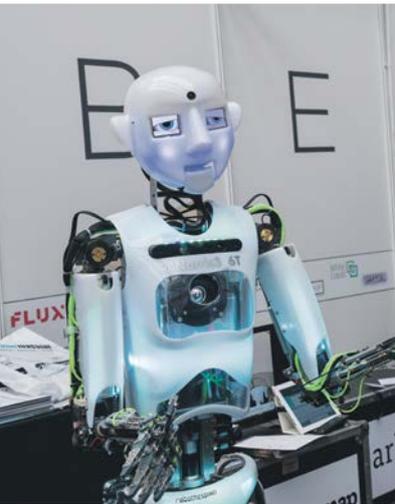
HOW THE OIL TITANS ARE ADAPTING  
IN THE AGE OF RENEWABLES

### **HOW TO AVOID YIELD TRAPS**

WE EXPLAIN HOW TO NAVIGATE  
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# WELCOME



Dear Reader,

You'd probably never expect me to blow the trumpet for competitors.

Today, I am going to do just that.

Forget for a moment all the experienced, eloquent and well-informed contributors who are working for us. Instead, make a bit of space in your life for a number of other finance writers.

At the upcoming Master Investor Show, I'd like to introduce eight finance bloggers to you. With all of them coming from very different viewpoints and operating in different niches, I figured you'd be interested to learn about the work others are doing to help private investors make the best decisions.

In a first for Master Investor, we invited these eight bloggers to join us at our event. They will have a dedicated section all to themselves, right outside the Gallery Suite where companies are going to present throughout the day (and on the way to the Auditorium where we will host "How to" presentations).

They'll be there to meet and talk with you, to present the scope of their blogs, and to answer any questions you may have.

To read about exactly who we invited, simply follow this [link](#) to our press release.

Alternative media has been growing in importance and recognition. Much as we love reading the FT and similar publications that give us an understanding of the mainstream view, it's important to also scan independent thought-provoking blogs for information and ideas that can help make your investment decisions more successful.

Have you registered yet to attend our flagship event on 25<sup>th</sup> March? Check [masterinvestor.co.uk/show](http://masterinvestor.co.uk/show) for more information, or [download our free app](#) to browse through speaker schedules, exhibitor profiles and other essential information on your Apple or Android device.

I'll see many of you on 25<sup>th</sup> March. Until then...

Best regards,

Swen Lorenz  
Editor, Master Investor Magazine



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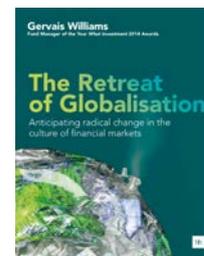
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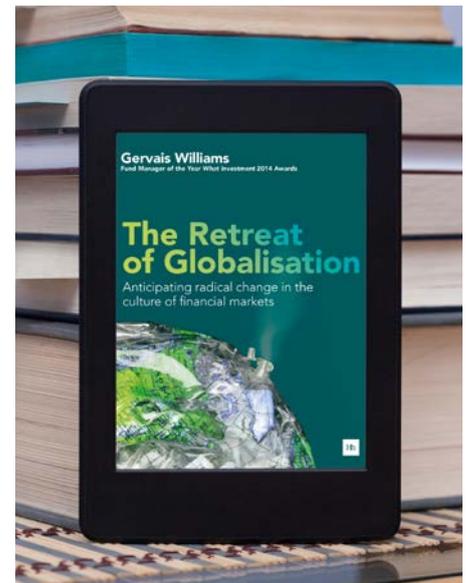
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BY JIM MELLON

## MELLON ON THE MARKETS

# ON THE ROAD AGAIN

**Well, I'm on the road again. This time, I'm travelling around the US, in part researching for the new book, which I hope will be out in early May but will definitely be featured in my talk at [Master Investor 2017](#) on March 25<sup>th</sup>. The other part of the trip is to observe the US in all its glory – and also to understand its weaknesses.**

I am writing this in Mama Mia's Trattoria in Portland, Oregon, after a long and rain lashed drive from San Francisco. Luckily, I am accompanied by my old mate and star stock picker Anthony Baillieu, he of Syrah and Aurora Labs. I will be going to Seattle, Jackson Hole, Boise, Boston, St Louis, Denver, Savannah, Memphis and Nashville, with lots of other stops. Then a grand finale back in Frisco.

In San Francisco, where I spend a bit of time and have an apartment, I met with some amazing so-called key opinion leaders (KOLs) in the field of longevity and ageing. Everyone I have met in this field has been extraordinarily generous with their time and careful in their explanations to a neophyte. (Big call out for Aubrey de Grey, Laura Deming, Len Hayflick and Walter Borz.) On this trip, we have some exciting stuff lined up in Boston as well.

Similarly, in Oxford, the labs of Professor Alistair Buchan and Profes-

sor Matthew Freeman have proved enlightening. Without spoiling the story, which is still being written, I have seen in Oxford the actual atoms of a molecule displayed on a screen in 3D, which is something just a few years ago no one thought possible. Clearly, once the atomic structure of cells is revealed, so much more can be understood about their workings. And without a doubt, the keys to the story of ageing lie in the basic building blocks of our bodies – cells.

So I will speak of Al Chalabi's and my new book, *Juvenescence*, at MI, as well as giving my tuppence worth

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**“ALTHOUGH CALIFORNIA VOTED FOR HILLARY, IT'S EASY TO SEE WHY TRUMP WON.”**

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on markets and opportunities for investors. As attendees know, MI is a serious event, not given to pointless rants by those who couldn't spot a winner if it was presented to them on a plate. Collaborations with the likes of Fidelity International, Seven Investment Management, Syndicate Room, ISDX and Edison give me tremendous hope for the show. Our objective is simply this: to provide a collaborative platform for investors, companies, management firms and other practitioners of the art and science of making a return on assets. And in this, we succeed very well. I am excited about seeing everyone there. It is selling out fast so please do [register](#). The ideas we presented last year have done particularly well in the past twelve months, and I will have a new crop to show this year. Ranters and attention seekers please stay away!

Moving on, I have a few observations from my trip in the US. Starting in San Francisco, home to the



world's largest and most influential technology companies, any observer will see what is right and wrong with the US in a microcosm. Huge brand new tower blocks rise to accommodate the legions of tech workers who flood into the city pushing rents to the highest levels in the USA. Meantime, and everywhere, the poor and dispossessed, the crazy, the down-at-heelers and the addicted sleep on the streets and roam the town.

There are an estimated 40,000 homeless in San Francisco, about 5% of the population, and it is a shameful sight to see them, hopeless and unconnected to the gleaming world all around them. And yes, these dispossessed are everywhere else in the US, living cheek by jowl with abandoned cars, rusting trailer homes and quite stunning scenery. No doubt, this level of wretchedness will be evident on our whole drive through the US, excepting some manicured enclaves reserved for the rich and fortunate.

These scenes do not exist in Europe in my experience; sure, there are poor and homeless people, but not on the scale evident here. If you don't make it in the US, life is unkind, and once discarded by society, there is no easy way to climb back on the ladder.

Although California voted for Hillary, it's easy to see why Trump won. While levels of inequality in the UK have been falling, in the US they have been getting worse. It's hard to see what can be done; Trump's prescriptions of "America First" sound fine to the lower rungs of society, but informed readers appreciate that free trade is a great thing, and any barrier to it should be removed. Walls of physical or metaphorical types result in less prosperity, not more.

I can see Trump finding a way to tame the untrammelled transfer of wealth from the have-nots to the tech titans, most of whom he clearly has little time for. If you ask me, I think the days of **Facebook (NASDAQ:FB)** and **Alphabet (NASDAQ:GOOGL)** are ending, partly because they will become regulated utilities, and partly because hubris and size will inflict their own brand of Schumpeterian destruction on them.

I have mentioned this paradox of extreme wealth amongst the *sans-culottes* before, but it's getting worse. Probably the worst thing that could happen is that Trump can't deliver the hoped-for prosperity to the poor of America, and that amidst rising discontent he engages in that old trope of unpopular leaders, foreign adventure. I am hoping not, and it is weird that just months after having railed against the elites of Wall Street he is engaged with those very same elites to the point where they largely populate the top ranks of his administration. Interesting times, but so far, we all live on and the stock markets remain robust, particularly in the US.



I said in the last *Mellon on the Markets* that I thought the US was priced to perfection, and I stick with that. The quality of earnings in the US is deteriorating, buoyed by share buybacks and increased leverage, and the strong dollar will soon be a drag on reported earnings from overseas. A cut in corporate taxes is already priced in – and the cherry-picking of companies on a daily-shame list from the White House isn't conducive to getting the wheels of capitalism to run smoothly.

There are some US companies that look great, however, and I will mention them in Master Investor. The US remains the bustling centre of enterprise and research in the world and

nothing will beat it for many years to come. It's just an expensive ticket to buy into it right now.

Meanwhile, my view that Brexit is a sideshow to much bigger problems in the EU appears to be coming true. A true cultural feast of terrible possibilities is displayed before us now. Where to start? The Dutch elections, the French or the German? Or the renewed travails of Greece? Portugal's effective bankruptcy? Or, more pressing, the certainty that Italy is in a debt trap?

All will be elaborated on at Master Investor 2017... But just consider this: although bond spreads between Bunds (German bonds) and those of the less prudent European nations have been widening, they are nowhere near wide enough to justify the risk of holding them. If you are foolish enough to buy Italian long bonds with a yield somewhere just over 2%, you deserve to lose your money, your house and spouse.

Given Italy's totally intractable position within the common currency, and its permanently rising debt, the better rate would be 10%, and even then, that might not compensate for the prospective devaluation of the new lira when (not if) Italy leaves the Euro.

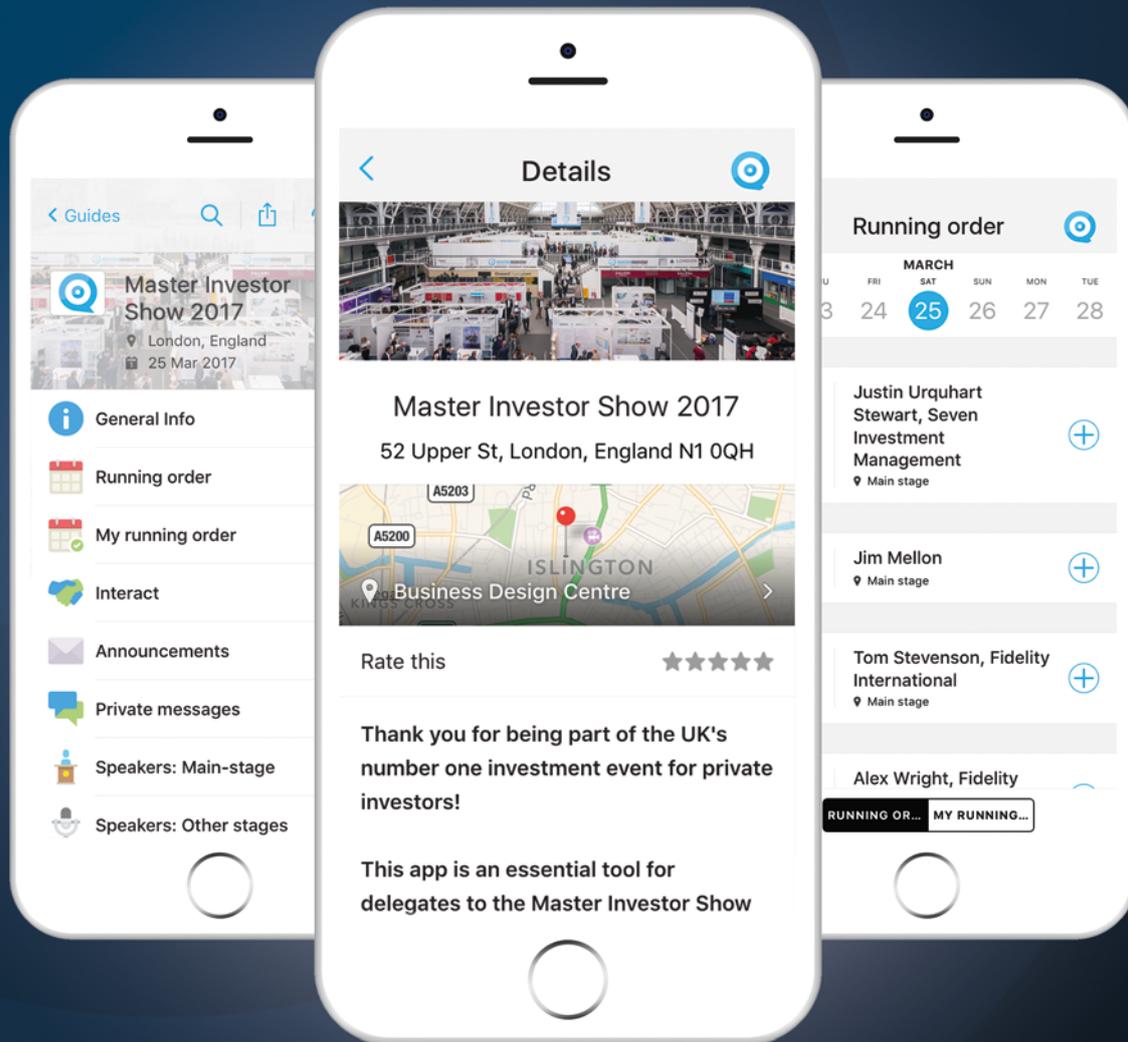
Italy's debt to GDP ratio is now 132%, it has only run two years of primary budget surpluses since 1992, its nominal GDP has not and cannot outrun the increase in debt, and interest payments are just shy of 4% of GDP. In short, it's up one of those creeks, of which there are many in Oregon, without the proverbial paddle.

As they say on planes, "assume the brace position".

**Happy hunting!**

**Jim Mellon**





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BY JAMES FAULKNER

# FIDELITY'S TOM STEVENSON

## KEEPING THE FAITH WITH MARKETS

**James Faulkner:** Hi Tom and thanks for taking the time to speak with Master Investor. Many of our readers will be familiar with your work in The Telegraph and elsewhere, but can you tell us a little about your role at Fidelity International?

**Tom Stevenson:** As investment director at Fidelity Personal Investing, my principal role is to define and articulate our investment view for our 270,000 personal investing customers in the UK. We believe good investing should be easy and to help our customers to achieve the best possible investment outcomes we have created what we want to be the best investment guidance service in the UK. Not advice but guidance – we point our customers in the right direction but the final say is always theirs.

Every quarter I write an Investment Outlook report that sets the scene with my views on all the main asset classes and geographical areas. The idea is that this provides the context within which our investors can pick the best funds for their portfolios. The Outlook sits alongside our Select 50 list of our favourite funds, which we created with our fund selection colleagues within Fidelity's investment team.

In addition to my investment role, I'm also Fidelity's main spokesperson in the UK, helping journalists with their investment and personal finance stories and

appearing regularly on national radio and television.

It's a great job that combines my former career in financial journalism with my knowledge and passion for investment.

**JF:** I actually started reading your articles in my teens when I'd just started investing. What advice would you give to someone who's about to embark on their investing career?

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**“THE REALITY IS THAT YOU CAN ALWAYS FIND REASONS TO KEEP OUT OF THE MARKET AND THIS IS MORE OFTEN THAN NOT THE WRONG APPROACH.”**

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**TS:** There's so much great advice for novice investors out there, so read widely. I worked closely with Jim Slater in the 1990s on his investment books and these are a good starting point.

My second piece of advice is to get started. Time is the investor's friend and a young

investor starting out has the advantage that they can take greater risks knowing that the ups and downs of the market will even out over the long haul.

Be disciplined. The mistakes I have made have been when I have just invested on a whim, following up on a tip from a friend without really doing my homework. Sometimes you might get lucky but there's no substitute for hard work.

Lastly, be well diversified. We don't have crystal balls. No-one knows what is round the corner and nasty surprises come along with alarming regularity. Make sure that you live to fight another day.

**JF:** One of the great things about being an investor today is that there is so much variety out there, all of it accessible at the push of a button and at relatively little cost. However, some would argue there has never been a worse time to find oneself with spare money to invest. Record low interest rates have driven everyday savers into the markets in search of yield at a time when valuations are generally accepted to be at historically high levels. Is your glass half empty or half full?

**TS:** I'm not sure that this is a bad time to have spare money to invest. The reality is that you can always find reasons to keep out of the market and this is more



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**“PRIVATE INVESTORS  
UNDERPERFORM THE MARKET  
BECAUSE THEY LACK THE  
DISCIPLINE TO RUN THEIR PROFITS  
AND CUT THEIR LOSSES.”**

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often than not the wrong approach. Actually, I'd say that not enough savers have ventured into the markets in search of a better return. They have remained in the false haven of cash, accepting a dismal yield for years while the stock market has ground higher. This has been the most grudging of all bull markets. No-one has believed in it. And that, for me, is a reason to be optimistic that it can continue. Markets reach a peak when everyone is enthusiastic about stocks and shares. That just isn't true today.

It's true that valuations are not as cheap as they were. The bull market has been going on for a long time now and it might feel long in the tooth. But with interest rates on the floor, equity yields of 4 or 5 percent are still pretty compelling. Where else are you going to put your money? Not in bonds. Not in cash. Definitely, I'm a glass half full investor at the moment.

**JF:** So many private investors end up underperforming the market. Why do you think that's the case?

**TS:** Private investors underperform the market because they lack the discipline to run their profits and cut their losses. They bail out too early when they make a small gain and they hang onto losers in the hope that they will come good. It's a simple rule but it's one of the most powerful.

Investors also trade way too much. Warren Buffett always talks about having a punch card that allows you to make only a limited number of trades during your investing lifetime. If we all thought we could only make a few purchases and sales, we would think a lot more carefully about them and we would hold onto our investments for much longer.

**JF:** Even the professionals often fail to meet their mandates and end up underperforming the market. With this in mind, isn't the best course of action for a novice investor simply to buy the market through a tracker index?

**TS:** There's a beguiling simplicity about tracker funds and they do have the advantage that they are cheaper than actively managed funds. But that's as far as their advantages go for me. The reality is that a market capitalisation-weighted passive fund will force you into buying



Fidelity Investor Centre, 25 Cannon Street, London

the biggest, most popular and so-over-priced shares at the wrong point in the cycle.

Not every active investor will beat the market consistently but buying a tracker ensures that you will underperform the market (to the extent of fees) each and every year. Skilful investors are not easy to find but they do share some predictable characteristics. Look out for those with a decent track record who do what it says on the tin. And then stick with them for the long haul.

**JF:** Although passive investing has certainly grown in popularity in recent years, it is undeniable that some active managers seem to be able to deliver the goods time and again. One name that immediately springs to mind is Neil Woodford. Which other fund managers have caught your eye over the course of your career?

**TS:** Woodford is good. So is Nick Train. And Terry Smith. One I particularly like is James Thomson who runs the Rathbone Global Opportunities Fund. At Fidelity, I had the privilege of working with Anthony Bolton. He possessed a wonderful ability to stand back from the fray and make consistently sound decisions. He was a contrarian but he listened to what the market was telling him. He is also an extraordinarily nice man.

I mentioned Jim Slater earlier. He was a totally different type of investor but I learned a great deal from him. For him, investment was all about focus. Decide on your area of competitive advantage and stick to it. He chose to excel in smaller growth shares. His son Mark is continuing the family tradition with great success.

**JF:** The charging structure of the industry has come under a lot of scrutiny lately. What are the fees and pitfalls investors should be aware of when they choose a fund? What measures is the industry taking to drive better value for money for investors?

**TS:** In a raging bull market, no-one was too fussed if professional investors took an outsized fee each year. If you are making 10% a year you are happy to give away 2% to a fund manager. That's not the case when returns are persistently lower, and so the downward pressure on fees is going to continue for some time. That's good news for investors in funds and I do think that they get much better value than they used to.

However, there is a limit to this argument. Good investing is still a labour intensive business. It involves a lot of hard work, putting analysts and portfolio managers on the ground around the world, turning over every stone to find the few gems out there. There is inevitably a cost involved

and it is right that investors should pay for this. But – and it's a big but – only if fund managers are genuinely adding value. No-one should pay an active management fee for closet index tracking.

Thanks to the Retail Distribution Review, the non-investment costs of owning shares on a platform have come down dramatically. Investors today can get a very good deal if they shop around.

**JF: Many of our readers at Master Investor are active investors who prefer to manage their portfolios directly through investing in individual companies. However, funds and trusts can still be useful for gaining a more diversified exposure to niche areas or difficult-to-access markets. A good example of late has been Japan, which has experienced a terrific run over the past few years. Are there any particular regions or niche sectors that you think could come up trumps for investors in 2017?**

**TS:** I've mentioned the benefits of diversification already. It is absolutely key to a successful investment strategy and mutual funds and investment trusts can be a simple and cheap way to put your eggs in a variety of baskets.

My own portfolio holds investments all around the globe from Japan, to Europe and the US, across developed and emerging markets and across asset classes. Although the US is one of the more expensive markets in the world today, I think that is justified by its better prospects. Japan and Europe are relatively cheap. The UK is a great source of income, which, compounded year after year, is a great contributor to total returns.

I think equities will outperform bonds this year. Developed markets are likely to outperform emerging markets. The dollar will rise against most other currencies. Cyclical stocks will outperform defensives.

**JF: It's said that bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria. Where do you think we are on that spectrum right now?**

**TS:** This has been the most grudging bull market I can remember. We are probably somewhere between scepticism and optimism at the moment, even eight years after markets bottomed out in 2009. The lack of euphoria is the biggest single reason I think the bull market has further to go. Bull markets don't just die of old age.

**JF: The markets seem to be taking Trump at his word in his promise to reflate the US economy. Is this wise?**

**TS:** We were warned to take Trump seriously but not literally. However, since his inauguration he seems to be delivering most of what he promised – even the more outlandish stuff that no-one really expected to see the light of day. I think he will struggle to deliver the growth many people expect because he will need to persuade Congress to back him on things that might make even his fellow Republicans uneasy. But my central case is that a Trump administration will be pro-growth and good for equities.

**JF: I noticed a piece you published recently where you told readers that a re-run of the 1970s inflationary spiral was unlikely. But isn't it the case that people will still feel the pinch even with relatively low nom-**

**inal levels of inflation when interest rates are at rock bottom and wage growth is low? Isn't there a chance that what the West is experiencing now could be akin to the Japanese experience over the past couple of 'lost' decades?**

**TS:** Inflation is certainly picking up, albeit for different reasons on either side of the Atlantic. Over here, it's all about the fall in sterling, which is pushing up the cost of imported goods, notably fuel and food. I actually think the pound has fallen far enough, even with all the uncertainty of the next two years' Brexit negotiations ahead of us. In time that will bring inflation back under control.

In the US, inflation is a reflection of the Trump growth agenda. Here, too, however I am not particularly worried because I expect even a modest interest rate cycle to have the desired effect quite quickly. The fundamentals of the global recovery are not that strong so inflation could be snuffed out quite quickly by tighter monetary policy.

The West is in a very different position from Japan. That country's ageing population and attitude to immigration have been the key drivers of the past two lost decades.

**JF: Thanks for your time, Tom.**

**TS:** You're welcome.

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BY JOHN KINGHAM

## DIVIDEND HUNTER

# HOW TO AVOID YIELD TRAPS – PART 1

**As a dividend-focused investor I'm always on the lookout for high yield shares, whether that yield is high relative to the market average or high relative to the company's peers. However, as most yield-seeking investors soon discover, high yield stocks do not always deliver the yield you were hoping for. That's because dividends can be cut or even completely suspended, and the higher the historic or forecast yield the more likely that is to happen. This is the dreaded yield trap, where investors are lured in by an attractive yield and then stung with a capital loss when the dividend is cut.**

Like you, I want to avoid this fate wherever possible and so over the years I've built up a series of tests which every potential investment must pass before I'll invest so much as a penny. These tests do not have any magical power to spot yield traps with 100% accuracy, but I do think companies that can pass these tests are far less likely to cut or suspend their dividends than those that fail to pass them.

### **A two phase approach: First quantitative, then qualitative**

My approach to weeding out yield traps is twofold. First, I focus on a

company's financial numbers, looking for a range of features including: 1) a ten-year unbroken record of dividend payments; 2) a long history of relatively consistent revenue, earnings and dividend growth; 3) high

rates of profitability (return on capital employed); and 4) small debt and pension obligations. These are simple quantitative measures that I can use to rule a company out if, for example, its total borrowings are more



than five times its five-year average profits. You can find out more about these quantitative tests in previous Dividend Hunter articles.

Personally though, I wouldn't want to invest on a purely quantitative basis, so the second phase of my yield trap filter is to analyse each investment candidate using a series of mostly qualitative questions. These questions focus on what the company actually does to produce its revenues, earnings and dividends.

To give credit where credit's due, the bulk of these questions have been adapted from *Corporate Turnaround*, a book by Stuart Slatter and David Lovett. Their book contains a chapter on the symptoms and causes of corporate decline and it describes in detail a list of principle causes of decline. The list includes destabilising factors such as large acquisitions, excessive expansion and changing patterns of market demand.

I've found this list to be useful for two main reasons: First and most obviously, it helps me to avoid yield traps, which are often companies that are about to go into serious decline. Second, looking for these various causes of decline is a good way to build up a fairly detailed picture of what a company actually does and how it does it. For me it's important to have a fairly detailed understanding of what a company does because

**“FOR ME IT’S IMPORTANT TO HAVE A FAIRLY DETAILED UNDERSTANDING OF WHAT A COMPANY DOES BECAUSE IT HELPS ME TO AVOID PANICKING IF A COMPANY’S SHARES FALL BY SAY 30% OR EVEN 50%.”**

it helps me to avoid panicking if a company's shares fall by say 30% or even 50%. If I don't have a good idea of what the company does then a big chunk of my information will be coming from the share price, which is a volatile and nerve-wracking thing to focus on. But if I have a decent understanding of the company then I can much more easily ignore the share price and focus on the company, and companies tend to be much less volatile and much less stress-inducing than their share prices would suggest.

I've written the questions so that a positive answer is good and a negative answer is bad. In terms of ruling companies in or out, the only hard rule I have is that if a company has more negative answers than positive ones then I would put it into the "too risky" pile. However, such a bad score would be unusual and in most cases the decision to invest or not is more subjective than that. In other words, I gather the facts from the company's website and annual reports, answer the questions, look at the overall score, see what my gut tells me and then include or exclude the company as a potential investment.

### Avoiding bad management

The first couple of questions relate to whether or not the company has good management, or perhaps more accurately, whether it doesn't have obviously bad management. As a numbers man this sort of qualita-

tive statement (what is "good management"?) is about as far outside my comfort zone as it's possible to get. However, there are a couple of things the *Corporate Turnaround* book focuses on which I also think correlate quite well with good management, namely 1) a focus on the core business and 2) strategic consistency.

#### 1. Does the company have an obvious and dominant core business?

In most cases when I've invested in a company and it's all gone wrong, the new CEO (replacing the existing CEO is almost mandatory in turnaround situations) will invariably look to re-focus the company around its core business.

That's because a common cause of decline is excessive expansion into "exciting" new markets with great "synergistic" opportunities for growth. Or to put it another way, the core business has stalled and so the CEO launches or acquires new businesses in new markets in which the company has little or no experience. This can keep earnings per share growth on target when growth in the core business is no longer forthcoming.

Sadly, these new ventures often add complexity to the organisation and take management's focus off the company's core "cash cow" business. In many cases the core business will start to decline, although for a while this may be offset by growth in the new ventures. Eventually though,



the new ventures plateau or begin to decline (or never make a profit in the first place), and the folly of this strategy becomes obvious to everyone. After a profit warning or two the CEO "resigns" and a new CEO begins the process of selling off those non-core businesses while investing in and focusing on the company's core business and core competencies.

Not all companies have a single core business though. For example, Marks & Spencer has its largely separate Food and Clothing businesses, while GlaxoSmithKline has three core businesses of Pharmaceuticals, Vaccines and Consumer Healthcare. But these are still significant core businesses and different to the situation I'm trying to avoid, which is either a) a company that makes significant attempts to enter new markets in order to offset a stagnant core business, or b) a jack-of-all-trades company that has no obvious core competency.

I won't necessarily avoid a company just because its core business is weak or non-existent, but if that appears to be the case then I'll definitely mark it down as a potential risk.

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**“THERE IS MOUNTING EVIDENCE THAT COMPANIES WITH A CLEAR OVERALL GOAL OR PURPOSE HAVE A DEFINITE ADVANTAGE OVER THOSE THAT DON'T.”**

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## 2. Does the company have a clear and consistent goal and strategy?

There is mounting evidence that companies with a clear overall goal or purpose have a definite advantage over those that don't. The default goal of corporations in the 1990s was to maximise shareholder value, but that doesn't exactly inspire customers or employees. I know that when I used to work in the corporate world I didn't exactly do backflips every morning saying "Wow, today I get to maximise returns for shareholders – lucky me!"



Personally I much prefer to see companies where the goal or purpose is to make the world a better place in some way or other, and that maximising shareholder value is a powerful way to efficiently achieve that goal, but it is not the goal in and of itself.

Just as important as a clear and consistent goal is a clear and consistent strategy. As China has shown, the ability to develop and then stick to a long-term strategic plan is critical if you want to achieve long-term goals, especially if those goals are difficult, as most corporate goals should be. On the other hand, as some democratic nations have shown, bringing in new management, new goals and new strategies every four or five years can lead to lots of time wasted going around in circles, allowing those who can focus consistently on a single strategy to pull further and further ahead.

### Avoiding high cost companies

Companies that cannot compete on price are likely to run into serious trouble at some point. Yes, Unilever can sell Ben & Jerry's ice cream or Flora margarine at slightly higher prices than unbranded competitors, but most companies do not have that luxury and so an ability to compete on price is critical. And even if a company doesn't have to compete on price, keeping costs low is still important if returns (to sharehold-

ers, stakeholders and society) are to be maximised. Here I'll focus on two drivers of cost competitiveness: size and experience.

## 3. Size: Is the company one of the largest players in its markets?

I'm not obsessed about investing in companies that are number one or two in their markets (although it's nice if they are), but if a company is outside the top five or so I would definitely mark that down as a negative point. Being a small player may give a company more room to grow, but it also means headwinds in terms of economies of scale and the relative unfamiliarity of the company to its potential customers.

Looking back at Unilever, Marks & Spencer and GlaxoSmithKline again, these are all companies that have many market-leading products, ranging from ice cream to painkillers and underpants.

## 4. Experience: Has the company been operating in its current markets for many years?

Learning how to do something efficiently takes time, especially when that something is as complex as organising many thousands of people into a profitable enterprise producing goods and services that customers really want. Of

course, there is the potential for new companies to enter a market with completely new and more efficient ways of doing business. However, I have no idea how to pick winners from new entrants, so I'll stick to my current approach, which is to look for companies that have been running the same core business for decades, and in some cases centuries.

Again, using Unilever, Marks & Spencer and GlaxoSmithKline as examples, these are all companies with histories in most of their relevant markets stretching back more than a century.

### Avoiding large and risky "one-off" projects

Large "one-off" projects are a common cause of decline. These typically fall into two categories: 1) large projects to reinvent or radically change a significant part of the company, or 2) large revenue-generating projects which are a normal part of the company's core business.

#### 5. Is the company free of bet-the-company projects which could push it into a crisis?

The classic example of a bet-the-company project was Bill Gates' decision in 1995 to focus a huge amount of Microsoft's resources towards developing a free web browser to kill off the threat from Netscape's Navigator. In Microsoft's case this massive about-turn worked out well, but that was because it could rely on a tsunami of cash from its near-monopoly position within the PC operating system market. Such dramatic shifts in less dominant companies are massively risky, and it's a risk which is easily avoided (unless of course the shift begins after you've become a shareholder).

#### 6. Does the company generate revenues through the sale of millions of low-cost items rather than relying on large one-off projects?

These days everybody knows about bond proxies, also known as "the inevitables". These are companies that can generate relatively smooth revenue, earnings and dividend growth year after year, decade after decade. Most of these companies generate reve-

nues from brand-name low-cost items that people or businesses need every day. Toothpaste, soap, washing up liquid: these are all classic bond proxy products.

But not all companies sell powerfully branded toothpaste, and few of the bond proxies are available with yields that are even remotely interesting to income investors. So dividend hunters will often find themselves looking at companies that generate revenues and profits from multi-million pound, multi-year projects (typically in the form of a large contract).

Unfortunately, this can be a very risky way to earn a living. What often happens is that these contracts, perhaps to build a bridge or manage a prison, are won through a process of competitive tendering, where the lowest cost bid will frequently win. This pricing pressure leads to "suicide bidding", where very optimistic estimates of the cost of fulfilling the contract are used to justify a very low price to the client, whilst still (theoretically) generating a profit for the company. The suicide bidder then wins the contract, congratulates themselves on their "success", and then has massive cost overruns for the lifetime of the contract, leading to predictable and unavoidable losses over many years.

Another type of large one-off project is the blockbuster patent, most commonly used in the pharmaceutical industry. In that case a company like GlaxoSmithKline develops a new drug and patents it, which gives it a 20-year or so monopoly on that particular drug. Thanks to its monopoly position, profit margins and profits will be

reliably fat for many years. However, at the end of the patent's lifespan, those profits will vanish as generic manufacturers begin to manufacture the once-patented drug, driving profit margins down to wafer thin levels. If the company fails to replace expiring patents with equally impressive new patents then its profits and share price will be toast.

## “LARGE ‘ONE-OFF’ PROJECTS ARE A COMMON CAUSE OF DECLINE.”

Of course, this is not ideal and so I am especially wary of companies that depend on – and therefore must regularly replace – large contracts or patents. I have been bitten twice with this type of company, having had bad experiences with both Balfour Beatty (which depends on large one-off building contracts) and Serco (which depends on large one-off service contracts). It's an experience I'd rather not repeat, so although I won't necessarily rule these companies out (I still own GlaxoSmithKline and AstraZeneca, for example) I am especially careful about their other risk factors, such as the size of their debts, pension schemes or capital investment requirements.

Alas, I seem to have run out of space this month, so I'll finish off this list of yield trap questions in next month's issue. The remaining questions will cover a range of risk factors including capital intensity, acquisitions and sensitivity to commodity prices.

### 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*.

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BY VICTOR HILL

OPPORTUNITIES IN FOCUS

# OIL MAJORS IN THE AGE OF RENEWABLES



The global oil and gas industry is experiencing one of the most severe downturns in 30 years. A perfect storm of overproduction, geopolitical tensions and the long-term move towards alternative energy sources (renewables) has caused oil prices to fall to levels that are often below the long-term break-even cost of production.

Although the oil price is currently well above the low point of below US\$30 per barrel seen in January 2016, the long awaited rebound in the oil price has failed to materialise<sup>i</sup>. Many commentators now doubt that it ever will. That means, medium-term, the industry could be in trouble – unless it can change tack.

However, the fact remains that the oil and gas industry has produced some of the largest companies in the history of capitalism and the sector forms a giant pillar of the global economy. This month I ask: Whither the oil majors in the age of renewables?

### Don't get mad – break-even

As I write the price of Brent Crude is around US\$54.20. According to the [Knoema](#)<sup>ii</sup> website, the break-even oil price ranges from US\$149.90 in Venezuela to US\$60.50 in Qatar. So, on that basis, almost no one can make money in oil right now. But – hang on, that can't be quite right. **BP (LON:BP)** still made US\$720 million in the year to July 2016, although that was down 45 percent from US\$1.3 billion a year earlier<sup>iii</sup>.






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**“BP THINKS THAT A LARGE PROPORTION OF TODAY’S KNOWN RESERVES WILL NEVER BE EXTRACTED.”**

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other fossil fuel reserves – certainly more than enough to supply global demand until at least 2050 and probably well beyond. If oil producers thought that the price of oil was likely to rise significantly in the future then they would do better to leave it in the ground than extract it. But apparently they don't think that any more, if ever they did.

**Most of the oil in known reserves will never be extracted**

The inexorable rise of renewable sources of energy – principally solar and wind-power – is already impacting the demand for oil and that is likely to intensify. In fact, BP thinks that a large proportion of today's known reserves will never be extracted.

This suggests that oil prices are likely to remain flat or may even decline over the medium to long term. And in turn, there will be little economic incentive to develop new sources of supply, especially as new areas of exploration, such as the Arctic (where the Russians have ambitions) will come with much higher extraction costs. In the meantime, the abundance of oil resources may prompt low-cost producers to use their competitive advantage to increase market share.

**Exploration activity is already slowing**

The oil and gas majors found only 174 new oil and gas fields last year, the lowest figure since 1950, compared to an annual average of 400-500 in the years leading up to 2013, according to FT.com. This is partly due to reduced exploration budgets following the oil price slump. The oil majors have restricted exploratory drilling and instead have focused on locations with a very high probability of success.

We need to unpick the figures carefully. The Knoema figures are the life-of-field cost per barrel. They take into account all cash flows, positive and negative, occurring periodically over the life of a project. That includes exploration, development, production (based on its expected productive life) and eventually decommissioning costs. And this kind of discounted cash flow analysis critically depends on the choice of the appropriate discount rate – which would be the cost of capital to finance the project (which may change).

A better comparator is to be found on the [Market Realist](#) website which just focuses on current average operational costs. On this basis, the cost of oil production is highest in the UK at US\$52 per barrel, with Brazil second highest at US\$48.80. This compares with US\$36 in the USA – despite the shale oil revolution (see below). And the Gulf States still carry huge cost advantages with Kuwait the cheapest of all with a current production cost of US\$8.50 and Saudi Arabia a little more expensive at US\$9.90.

Given these figures, with the oil price at around US\$55 per barrel, the oil majors can still generate reasonable cash flow (although those which are heavily oriented towards the North Sea may

struggle). But few of the majors are going to be able to develop new reserves going forward, with the exception of the onshore producers in the Middle East.

As it happens, that may not be a problem as it seems that known reserves may see them through for the foreseeable future.

**The Peak Oil hypothesis has been junked**

I have been reading *Energy Outlook 2017<sup>™</sup>* published by the oil industry economists at **BP (LON:BP)**. If this reflects current thinking in the industry then it appears that the Peak Oil hypothesis has been junked. *Peak Oil* was the idea first developed back in the 1970s by the American geophysicist and oil economist [Marion King Hubbert](#). It states that there will be a point of peak oil production further to which production will steeply decline as established reserves run dry. During the course of this decline, as reserves are depleted – so Hubbert thought – the price of oil would soar to stratospheric levels with massively negative consequences for the global economy.

BP's study, in contrast, suggests that the world is overflowing with oil and

## Three stand-out US shale oil producers

[Chesapeake Energy](#) (NYSE:CHK) operates in Louisiana, Ohio, Oklahoma, Pennsylvania, Texas and Wyoming. On 23 February Chesapeake announced that average 2016 production amounted to 635,400 barrels per day – in line with 2015 levels. Total oil and natural gas proven reserves stood at 1.7 billion barrels of oil equivalent, a 14 percent increase compared to 2015. The com-

pany has succeeded in reducing production expenses by approximately \$336 million or 28 percent as compared with 2015.

[Devon Energy](#) (NYSE:DVN). According to its CEO, 2016 was a "transformational year" for Oklahoma based Devon Energy. The company decided to focus on its top two franchise assets, the STACK and Delaware Basin. The company's drilling programmes generated the best well productivity in its 45-year his-

tory, and cost control measures generated US\$1.3 billion of savings.

[Whiting Petroleum](#) (NYSE:WLL) is a crude oil producer in North Dakota where output is 130,000 barrels of oil per day. It also operates substantial assets in northern Colorado. Headquartered in Denver, Colorado, Whiting's share price has risen from about US\$4 one year ago to around US\$10.50 at time of writing – an increase of over 160 percent!

## Shale oil is cheapest

In the past decade, 190 billion barrels of shale oil and gas have been identified. US shale reserves are the lowest-cost option for future oil production and are likely to attract more investment than competing projects such as deep water fields, according to consulting firm Wood Mackenzie. About 60 percent of the oil production that is economically viable at a crude price of US\$60 a barrel is in US shale, and only about 20 percent is in deep water.

Oil companies with substantial US shale assets like the big US shale specialists (see panel) and, amongst others, Norway's [Statoil](#) (STO:STLO), are likely to be at a competitive advantage over the next few years. In contrast, producers that rely on oilfields in higher-cost regions such as the North Sea and the

deep waters off West Africa will have to cut costs or face shrinking output.

After the oil price plunge that began two years ago, production costs have been cut across the industry, but nowhere more so than in the US shale fields. Average costs per barrel have dropped by 30 to 40 percent for US shale wells, but just 10 to 12 percent for "conventional" oil projects. US shale regions which two years ago were in the middle of the cost curve for future oil supplies are now at the lower end.

The Eagle Ford shale field of south Texas on average requires a Brent crude price of above US\$48 a barrel to break even, according to Wood Mackenzie's calculations. For projects in the Wolfcamp (also known as Cline) shale formation in the Permian Basin in west Texas the break-even price is just US\$39 a barrel.

Conventional and unconventional (i.e. shale) oil resources behave differently in terms of their cash flow analyses. For shale oil, initial production is very high,

**“ABOUT 60 PERCENT OF THE OIL PRODUCTION THAT IS ECONOMICALLY VIABLE AT A CRUDE PRICE OF US\$60 A BARREL IS IN US SHALE, AND ONLY ABOUT 20 PERCENT IS IN DEEP WATER.”**



but tails off quickly – half the reserves might be produced in the first year. Conventional oil extraction is much more regular, with typically ten percent of reserves being produced over a ten year period (though this varies from field to field). This makes shale oil projects much more favourable in net present value (NPV) terms. Moreover, shale wells can be brought on stream in weeks, compared to five years or so for a typical deep water field.

### Oil demand will rise, but more slowly

If the oil business is mature it is by no means in decline, however, as mankind will continue to use oil for the foreseeable future.

In BP's base case scenario, world GDP will almost double between now and 2035 driven by fast growing emerging economies where more than two billion people will be lifted out of poverty. Rising prosperity will drive an increase in global energy demand, although the extent of this growth will be substantially offset by rapid gains in energy efficiency. Efficiency gains by petrol-powered cars alone will reduce global oil demand by nearly sixteen million barrels per day.

**“RENEWABLES ARE THE FASTEST GROWING FUEL SOURCE, AND WILL QUADRUPLE OVER THE NEXT 20 YEARS, SUPPORTED BY CONTINUING GAINS IN COMPETITIVENESS.”**

Amazingly, while global GDP will increase by over 90 percent between now and 2035, energy demand will increase by only around 30 percent.

The share of hydrocarbons in the fuel mix will continue to decline, although oil and gas, together with coal, will remain the dominant sources of energy. Renewables, along with nuclear and hydroelectric power, will provide half



of the additional energy required out to 2035.

Gas will grow more quickly than oil and coal, led by US shale gas. The rapid expansion of Liquid Natural Gas (LNG) is also likely to lead to a globally integrated gas market. What is special about LNG is that it is mobile – it can now be relatively easily shipped across great distances with no need for pipelines. This means that disparities in the gas price in different markets will henceforth be subdued: gas will quickly be shipped to higher price markets by LNG tankers, thus stabilising prices.

Demand for oil will continue to grow but the growth rate will slacken. Transport will be overtaken as the main source of demand growth by the petrochemical sector because of the predicted take-off of electric cars. In fact, the number of electric cars will rise one hundred fold from one million in use today to one hundred million in 2035. That of itself will reduce global oil consumption by about one million barrels per day.

By the way, self-driving or "driverless" cars are expected to be much more fuel efficient than human-driven ones. Add to that the fuel-saving potential of the sharing economy – pooled cars, Uber, shared journeys and so forth –

and the efficiency gains mount up even further.

And it's already happening. Only last month a deal was struck between [Peloton Technology](#) and [Omnitracs](#). This will allow vehicle-to-vehicle communications between trucks, so they can tailgate safely – saving up to an estimated 10 percent of their fuel consumption. The haulage industry, currently a huge consumer of hydrocarbons, is about to undergo a transformation. [Tesla \(NASDAQ:TSLA\)](#) and [Nikola Motor](#) of Salt Lake City, are both working on electricity powered trucks.

### Change or die

According to [Paul Stephens](#), a visiting professor at University College London, a fellow at Chatham House and energy expert, international oil companies must completely change their business model or face a "nasty, brutish and short end" within ten years. He thinks the oil majors are no longer fit for purpose – hit by low crude prices, more rigorous regulation and poor strategic management.

The urgency of the oil majors' predicament is not lost on investors. At the annual general meetings of both [Royal Dutch Shell \(LON:RDSA\)](#) and [Exxon Mobil \(NYSE:XOM\)](#) last year, share-



holders demanded that more be done to reduce those companies' carbon footprints – not so much because investors have all become environmentalists as because they know it makes good business sense.

Professor Stephens argues that there are only three ways forward for the oil majors. They can diversify into green energy; drastically reduce their operations; or they can consolidate through further mega-mergers. We are likely to see all three in the years to come.

The way forward for the big oil multinationals if they can't invest in shale oil and gas, is therefore to follow the market and to invest in renewables. Renewables are the fastest growing fuel source, and will quadruple over the next 20 years, supported by continuing gains in competitiveness. Ironically, the price of renewable energy assets has also fallen with the price of oil: therefore this is the ideal moment to diversify into renewables companies.

## China

China is now the world's largest consumer of energy. But its rate of economic growth is slowing and the structure of its economy is changing. It is moving from an industrial economy with intensive energy consumption to

a consumer-led economy where energy efficiency can be improved. China's energy mix is changing as energy policy shifts away from coal towards natural gas, renewables and nuclear power.

Global coal consumption will peak, as the continuing reform of China's economy causes demand for coal to slow sharply, although China will remain the largest growth market for energy overall.

In response to these challenges, China is becoming a global leader in renewables. Five of the world's six largest solar panel manufacturers are Chinese<sup>vi</sup> as is the largest wind-turbine manufacturer, **China Ming Yang Wind Power Group Ltd (NYSE:MY)**.

## Renewables

Renewable energy is any energy source that is collected from resources which are naturally replenished. These include sunlight, wind, rain, tides, waves, and geothermal heat (i.e. hot volcanic water). Renewable energy sources mainly provide energy by means of generating electricity, though they can also provide direct benefit, for example where geothermal springs provide

central heating as in Iceland and elsewhere. Hence the rise of renewable energy occurs in tandem with the *electrification* of, amongst other things, cars and trucks.

## Solar power

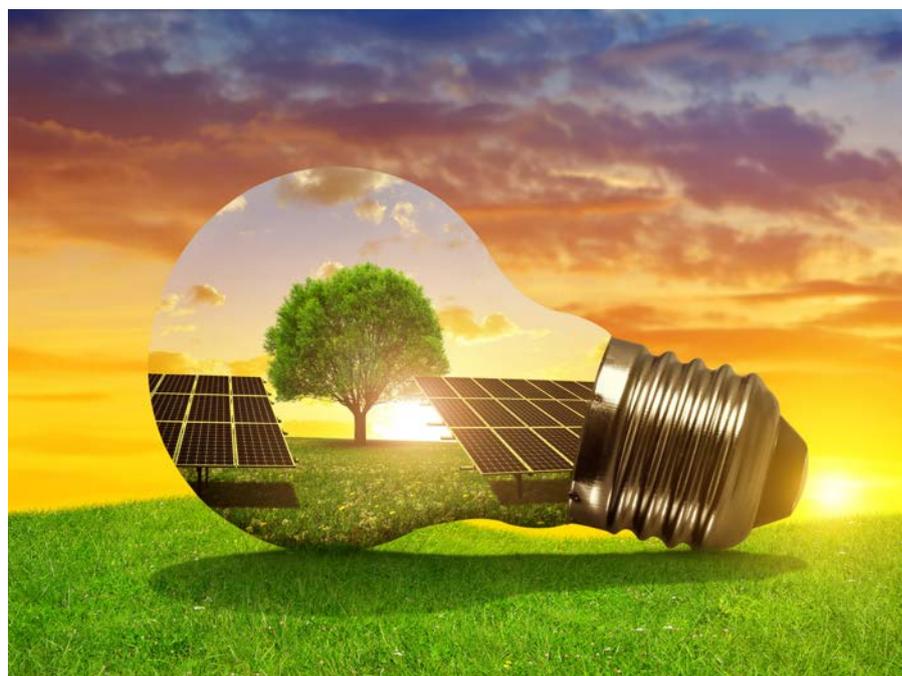
The Brussels-based [SolarPower Europe](#) pressure group believes that of all the oil majors, France's **Total (EPA:FP)** is on course to become the "green giant" of the future. In fact, Total was a founding member of SolarPower Europe back in 1985.

Total acquired SunPower back in 2011 (see panel) and recently announced that it wants to be one of the top three solar players by early next decade. There are rumours that it has been pushing for the French government to promote solar energy. Recently the French government announced its target to triple solar panel capacity in France by 2022. This could make France the leading solar power generator in Europe, overtaking Germany.

## Wind turbines

Two key issues in the wind turbine sector are the transmission of electricity produced from typically offshore

**“OF ALL THE OIL MAJORS, FRANCE’S TOTAL (EPA:FP) IS ON COURSE TO BECOME THE ‘GREEN GIANT’ OF THE FUTURE.”**



**“WHILE ONE CAN IMAGINE THAT THE OIL MAJORS WILL BECOME ACTIVE PLAYERS IN THE RENEWABLES MARKETS, THE BARRIERS TO ENTRY TO THE NUCLEAR ENERGY INDUSTRY MAY BE TOO HUGE EVEN FOR THEM.”**



installations to the grid, and storage. Progress in the design of battery storage systems continues apace.

There is now a global race to develop flotillas of wind turbines that can be rolled out in deep oceans and thus catch the strongest winds on the planet. Conventional offshore wind turbines, standing on concrete and steel foundations driven into the ocean floor, flounder in depths of more than about 40 metres. The new generation of floating windfarms are more robust and can be used in countries like Portugal and Japan where the seabed plunges steeply offshore.

In the UK, home to some of the world's strongest winds and already hosting the most offshore windfarms, floating turbines are about to arrive at **Statoil's** Hywind installation off the Scottish coast (see panel).

## Nuclear power

Proponents of nuclear power argue that it is the cleanest and most reliable way to generate electricity on a massive scale. What the original proponents of the 1950s did not know, but which is critical for contemporary ad-

vocates, is that nuclear power generation uses no fossil fuels and produces zero CO<sub>2</sub> emissions.

Some climate gurus like Professor James Lovelock (still happily with us aged 97) and [Mark Lynas](#) have changed their minds on the issue and are now strong advocates of nuclear power. Mr Lynas believes that that while renewables will surely play an important part in our future energy strategy, relying on renewables to deliver the world's future power needs is "dangerously delusional".

Opponents of nuclear power emphasise its dangers. There are two aspects to this. The first is the issue of what to do with nuclear waste – the radioactive material left over when nuclear reactors are upgraded. The second is the fact that, supposedly, nuclear facilities are prone to accidents with devastating consequences – the most recent being at the Fukushima plant in Japan after the earthquake and tsunami of 2011.

We have now had nearly 70 years to solve the nuclear waste problem, but it is still a source of controversy. Companies like British Nuclear Fuels Limited (BNFL), which was liquidated in 2009

partly because of its notoriety, developed highly sophisticated technologies to dispose of nuclear waste. The issue is sensitive because people naturally do not like the idea of radioactive material being stowed away near where they live, which will remain a threat to human and animal health for potentially thousands of years to come. Even in France, where nuclear power has widespread public support, there have been violent protests against the disposal of radioactive canisters in underground caverns near the town of Bédarieux in the *Parc Naturel du Haut Languedoc*.

The basic approach to the treatment of high level nuclear waste such as spent fuel rods is to transport it, treat it and vitrify it – that is, encase it in glass. The glass canisters are then sealed inside steel cylinders which are in turn enveloped in concrete. The material is then buried in deep final repositories – often boreholes in geologically stable areas.

In terms of nuclear accidents, there have actually been very few over the last sixty years or so, but when they have occurred they have been devastating. Three Mile Island (Pennsylvania, 1979), Chernobyl (Ukraine, 1986)

## Four oil majors transitioning from black to green

**Royal Dutch Shell (LON:RDSA)**, Europe's largest oil company, has established a separate division, *New Energies*, to invest in renewable and low-carbon power. This new division brings together its existing hydrogen, biofuels and electrical activities but will also be used as a base for a new drive into wind power. With US\$1.7 billion of capital investment currently allocated and a budgeted annual capital expenditure of US\$200 million, *New Energies* will be run alongside the Integrated Gas Division under executive board member Maarten Wetselaar. Last April, the group and its partners made a bid to build two windfarms off the coast of the Netherlands that could generate enough electricity to power 825,000 households. Bear in mind that the division's annual expenditure is less than one percent of the total US\$30 billion that the Anglo-Dutch group spends on oil and gas. Moreover, Shell used to have a major solar panel business but this was scaled down several years ago. Shell still has a stake in the Japanese diversified energy company **Showa Shell Sekiyu (TYO:5002)** but has no solar interests in Europe at present.

**Total (EPA:FP)** of France, which already has its own *New Energies* divi-

sion, boasts that it is the world's second-ranked solar energy operator as a result of its acquisition of a 60 percent stake in **SunPower Corporation (NASDAQ:SPWR)** of the USA for US\$1.38 billion in April 2011. Total then announced in May last year that it planned to spend nearly €1 billion on buying the veteran battery manufacturer **Saft**, a world leader in battery technology. Chairman and chief executive Patrick Pouyanné said the deal would "allow us to complement our portfolio with electricity storage solutions, a key component of the future growth of renewable energy". Monsieur Pouyanné said in April last year that electricity would be "the energy of the 21st century" and that he wanted his company to take advantage of the entire electricity value chain, including batteries, solar power and biogas generation. Total announced last year that it was spending €200 million on transforming an unprofitable oil refinery near Dunkirk into a biofuel plant. The company plans to invest \$500 million this year in renewables.

**Statoil (STO:STLO)** last year outlined plans to spend €1.2 billion in partnership with Germany's **E.ON (ETR:EOAN)** on the German Arkona windfarm in the Baltic sea. "This investment is in line with our strategy to gradually complement our oil and gas portfolio with profitable renewable energy and other low-carbon

solutions," said Eldar Sætre, Statoil's President and CEO. Last year Statoil was granted a seabed lease that will allow it to build the world's largest floating windfarm, Hywind, 15 miles off the coast of Peterhead, Scotland. This is expected to be operational by the end of this year. A new battery storage solution for offshore wind energy will be piloted from the same project. Statoil has followed the trend and established a *New Energy* division for wind power and carbon capture and storage. The Norwegian state operator has also established a new fund, **Statoil Energy Ventures**, which will invest up to US\$200 million over the next seven years<sup>vii</sup>.

**Exxon Mobil Corporation (NYSE:XOM)**, often dismissed by climate change activists as the arch villain of the oil industry, is going green. Last October the giant unveiled plans to investigate carbon capture and storage more fully in a joint venture with **FuelCell Energy, Inc. (NASDAQ:FCEL)**<sup>viii</sup>. They have identified a location to test an innovative fuel cell carbon capture technology. The James M. Barry Electric Generating Station, a 2.7 gigawatt mixed-use coal and gas-fired power plant operated by **Southern Company (NYSE:SO)** subsidiary Alabama Power, will host the tests. The technology uses carbonate fuel cells to concentrate and capture carbon dioxide streams from power plants.

and Fukushima (Japan 2011, operated by **Tokyo Electric Power Company (TKY:9501)**) are names that conjure fear.

Despite this, in the very year of the Fukushima accident, **Total (EPA:FP)** invested in nuclear energy, acquiring an 8.33 percent stake in the consortium commissioned to develop the European pressurized reactor project in Penly, France, with **EDF (EPA:EDF)** and GDF Suez (now known as **Engie SA (EPA:ENGI)**).

While one can imagine that the oil majors will become active players in the renewables markets, the barriers to entry to the nuclear energy industry may be too huge even for them,

at least without collaboration with existing players. And the recent travails of **Toshiba Corporation (TKY:6502)**, attributed largely to the failings in its **Westinghouse** nuclear power division, are a reminder that the economics of the nuclear industry can be highly uncertain.

## The climate question

The world economy will continue to electrify, with nearly two-thirds of the increase in global energy going into the power sector. In BP's base case scenario, carbon emissions from total energy production will grow at less than a third of the rate of the past 20 years, reflecting gains in energy efficiency and the changing fuel mix.

But emissions overall will still continue to rise, even though much slower than in the recent past. The stated objective of the **Paris Agreement of Climate Change**, signed in April last year, was to stabilise carbon emissions "as soon as possible" so as to cap global warming at 1.5-2.0 degrees centigrade above pre-industrial levels. On the basis of BP's *Energy Outlook* this is unlikely to happen.

That means that the concentration of carbon dioxide in the atmosphere will continue to rise to unprecedented levels. If standard current climate change science is correct (which is debatable) then we are still in trouble, whether oil companies diversify into renewables or not.





## Carbon capture and storage (CCS)

The idea that carbon emissions could be capped, and even reduced, if only we could capture and store the carbon dioxide generated in the combustion of fossil fuels has been around for some time. But it has proven difficult to translate the theory into a practical technology which is economically viable.

There are currently numerous pilot projects in operation around the world. Here in the UK Doosan Babcock has modified their Clean Combustion

Test Facility (CCTF) in Renfrew, Scotland to create the largest *Oxyfuel* test facility currently in the world.

The IPCC estimates that effective CCS could mitigate between 10 and 55 percent of total carbon emissions between now and 2100. CCS could be the game-changer in the battle against climate change. Any oil major which can crack this could sweep the board. We shall maintain a close watch on this space.

## Conclusions

BP's latest *Energy Outlook* implies that oil prices are likely to remain subdued

for the foreseeable future. The most profitable companies will be those with significant US shale assets. Oil companies will respond by diversifying further into renewables. Given the abundance of known reserves and the need to focus on low-cost fields, the outlook for oil exploration companies is uninspiring.

## Action

The oil business will be around for many years to come. A mature industry, nearly all of the oil majors pay decent dividends, so most of the return on oil stocks will continue to come in the form of income rather than capital gain. That said, if you want to allocate to the oil sector you should give preference to those oil majors which have demonstrated a clear strategy of diversification into renewables (of which I have highlighted just four – see panel). The French oil giant **Total SA** stands out. You should also prefer those majors with significant shale oil assets (such as **Statoil**) to those with exclusively offshore operations in the North Sea and West Africa.

Additionally, you may wish to allocate to renewables players. Not only is this a rapidly expanding business sector but there is now the prospect that independent solar and wind energy manufacturers and operators will be taken over in time by one or other of the oil majors. Check out the **Power Shares Wilder Hill Clean Energy ETF (NYSEARCA:PBW)**. This was the first renewable energy ETF to launch. Caution is required, however, as renewable energy ETFs can be expensive. There are more renewable energy ETFs listed at [ETF.com](http://ETF.com).

- i See chart at: <http://www.macrotrends.net/1369/crude-oil-price-history-chart>
- ii See: <https://knoema.com/vyronoe/cost-of-oil-production-by-country>
- iii See: <https://www.bloomberg.com/news/articles/2016-07-26/bp-profit-drops-45-on-lower-crude-oil-prices-misses-estimates>
- iv Download at: <http://www.bp.com/en/global/corporate/energy-economics/energy-outlook.html>
- v See Financial Times, 13/07/2016 available at: <https://www.ft.com/content/0a7a817a-4863-11e6-8d68-72e9211e86ab>
- vi See: <https://www.theguardian.com/environment/2017/jan/06/china-cementing-global-dominance-of-renewable-energy-and-technology>
- vii See: <https://www.theguardian.com/business/2016/may/21/oil-majors-investments-renewable-energy-solar-wind>
- viii See: <http://news.exxonmobil.com/press-release/fuelcell-energy-and-exxonmobil-announce-location-fuel-cell-carbon-capture-pilot-plant>

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# THE FUTURE OF MONEY MANAGEMENT

## AN INTERVIEW WITH ETORO

**There are a lot of trading platforms out there, but few are as innovative as eToro. We caught up with them to gain a better insight into how they operate...**

**Master Investor:** Your trading platform is run on a similar ethos to our publishing and events platform. We give our readers access to "Master Investors"; you give your followers access to "guru traders" who you call "Popular Investors". Please explain to us what eToro is all about?

**eToro:** As the world's leading social trading network, eToro is helping to democratise the financial markets by allowing people to take control of their finances. With offices in London's Canary Wharf, and regulated by the FCA, our six million clients are able to communicate, follow and automatically copy the trades of one another to harness the wisdom and share the success of others. We encourage responsible trading, and reward our successful traders by giving them the option to join our highly rewarding Popular Investor programme. The programme pays the client every month according to how either many people are copying them, or the total amount invested in copying them

**MI:** Are there any studies that compare the performance of copy traders to those traders who perform their investing manually?

**eT:** On our intuitive platform, clients are able to trade CFDs on over 1,200

instruments alongside copying our leading Popular Investors and investing in our new CopyFunds. We have seen 80% of all copied trades close in profit, and throughout 2016 over 62% of our Popular Investors yielded a positive result. Soon after launching CopyTrading, research was conducted by the Massachusetts Institute of Technology (MIT) Media Lab that proves, that with guidance on who to copy at eToro, traders can earn 6-10% more than trading independently.

**“WE HAVE SEEN 80% OF ALL COPIED TRADES CLOSE IN PROFIT, AND THROUGHOUT 2016 OVER 62% OF OUR POPULAR INVESTORS YIELDED A POSITIVE RESULT.”**

**MI:** Which investments and asset classes are available on eToro?

**eT:** Our customers can trade CFD stocks, currencies (including digital cryptocurrencies like Bitcoin and Ethereum), commodities, indices and ETFs. Furthermore, in Q4 of 2016, we launched our next generation investment product – CopyFunds™, which enables eToro

customers to trade CFDs on a range of specially created, themed funds such as technology, banking and our top traders. eToro's BigTech CopyFund has to date provided over 20% growth.

**MI:** How does your fee structure work and can you offer better value for money than other trading platforms?

**eT:** Comparing us to other platforms is like comparing apples to highly advanced, futuristic, tech powered oranges! We offer manual trading in a variety of asset classes that are expanding on a regular basis. We offer CopyTrading, enabling people to copy other traders, and our CopyFunds provide a medium to long-term investment strategy. In addition to all this, we operate a social investment network enabling any of our members to interact with each other, exchange tips, discuss strategies and share their trading portfolio. So in terms of better value for money than other trading platforms, we offer far more than anyone else can offer.

**MI:** Do you see eToro as a platform that gives investors access to tools and information that, previously, only professional and institutional investors would have had access to?

**eT:** eToro offers every trader and investor

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**“AS THE WORLD’S  
LEADING SOCIAL  
TRADING NETWORK,  
ETORO IS HELPING  
TO DEMOCRATISE  
THE FINANCIAL  
MARKETS.”**

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powerful and innovative financial tools to simplify the experience of trading in the financial markets. Furthermore, we create the ability for any non-financially-savvy individual to learn and benefit from seeing how other, more knowledgeable clients operate. Portfolios can be viewed or followed without any fee or limitation.

**MI:** It appears that you have put a lot of effort into making your website easy to use, but also transparent. Does it help you attract clients that did not previously invest into shares but are using eToro to learn how to take charge of their financial destiny?

**eT:** Transparency and simplicity are some of our core company values. Our website and all of our products are designed to reflect this. Opening up the financial markets and simplifying access to them is what we are all about.

**MI:** Your community has grown incredibly quickly over the past few years. You already have over 6m clients who have executed over 200m trades. How can investors join the community, what are the steps and requirements?

**eT:** We have experienced tremendous year-on-year growth and now have clients in over 140 countries, and offices around the world. Joining our community requires only a simple and quick sign up process, with no initial or monthly cost. Additionally, we provide a free virtual money portfolio so clients are able to experience the platform before making a decision on whether to deposit funds.

**MI:** For those of your clients who manage to become a "Popular Investor", what additional financial benefits can they enjoy? Can you name one or two concrete examples of investors who have managed to attain this status and how much they earned?

**eT:** The idea behind the Popular Investor programme is firstly to reward clients who are being copied by other people. It's important to note that we don't charge performance or success fees to the copiers and we don't pay Popular Investors based on the commissions generated by their copiers. We do this intentionally to avoid a situation where we are incentivis-

**“ONE OF OUR MOST SUCCESSFUL ELITE POPULAR INVESTORS STARTED HIS JOURNEY WITH ETORO AS A COPIER, LEARNING THE ROPES UNTIL HE DECIDED TO TRADE FOR HIMSELF.”**

**eToro** Introduces CopyFunds™  
The Next Generation Investment Product

ing them to trade for the sake of generating commissions, rather than responsible trading opportunities that arise in the markets.

The programme consists of four levels, starting at Cadet and ending at Elite. There is no maximum monthly payment amount, although the first levels are paid a fixed monthly amount. At the top level, Elite, they receive a 100% spread rebate, and they are paid a monthly payment from 2% of their annual AUM. In addition, they receive a fixed monthly payment of \$1,000. An Elite Popular Investor who closes the month with \$5,000,000 AUM for example, is paid \$8,333 for that month from their AUM, plus a \$1,000 fixed payment plus the spread rebate covering the previous month's trading costs.

One of our most successful Elite Popular Investors started his journey with eToro as a copier, learning the ropes until he decided to trade for himself.

**MI:** Trading is, of course, risky. Does eToro offer any support or education in managing risks?

**eT:** Reducing the risks associated with trading is extremely important to us which is why we have created tools and literature to manage this for all our clients.

For manual traders, we have, by default, relatively low leverage settings and measure their risk by an in-house developed risk scoring system. All clients can monitor their own current and historical risk score on their public portfolio, representing how much of their equity is exposed to volatility.

It's especially important that our Popular

Investors are required to trade with consideration and extra responsibility at all times, due to the fact that other people are copying them. High risk traders cannot be copied at all. Whilst, copiers of low to medium risk traders, who become high risk, will receive notifications and warnings from us informing them that they may wish to consider copying someone else.

Furthermore, when copying, you can set what we call a 'Copy Stop Loss' enabling you to automatically stop copying someone, should their drawdown reach the value you set.

**MI:** Last question, what other innovation does eToro have in the pipeline – is there anything you can give us a sneak preview of?

**eT:** We have had some impressive performance with our own CopyFunds since inception. Recently we have started to team up with external institutional partners to create Partner CopyFunds, which are based on the partner's own investment portfolios or strategies. We have more and more Partner CopyFunds in the pipeline.

With eToro, we are constantly innovating, improving and releasing new tools and features, so to give a sneak preview of what's in the pipeline would require far more space! The best tip is to register an account with us, explore our system, tune in for our regular updates and experience the most innovative and intuitive investment environment there is.

Learn more about eToro's CopyFunds by visiting [www.etero.com/copyfunds](http://www.etero.com/copyfunds)

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BY NICK SUDBURY

## FUNDS IN FOCUS

# A CONTRARIAN APPROACH

**The stock market is driven by investor sentiment with share prices often trading nowhere near their true fundamental value. One way to take advantage of this is to adopt a contrarian strategy and look for out-of-favour companies with the potential to turn things around.**

Those who rely on this approach use various techniques to identify stocks where they have a high degree of conviction that the market has got it badly wrong. They then open a position and wait for the shares to be re-rated.

This sort of strategy requires a lot of courage because it means going against the herd and having enough faith in your stock picking skills to maintain the investment until the market proves you right.

The contrarian approach is most closely associated with value investors who put together a concentrated portfolio of stocks that are trading at a significant discount to their intrinsic net worth.

Its efficacy is supported by highly regarded academic research including the seminal paper, 'Does the Stock Market Overreact?' This was written in 1985 by Werner F M De Bondt and Richard Thaler, and clearly shows that portfolios of underperforming shares often go on to significantly outperform the markets.

### Leading the way

One of the men who used this technique to good effect was Anthony Bolton, who ran the Fidelity Special Situations fund for 28 years until 2007. Over that period he generated annual returns of almost 19.5%, well ahead of the market, although he struggled when he applied the same technique to the Chinese stock market in his China Special Situations investment trust.

Bolton was a contrarian investor who looked for unloved stocks and then conducted extensive fundamental research into their business model and prospects. He tended to favour overlooked smaller companies or turnaround situations where the market had been slow to price in the recovery potential.

One of the main reasons for his success was that he was disciplined enough to stick to his guns, most notably during the dotcom bubble of the late 1990s when he avoided the tech stocks as they were bid up to ridiculous valuations. This meant

that investors in his fund missed out on the huge returns, but they were also able to avoid the worst of the fallout when the bubble burst in the year 2000.

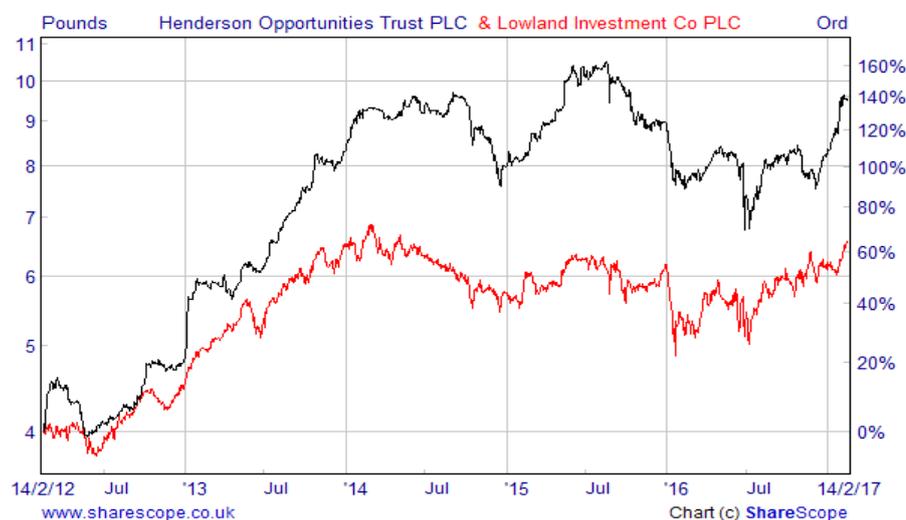
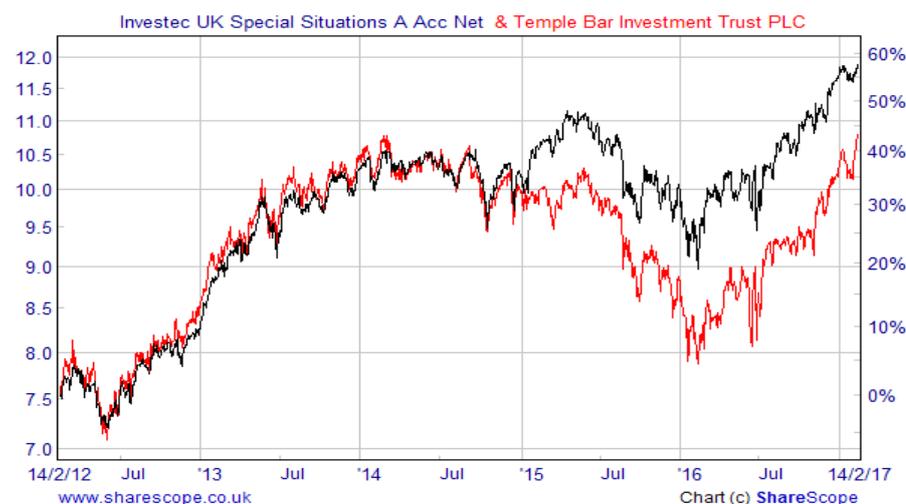
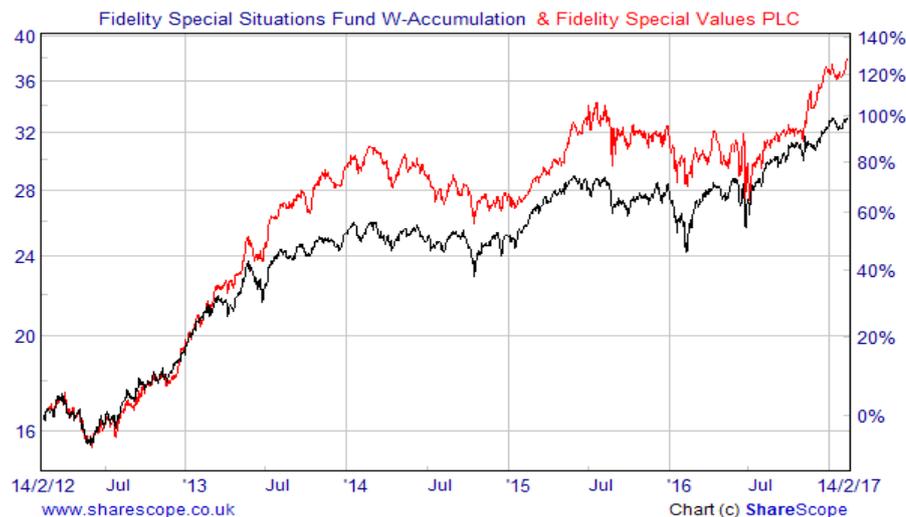
### Safe pair of hands

Fidelity Special Situations is now in the safe hands of another contrarian investor, Alex Wright, who also manages the **Fidelity Special Values (LON:FSV)** investment trust. Both are top quartile performers with five-year returns of 99.3% and 150.9% respectively.

Wright looks for unloved companies where he believes the market has overlooked the potential for recovery with a key part of his strategy being to understand the potential downside risk. This helps him to avoid value traps that have been written down for a good reason.

The Fidelity Special Situations fund has almost £3bn of assets under management and mainly invests in large, mid and small cap UK companies, although it can also take ad-





vantage of overseas opportunities and currently has 13.3% in US-listed stocks. It is quite a concentrated portfolio with the 50 largest positions accounting for 94.3% of the assets.

The geographic allocation and largest positions are very similar to his £615m Fidelity Special Values investment trust. This suffered as a result of its small and mid-cap bias after the Brexit

vote, but has rebounded strongly and is one of the Winterflood Investment Trust team's recommendations for 2017.

### A refined approach

Alastair Mundy who runs the Investec UK Special Situations fund and the **Temple Bar investment trust (LON:TMPL)** is another respected con-

trarian investor who has developed his own unique strategy.

Mundy uses a bottom-up stock selection process to invest in out-of-favour companies with strong balance sheets. These will usually be FTSE 350 stocks and must have fallen by at least 50% in the last five years relative to the market to be considered for inclusion. His funds have concentrated portfolios as not many companies will qualify, with each constituent typically held for four to five years to give them the maximum possible chance to recover.

The £859m Temple Bar investment trust holds 45 shares and four bonds with the 10 largest positions accounting for just over half of the assets. These include companies such as HSBC, Glaxo, Royal Dutch Shell, BP, Barclays, Lloyds and Tesco. Over the last five years the shares have returned 71%, which makes it a midtable performer. The £1.1bn Investec UK Special Situations fund has a very similar portfolio and is also ranked in the middle of its sector over five years with a gain of 63.6%.

### If the name fits

Another manager that falls into this category is James Henderson of Henderson Global Investors, who runs the Lowland and Henderson Opportunities investment trusts, as well as the Henderson UK Equity Income & Growth fund.

Like all the other contrarian managers he will always check to see if a share deserves to be cheap or if it is a good business that can overcome the problems that have affected its valuation. Ideally he also likes the companies to have strong barriers to competition such as a popular brand.

The £76m **Henderson Opportunities Trust (LON:HOT)** aims to achieve higher than average growth over the medium to long-term from a portfolio comprised of mainly UK companies. At the end of December there were a total of 89 holdings including large caps like HSBC and Rio Tinto, as well as various mid and small cap names.

His £399m **Lowland Investment Company (LON:LWI)** has a similar mandate, albeit with a greater focus on income. The portfolio is more di-

verified with 118 separate positions and the 10 largest are mainly blue chip stocks such as Royal Dutch Shell, HSBC, Prudential and Standard Chartered. It is very similar to his £490m UK Equity Income and Growth fund and shares many of the biggest holdings.

HOT and LWI are top quartile performers in their sectors over five years with share price returns of 156.5% and 90.4%. Despite this they are trading at a discount to NAV of 16.1% and 4.4% respectively.

## Turning Japanese

It is also possible to find contrarian managers operating in other markets with a good example being Stephen Harker who runs the Man GLG Japan CoreAlpha fund. He believes in mean reversion and has a deep value approach to investing in Japan's most out-of-favour companies.

Harker's £1.5bn fund has a relatively concentrated portfolio with the top 10 holdings accounting for 48.5% of the assets. It mostly invests in large cap stocks with the main overweights being the banks and iron & steel, whereas the largest underweight is the information and communication sector.

Over the five years to the end of December Man GLG Japan CoreAlpha returned 112% versus a sector average of 88%. This meant that it was ranked fifth out of its 46-strong peer group and was a first quartile performer.

It is worth bearing in mind that all contrarian funds have the potential to lag behind the market for long periods of time as it is impossible to accurately determine when an out-of-favour stock will stop falling in value. As long as the manager is able to identify enough companies that are able to successfully turn things round, they should ultimately deliver better long-term performance.

## Fund of funds

The contrarian approach is ideally suited to a fund-of-funds manager who is willing to target out-of-favour investment trusts, as these often trade at substantial discounts to their underlying net asset values. A prime example is Nick Greenwood who runs

**“CONTRARIAN FUNDS HAVE THE POTENTIAL TO LAG BEHIND THE MARKET FOR LONG PERIODS OF TIME AS IT IS IMPOSSIBLE TO ACCURATELY DETERMINE WHEN AN OUT-OF-FAVOUR STOCK WILL STOP FALLING IN VALUE.”**



the Miton Global Opportunities trust (MIGO) as well as its open-ended equivalent, the CF Miton Worldwide Opportunities fund.

Greenwood uses a common sense approach to invest in a range of uncorrelated, top down global themes, whilst benefiting from the market inefficiencies commonly found among investment trusts. This enables him to profit from improvements in investor sentiment via the narrowing of the discounts.

The top ten holdings in the £56m Miton Global Opportunities trust make up just over half of the assets. These include the India Capital Growth fund, Taliesin Property, EPE Special Opportu-

nities and AP Alternative Assets. Almost all of the assets are held in the largest 30 holdings, although the final 3% is divided between another 19 funds.

MIGO aims to outperform the three month LIBOR rate plus 2% per annum over the longer term with the share price return of 76% in the last five years making it a top quartile performer. It has ongoing charges of 1.16% and is trading on a discount to NAV of 6%.

The CF Miton Worldwide Opportunities fund is much smaller with total assets of £15.5m, but provides exposure to a similar portfolio. Over the last five years it has returned 68%, which makes it a top quartile performer in the Flexible Investment sector.





BY FILIPE R. COSTA

## THE MACRO INVESTOR

# MAKING MEXICO GREAT AGAIN

*"The dishonest media does not report that any money spent on building the great wall (for sake of speed), will be paid by Mexico later."*

- Donald Trump, [Twitter](#) (@realDonaldTrump), January 6 2017

### Globalisation: The enemy?

During his campaign, Donald Trump directed a fierce attack on free trade, globalisation and immigration, blaming these forces for sluggish economic growth and the loss of American jobs. Trump argued that most trade deals have resulted in trade flows unfavourable to the US, and have contributed towards the country's large trade deficit and a loss of competitiveness. Mexico has been the central target of Trump's anger, as it is a country he deems responsible for a rise in crime (due to illegal immigration) and a loss of jobs (due to trade imbalances) in the US.

While many thought that, upon becoming President, Trump would concentrate his efforts on pursuing his promised infrastructure spending and tax reforms, the truth is that next to nothing has been achieved on that front. Instead, he's scrapped the Pacific trade deal and insists on

building a wall along the US's border with Mexico. At the same time, the Nafta deal appears to be up in the air, and tensions between Trump and Enrique Peña Nieto (the President of Mexico) have intensified over the last few weeks, with a meeting between the two having been cancelled.

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**“WITH MEXICAN EXPORTS TO THE U.S. AMOUNTING TO \$294 BILLION A YEAR – 80% OF THE COUNTRY’S TOTAL EXPORTS – INVESTORS HAVE REASON TO BE WORRIED ABOUT THE FUTURE FOR MEXICO.”**

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With Mexican exports to the US amounting to \$294 billion a year – 80% of the country's total exports – investors have reason to be worried about the future for Mexico, as any sudden rise in trade tariffs could derail the export-driven Mexican economy. As a result, the dollar is up 11% against the peso since 8 November (the day when Donald Trump was elected) and Mexican equities are down 13% in the same period (as measured by the iShares Mexico ETF). Conversely, boosted by a rise in commodity prices and by some positive externalities stemming from Trump's expected fiscal shock, many emerging markets have been doing rather well. Nevertheless, this is not the case with Mexico, which seems to be on the verge of collapse after becoming the target of some of Trump's uglier threats.

But although some of the negativity may be justified by the risks, the harm Trump can inflict on the Mexican economy may have been over-

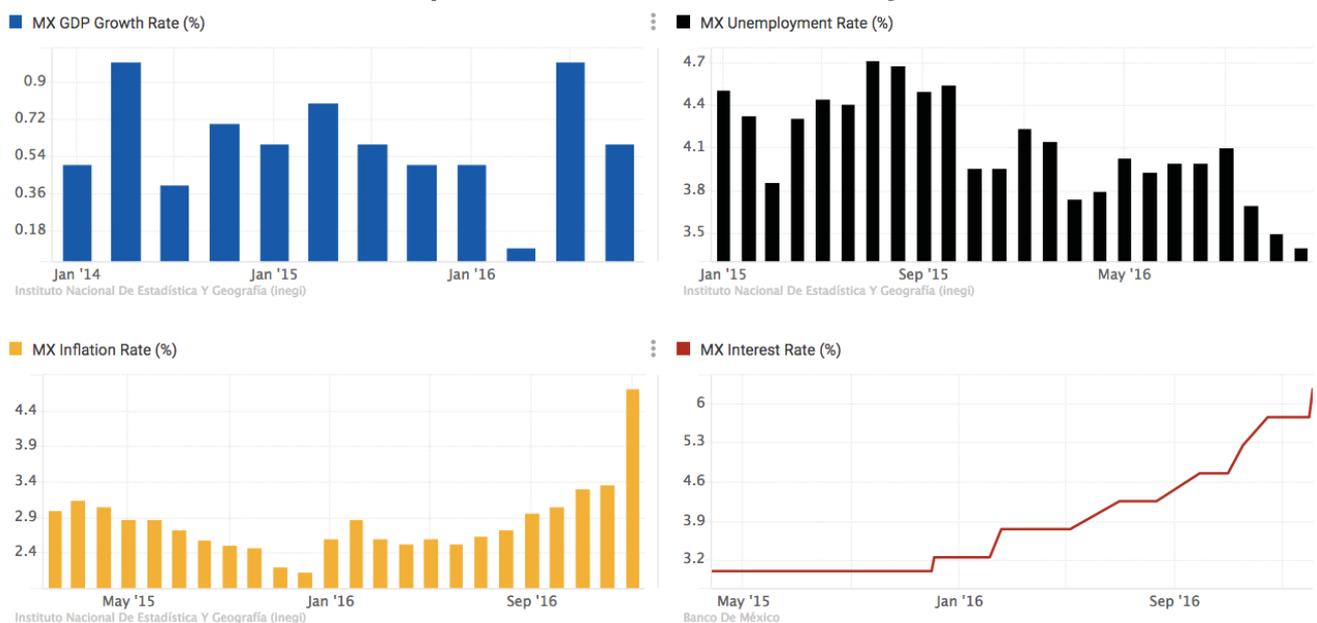
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**“A BATTERED  
DOWN MEXICO  
SEEMS LIKE  
A BASIS  
FOR A GOOD  
INVESTMENT  
OPPORTUNITY.”**

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## Snapshot of the Mexican Economy



Source: iEconomics

hyped by the media. From the perspective of value investing, it is at times like this that the best opportunities arise. For a country that took more than 20 years to become a large exporter of things it didn't even produce before the Nafta agreement, it stands to reason that it may take more than a single four-year term to reverse it all. At the same time, economic theory doesn't validate the idea that blocking imports from Mexico could contribute to any improvement in the US economy. All the facts must be carefully weighed by investors, but a battered down Mexico seems like a basis for a good investment opportunity.

### 'One-sided' trade deals

Donald Trump has often justified the scrapping of trade deals through arguing they are "one-sided" agreements, reaping benefits for all parties involved but the US. But there is no such thing as a one-sided trade deal, because for a country to become an importer of something, another country must become an exporter, and vice versa. Provided that trade occurs by the free will of the parties involved, it is reasonable to assume that a country imports something because it can't produce it in a more efficient way. In that sense, both parties should benefit from the trade.

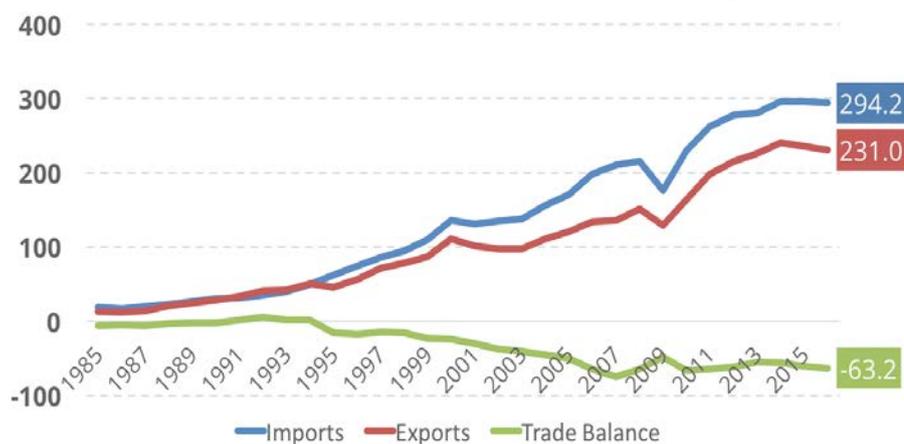
Before 1994, when Bill Clinton signed the Nafta agreement that connected



the US, Canada and Mexico, trade amongst the respective countries was relatively low. At the time, Mexico was running trade deficits with the US. But in 1995 the trend inverted and Mexico has run trade surpluses ever since. Because of the lower labour costs, Mexico became a target for American capital and the country was turned into a large exporter of automobiles,

electronics and appliances. From \$49.5 billion exported in 1994, exports rose to \$294.2 billion in 2016 and a trade deficit of \$1.3 billion was turned into a surplus of \$63.2 billion. Mexico made major progress in the automobiles industry, attracting Ford and GM from the US to build their new plants in Mexico, where they had access to lower production costs, not only in terms of labour but

U.S Trade With Mexico (in \$ billions)



also in terms of rents and building materials. US-owned companies and their affiliates employed 1.3 million Mexicans in 2015, generating \$253 billion in sales. Mexican companies in the US employed a more modest figure around 78,000, with sales of \$32.8 billion.

The ascent of the US economy and that of the dollar as a reserve currency are at the root of the globalisation movement. Money was accumulated in the US waiting for a passport to flow freely across the globe and seek out better opportunities than were available in the US. Mexico, a US neighbour where labour costs were very low, was an obvious target for this money. A trade deal between the two countries would pave the way for US companies to relocate their manufacturing to Mexico, and thus reduce their production costs. They could then export the final product back to the US, and at much lower prices than before.

When the trade deal was arranged, the US had much more to gain than Mexico. But even in the case where a trade deal results in what Trump refers to as a one-sided deal (in the sense of leading to trade deficits year after year), there may still be gains for both parties. From the perspective of Mexico, the country is able to reduce unemployment and increase production. Resources that were wasted are now employed, helping to increase the country's wealth. From the perspective of the US, the country is able to free up resources and allocate them to more efficient uses, because it now has access to the same final product at much lower prices. Trump has blamed companies like Ford and GM for investing in Mexico, and has promised a war on companies investing outside America. In the case of Ford, for example, it appears Trump's threats have had some effect, as the company recently retreated from its plans to invest \$1.6 billion in a new plant in Mexico, prom-

**“CONTRARY TO TRUMP’S PROMISES, IT IS NOT MEXICO THAT WILL PAY FOR THE GREAT WALL, BUT RATHER THE U.S. CONSUMER.”**

ising to instead invest \$700 million in Michigan. But the main question is *Will it benefit the US?*

Assessing trade deals based on trade deficits is short-sighted. In the specific setting of the automobile industry, which has been massively relocated from the US to Mexico over the last 20 years, the Nafta deal means that automobile parts that were made in Michigan are now being assembled in Monterrey. Undoubtedly, job gains have been made in Monterrey at the expense of job losses in Michigan. But then automobiles produced in Monterrey return to the US as a final product at much cheaper prices. The US consumer will purchase the same automobiles with less money, freeing up purchasing power to spend elsewhere. Demand for other products increases and job creation follows.

Overall, there is a reallocation of resources, which should result in productivity gains and a more efficient use of resources. Ultimately, each country ends up producing whatever it does better and cheaper. Even were the US to sell nothing to Mexico in return



## “IT SEEMS LIKELY THAT TRUMP WILL U-TURN REGARDING NAFTA, IF HE OR HIS ADVISERS HAVE ANY SENSE.”

for what it imports, both could gain from the trade, because the gains for the US would be reflected elsewhere in the trade with other countries, as the resources liberated from inefficient automobile production would be reallocated to increased production within more efficient industries. Ultimately, the Nafta deal should lead to an increase of the combined GDP of all countries involved.

### There are no winners from protectionism, only losers

Trump has been insisting on creating a new tariff on imports from Mexico in order to rebalance trade and to pay for the 'great wall' he promised to build during his campaign. But, being a tax on prices, a tariff increases the final price paid by consumers and will mainly be paid by consumers (or at least shared between consumers and retailers). Contrary to Trump's promises, it is not Mexico that will pay for the great wall, but rather the US consumer, in the form of higher prices on the finished goods purchased. Any other attempt to dent the trade deal will result in pretty much the same – higher prices for the American consumer and a waste of valuable resources. Sooner or later, such measures would result in a decline in living standards in the US. Jobs are unlikely to be created as a consequence of such a measure.

Meanwhile, the exchange rate between the dollar and the peso will act as a security valve. The peso has already declined due to expectations of trade deterioration between both countries, and the trend will continue if Trump scraps the trade deal. Ironically, a lower peso helps to increase exports and decrease imports, lowers wages in dollar terms and increases the appeal of Mexico for US companies.

The recent acrimony between the US and Mexico can only lead to more illegal immigration, a loss in production efficiency, and rising security issues – all at a time when net migration from

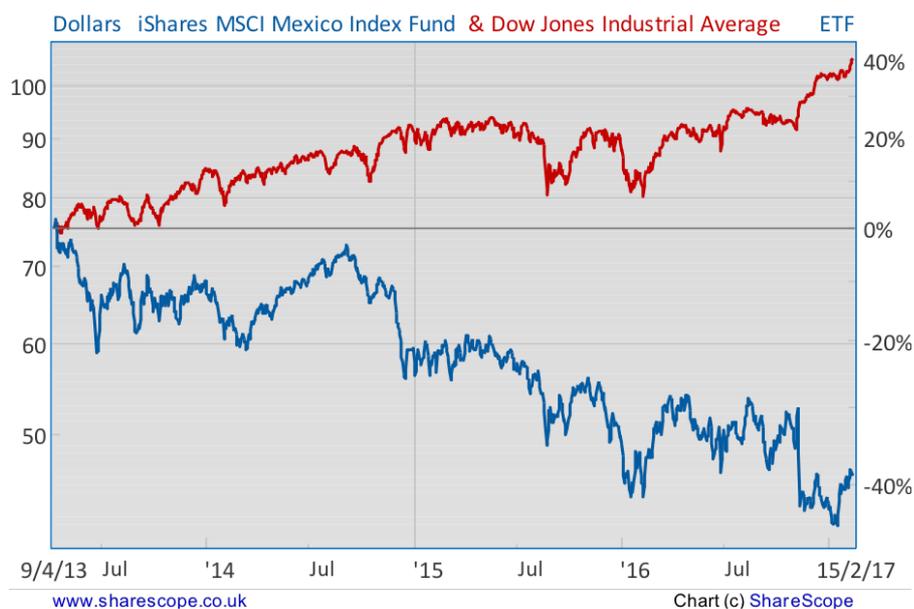
Mexico to the US is negative. Academic studies all conclude that Nafta provides benefits to all countries involved and statistics show that crime has been declining and has little connection with migration.

### An investment opportunity arises

Putting it all together, it seems likely that Trump will u-turn regarding Nafta, if he or his advisers have any sense. Even if he doesn't, Mexico has the resources it needs to continue to attract foreign investment. At the same time, Nieto's government has been implementing some substantive structural reforms which aim to offset wealth differences between the north

and the south of the country and open up sectors like telecommunications, oil, and the digital economy to private capital. New opportunities are arising for foreign investors.

The **iShares MSCI Mexico ETF (EWW)** has declined by around 13% since Trump was elected but the trend was ignited in April 2013, mainly due to the structural changes going on in Mexico. Since the latter date, the iShares Mexico ETF has declined 40% while the S&P 500 has risen 40%. Fundamentals don't justify the divergence of the two markets, and the huge gap should be closed over time. At this point the reward prospects seem good enough to justify a long position in the iShares MSCI Mexico ETF or a similar security.



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# HUDDLE CAPITAL

## SHAPING THE FUTURE OF BUSINESS-TO-BUSINESS LENDING

MASTER INVESTOR INTERVIEWS JAY TIKAM, FOUNDER OF HUDDLE CAPITAL

**Huddle Capital is a new business-to-business lending platform that aims to match small to medium-sized (SME) businesses that have excess cash reserves with other SMEs looking for financing.**

**Huddle has chosen the Master Investor Show to exclusively launch the platform. We managed to get hold of Huddle Capital's founder, Jay Tikam, a successful serial entrepreneur based in the City of London...**

**Master Investor:** Jay, the upcoming launch of your new venture, Huddle Capital, will come with quite a splash. The first 100 investors to invest more than £5,000 through your platform will get a £1,000 cash bonus from you. That's quite an incentive! What enables you to offer such a cash bonus?

**Jay Tikram:** Huddle is a subsidiary of Access Commercial Finance, a balance sheet lender founded in 2014. In the space of just two short years, they've built up a sizeable business loan portfolio exceeding £8 million. Huddle is therefore starting out on a strong footing with the backing of its parent company.

Not only does Huddle get capital backing, it's also built on the same success with which Access Commercial Finance has been built. Any startup beginning life with a healthy capital base and with experienced founders has more of a chance for success compared to a firm

that is cash-strapped or has inexperienced founders.

The Huddle 100 club has been made possible by the parent company, and it shows our commitment to the founding investors who back the platform at

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**“THE HUDDLE 100 CLUB HAS BEEN MADE POSSIBLE BY THE PARENT COMPANY, AND IT SHOWS OUR COMMITMENT TO THE FOUNDING INVESTORS WHO BACK THE PLATFORM AT LAUNCH, AND WILL HELP US TO SCALE RAPIDLY.”**

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launch, and will help us to scale rapidly. Any marketplace lender generally has a challenge in attracting borrowers and investors, especially in the early days. Borrower acquisition is a core competence within the group; however, investor acquisition is slightly more challenging. We believe that the significant cash incentive will help us attract experienced investors, who will be re-assured by our commitment to ensuring they benefit by lending through our platform.

**MI:** Your entrepreneurial ambitions come on the back of a long career in banking, insurance, compliance and risk management, and now fintech. Can you give us a brief overview of your career and what brought you into the alternative lending space?

**JT:** In 2013, when Fintech and Alternative Finance just started to emerge, I envisaged a massive transformation about to take place in financial services. Today I

stand by that belief – in five to ten years from now, the financial services landscape will look very different from what it looks like right now. We are at a turning point, and the pioneering Alternative Finance and Fintech entrepreneurs of today are building the JP Morgans and Goldman Sachs of the future.

The disruption in financial services is not accidental. It's being driven by an awakening of consumers. Some were awakened by the financial crisis, coming to a realisation that their bank or insurer or asset manager wasn't really acting in their best interest. Millennials, on the other hand, grew up in an environment where they probably found it very challenging to access financial services. Think

of the Millennial going to apply for their first student loan and being turned down. Then they tried to buy their first car on credit and had to rely on their parents rather than a bank. Now they are struggling to enter the housing market because they don't qualify for a mortgage. This new age consumer wants something different and their traditional financial services providers can't address their specific needs.

UK businesses have equally struggled to access finance in traditional markets. They are fed up of begging banks for a loan. Even if they get a loan, it usually takes months to get it approved and the terms of the loan are often not in their best interest.

Alternative finance providers have recognised the gap and are building businesses that put customers first. Any business that anticipates and delivers on customer needs is going to have a high chance of success. It's no surprise that fintech firms can become \$1 billion unicorns within an average of six years.

**MI: Your company has the backing of another successful entrepreneur. Can you tell us more about him?**

**JT:** Terry Fisher is a driving force and investor behind both Access Commercial Finance (the parent company) and Huddle Capital. Terry is a successful serial entrepreneur, with an impressive track record of achievement.



He founded Travelworld aged 19 and grew it to become the UK's fifth largest travel agent with 123 outlets and £130m turnover. He sold it to Airtours in 1998 and joined their Board to become Managing Director of UKGL Retail, with £1 billion turnover and 1,000 outlets.

After a spell building finance and investment businesses in Spain via Fisher Europa and investing in different businesses in the USA, he was invited to become CEO of Gold Medal Travel Group in 2006, tasked with restoring profitability and preparing it for sale. The firm was sold to Thomas Cook for £86.5 million in 2008, and Terry joined their Board and became CEO of the newly formed Thomas Cook Scheduled Business with P&L responsibility of £1bn.

In 2010, Terry returned to Fisher Europa to continue his entrepreneurial journey.

**MI:** During the initial phase, Huddle Capital will be focused on having businesses lend to other businesses – mostly SMEs. Who'd be your ideal investor, and what sort of returns can they feasibly look for?

**JT:** Huddle Capital will focus on UK based SMEs with surplus cash to invest. As a well run business, a company ends up with a healthy reserve that is not needed immediately within the business. This is true for a lot of service based businesses that have low overheads. It's worthwhile seeking to make sure that the company makes use of those cash assets, in the form of higher returns than what could be expected at a bank. Although most SMEs have probably never thought of it before, lending to another SME could make a healthy return. Well run SMEs struggle to get a loan from banks and other traditional finance providers, leaving a gap for private and business lenders. Sure, lending to SMEs comes with its own risks, but the rewards are equally as good, as investors can expect to earn between 6% and 14% returns on their loans.

You may also believe that SME lending is an illiquid investment, tying up your cash over the life of the loan. But in fact, we

will have a healthy secondary market on our platform that will allow creditors to sell their investment to other investors, so they can get out at any time, should they need their cash in a rush.

The alternative SME lending market has grown considerably over the last few years and this trend seems to be continuing because of the pent up demand for access to finance. We are working to get a regulatory licence to be able to offer the same opportunity to individual retail investors.

**MI:** The opportunity to join the "Huddle 100 Club" will be launched at our event. What will the club membership bring in terms of benefits?



**JT:** Huddle 100 Club members are the first 100 exclusive founding members of Huddle. They will automatically become lifetime members of our elite Club Red, and when they invest £5,000 or more, they will get a generous credit of £1,000. Club Red members will get a credit of £1,000 each year that they invest more than £25,000. Club members will also get access to exclusive events.

**MI:** What else will set Huddle Capital apart from other P2P lending platforms?

**JT:** Huddle is focused on a very specific niche. Because of our focus, we understand the needs of our investors and borrowers, who by the way are also only UK businesses. We focus on building a community of SMEs who can network and benefit from one another through our networking events. Most importantly, we believe strongly in educating and not

advertising to our market. Alternative lending is a new space and should be approached with great caution. What also makes us different is the fact that the firm was founded by experienced financiers and with a strong capital backing.

**MI:** It must be exciting to launch this new venture at a time when the investing public is truly waking up to the possibilities offered by P2P platforms. Where would you like to see Huddle in one year's time?

**JT:** We'd like to be a fully-regulated firm that operates in the regulated and unregulated spaces. Unlike our competitors, we don't just want this business to generate revenue; we want it to be profitable in the first 12 months of its existence, and we are confident that we can achieve this. We're aspiring to a loan book of between £8 million and £10 million within our first year, funded by retail, professional, corporate and institutional investors.

**MI:** Can interested investors join on the day of the show? What do they need to bring to stand 50 to go through the sign-up process?

**JT:** Absolutely! Investors can sign up on the day. But just remember that Huddle Capital is at this stage only open to investors who invest through a limited company. Investors can fill out relevant details on an online form, available on laptops and iPads on the stand at the event. They and their companies will be automatically verified. If in the unlikely event that we need further information to verify their details, then we will get in touch with them after the show.

Once verified, they are ready to start investing in exciting SME lending opportunities. In fact, at the show, we will be hosting a live loan-based fundraising round that investors can participate in. They'll get to see the process in action and get an insight into how we select borrowers and underwrite their loan applications.

**MI:** Thank you, Jay!

**JT:** You're welcome.

You can find Huddle Capital on stand 50 at the [Master Investor Show](#) in Islington on Saturday 25<sup>th</sup> March. Also, join Huddle and Master Investor in a live Q&A Twitter chat on Tuesday 21<sup>st</sup> March from 1pm. Send your questions to [@masterinvestor](#) and [@HuddleCapital](#) using the hashtag #AskHuddle

Come find us on  
**Stand 50!**

*huddle*



## ***Huddle Wants You!***

**Huddle Capital is a business to business lending platform designed to make your money work harder. The platform will be launching at this year's Master Investor Show on March 25th, and we want you to be one of our 100 founding members!**

The first founding members will form part of Huddle 100, and gain lifetime membership to the platform. Members can take advantage of exclusive benefits such as £1,000\* credit to invest through the platform as well as a free ticket to the 2017 Master Investor Show this March, where we'll be exhibiting as exclusive partners.

We have 100 FREE TICKETS (available on a first come first serve basis) for the Master Investor Show, where you can meet with us for a demo and to find out more about the Huddle Capital platform.



REGISTER YOUR INTEREST AT:

***[www.huddlecapital.com](http://www.huddlecapital.com)***



\*terms & conditions apply



BY RICHARD GILL, CFA

## FROM ACORNS TO OAK TREES

# ARE THESE THE FASTEST GROWING SMALL CAPS IN LONDON?

**According to finance theory there are three components to the total return which an investor can make from a share.**

Firstly, we have dividends. Often being the most modest source of equity returns, dividends can nevertheless be consistent and provide a useful source of income for investors. Those with shares in dividend paying FTSE 100 companies, for example, are currently enjoying average yields of c.3.8%, within a range of 0.24% to 7.9%. Over and above these "normal" dividends is the sought after *special dividend*, paid by companies which generate significant amounts of excess cash or those which earn a bonus from an extraordinary event such as an asset sale or legal victory. Of course, dividends can never be negative.

The second component to equity returns is changes in the price/earnings (PE) ratio which a share trades on over time. Say a company makes 10p of annual earnings and trades on a PE ratio of 10 times, then its price will be 100p. If earnings remain

the same but the PE ratio changes to 12 times, then the shares will be trading at 120p, a gain of 20%. On the other hand if the PE ratio changes to 8 times the shares will be priced at 80p – a loss of 20%.

Changes in the PE ratio can be an important source of returns, especially for those who take the "value" approach to investment. These investors hope to buy shares on low PE ratios and see the market re-rate them to higher levels before selling at a profit. Buying shares in times of recession, when pessimism is at its peak and valuations are their lowest, can also be a good strategy to target gains from rises in the PE multiple over time.

Finally, growth in earnings is the last element of equity returns. Similar to the example above, if a company grows its earnings per share from 10p one year to 12p the next, and the earnings multiple remains at 10 times, then the shares will have risen from 100p to 120p, a gain of 20%. **In theory, gains from growth in a company's earnings are**

**unlimited.** That's why many investors focus on earnings growth as the most important factor when looking for a new company to add to their portfolio.

On that note, the three London listed firms below have all attracted attention from investors in recent times on the back of surging growth across their operations. But with high growth comes high valuations, so are they still worthy of your investment?

### **Bohoo.com**

Most readers will be aware that internet fashion stocks have delivered multi-bagging returns for investors over recent years. Perhaps the best example of this is stock market darling **ASOS (LON:ASC)**, shares in which rose from 3.25p to £70.50 between August 2003 and February 2014 – that's a gain of 223,709%. One company which is doing its best to emulate its larger rival is **bohoo.com (LON:BOO)**, another online fashion retailer but one that focuses on the value end of the market.



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**“IN THEORY,  
GAINS FROM  
GROWTH IN A  
COMPANY’S  
EARNINGS ARE  
UNLIMITED.”**

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**boohoo.com**  
 TWENTYFOUR | SEVEN | FASHION

## Tears and joy

Boohoo's business proposition is simple. It sells cheap clothes on the internet to youngsters. But investors have not had quite such an easy ride in the shares since the company went public in March 2014.

Things started well, for a few hours at least, with the shares rising by 54% on the first day of dealings as the markets got excited about the company's growth prospects. But it all went downhill from there, with the fall being punctuated by a disastrous profits warning in January 2015, caused by boohoo

being forced to heavily discount its products amidst tough market conditions.

The company's reaction and recovery since then have been as impressive as the profits warning was shocking, with the shares having risen almost sevenfold on the back of a string of impressive trading updates and uplifts in profit guidance.

### From Pretty Little to Pretty Big

Since being founded just over a decade ago boohoo.com has built itself up into one of the largest pure-play

**“BOOHOO.COM HAS BUILT ITSELF UP INTO ONE OF THE LARGEST PURE-PLAY ONLINE FASHION RETAILERS IN THE UK.”**

online fashion retailers in the UK, selling its own-brand clothing, shoes and accessories around the world to a core demographic of 5.1 million active customers, mainly aged 16-24. The company designs and sources its own products, claiming to launch up to 100 new pieces every day, and fulfils orders from a 525,000 square foot warehouse in Burnley, which is currently being expanded to support further growth. The UK remains the company's core market, but overseas sales are rapidly becoming more important, especially in the US where revenues surged by 188% in the four months to December last year.

Adding to the strong organic growth being posted, two recent acquisitions have started contributing to boohoo's income. In December a 66% stake was acquired in fashion website PrettyLittleThing (PLT) for £3.3 million. This is a fast growing business, with a similar but complementary product profile, which saw revenues grow by over 400% to £17 million in the last reported financial year (to Feb 2016). Joining PLT at the end of February was the acquisition of certain intellectual property assets and customer databases from the bankrupt US retailer Nasty Gal for \$20 million. Helping to fund these two deals was boohoo's large net cash pile, which was most recently reported as standing at £69 million as at 31st December.

Just before this article was sent to the Editor boohoo further impressed the markets by announcing an upbeat trading statement covering the 2017 financial year (ending 28th Feb). Trading since 10th January, when the previous update was announced, was slightly ahead of expectations, resulting in

full year revenues being up by c.50%. This was ahead of prior guidance for growth of between 46% and 48% and implies full year sales of around £293 million. In addition, the operational gearing continues to kick in, with the adjusted EBITDA margin forecast to be at the top end of the previously guided range of 11% to 12%.

**Will the shares continue to BOOm?**

Having regained the market's confidence shares in boohoo.com currently trade at an all-time high of 152.75p per share, capitalising the company at £1.72 billion. Behind ASOS and Abcam that makes it the third largest business listed on AIM.

Boohoo is now trading on a multiple of around 70 times market consensus forecasts for the financial year just ended, falling to c.60 times for financial year 2018. Those ratings are much lower than the IPO valuation of 218 times historic profits and round about in line with multiples currently attributed to ASOS.

Talking of ASOS, boohoo, in terms of its financials, is currently at round about the same stage as ASOS was in 2011. The fact that ASOS has grown revenues more than fourfold since then demonstrates the potential that boohoo has, especially with exceptionally strong



growth being seen internationally. I also have the view that boohoo should trade on a higher multiple than ASOS given its wider margins.

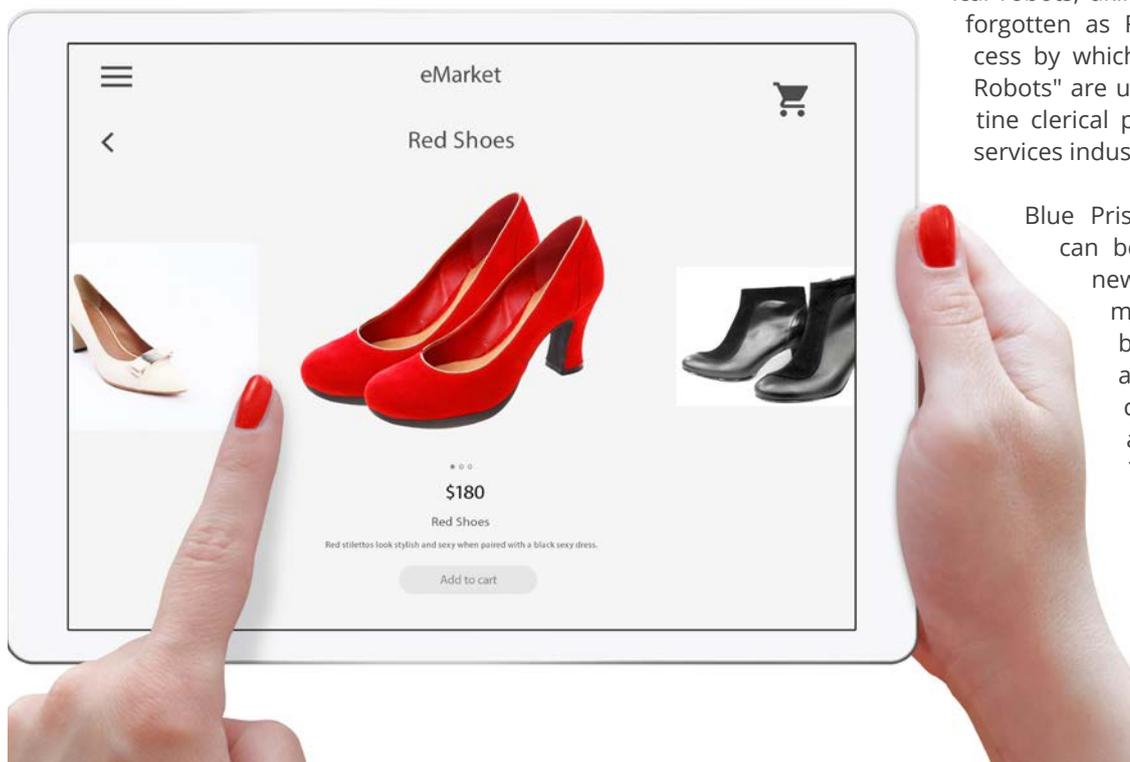
On balance, boohoo shares are clearly expensive but given the growth being seen, combined with a reputation being gained for increasing profit guidance, investors should not write off further gains. On the downside they look exposed to the possibility of a sharp decline should another profits warning be announced. For me, boohoo shares should only make up a small part of a portfolio and remain a **highly speculative buy**.

**Blue Prism Group**

Having been billed by several market commentators as the UK's next ARM Holdings, technology firm **Blue Prism Group (LON:PRSM)** has a lot to live up to. But less than a year after listing in London the company is already managing to meet these high expectations.

Founded in 2001 by current CEO Alastair Bathgate and Chief Technology Officer David Moss, Blue Prism describes itself as being a global leader in "Robotic Process Automation" or RPA. Any thoughts that readers have of this being based on physical robots, akin to C3PO, should be forgotten as RPA refers to a process by which so called "Software Robots" are used to automate routine clerical processes in business services industries.

Blue Prism's software robots can be trained, just like a new employee, to automate manual, rule based processes such as order processing, credit checks, billing and many others. This frees up time for existing employees to focus on other more valuable tasks or can even negate the need for their position at all. For clients, the benefits can be large, with one



## “HAVING BEEN BILLED BY SEVERAL MARKET COMMENTATORS AS THE UK’S NEXT ARM HOLDINGS, TECHNOLOGY FIRM BLUE PRISM GROUP (LON:PRSM) HAS A LOT TO LIVE UP TO.”

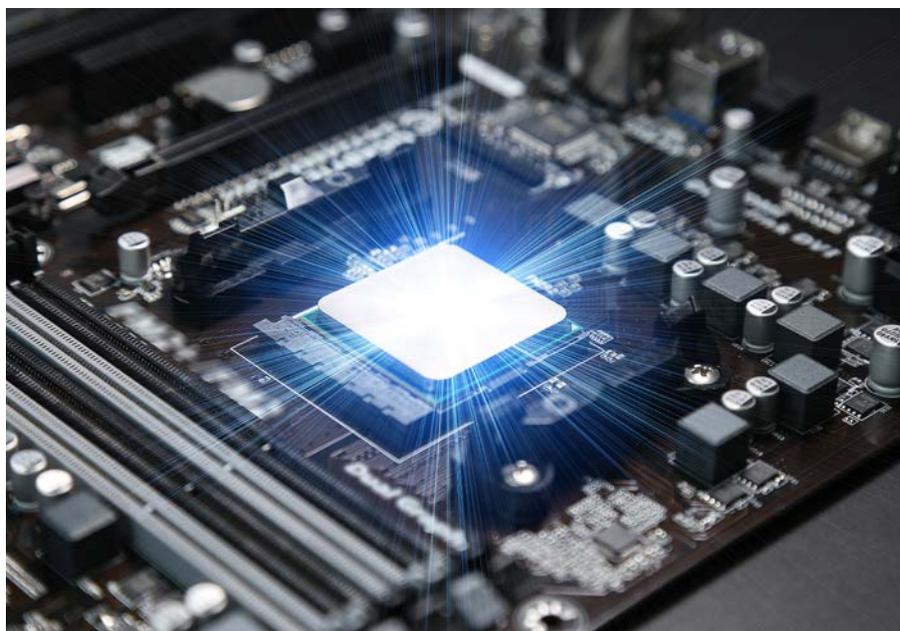
case study in the company's admission document pointing to a 12 month payback period for one client and a return on investment over three years of between 650% and 800%. Some big name clients who have signed up for Blue Prism's services to date include the likes of Barclays, Co-op Bank, Telefónica O2, and in the US, BNY Mellon.

The majority of Blue Prism's income comes from the sale of licences for its software robots, which creates a long-term recurring source of revenues. These are supported by professional services and training fees but these are becoming less important to overall income as licence sales take off. The company's main route to market is via various channel partners who provide access to large customer bases and the opportunity to scale up sales more quickly than if all sales were done in-house.

### Rise of the robots

Blue Prism joined AIM in March last year, raising a net £8.8 million to spend on supporting its expansion and strengthening the balance sheet. The firm came to market with a solid track record of strong growth, with revenues growing at a CAGR of 43% over the financial years ending 31st October 2013 to 2015. Its reputation was then further increased by announcing no less than three times in 2016 that trading would be ahead of previous expectations.

Maiden full year results as a public company showed further top line expansion, with total revenues up by 59% at £9.64 million after the company outperformed its targets across all areas of the business. However, the total operating loss widened from £0.75 million to £5.27 million after investment in growth, including a doubling of the global employee base to 86. Operational highlights of the period included the winning of 96 new



customers, taking the total customer base to 153. Growth in the US continued apace with 18 new customers and 19 upsells to existing customers.

The most recent trading update reported on the first quarter of the current financial year, with the posi-

tive trading momentum having continued and revenues for the full year once again expected to be "materially" ahead of market expectations. There were 83 new software deals signed in the period, with 49 new customers coming on board and 34 upsells to existing customers.



### Shareholder blues?

RPA is a fashionable sector to be involved in at present, with a number of recent studies and reports suggesting that robotics and automation is set to dramatically impact labour markets around the world. For example, a 2013 study from the University of Oxford found that 47% of US jobs were at a "high risk" of being replaced by technology and in November 2015 the Bank of England warned that 15 million jobs in the UK could be at risk of automation. So, with the growth opportunities here being clear, the sector has of course attracted the interest of investors.

**blueprism**<sup>®</sup>

As I mentioned in the last issue of Master Investor Magazine, Blue Prism Group was the best performing AIM new issue of 2016, the shares surging by a mammoth 470.5% from the first day of dealings to the end of the year. In 2017 the performance has been muted, with an overall rise of just 1.8% to the current 453p.

Now capitalised at just over £280 million Blue Prism is a very highly valued business. To give credit to management, things could not have gone much better for the company as a public entity. But unfortunately for new investors, with forecasts pointing to the business remaining loss making for the next few years, it looks as though

the current valuation has detached itself from reality. There is a lot of hope value currently in Blue Prism shares, and if trading sees even the smallest set back I believe they could lose their premium rating.

**I think that Blue Prism should be avoided at this price but to give an alternative view, albeit the one of the house broker, Investec has a 580p target price.**

### LUCECO

Finally, we look at a business which offers growth, value *and* income.

Having been bought out by management in 2005, Luceco is a manufacturer and distributor of high quality LED lighting products and wiring accessories. Its four key brands are Luceco – energy efficient LED lighting products and associated accessories; British General (BG) – wiring accessories, circuit protection and cable management products; Masterplug – cable reels, extension leads, surge protection, timers and adaptor products; and Ross – television wall mounts, audio visual accessories and other items.

Luceco supplies its products to customers worldwide including trade distributors, retailers, wholesalers and project developers, with some of its blue-chip clients including Kingfisher Group, Homebase, Sainsbury's, Tesco and Travis Perkins. The company operates from a wholly-owned 52,500m<sup>2</sup> manufacturing and product development

facility in Jiaxing, China, which enables control to be maintained over the cost base and helps it to bring products to market quickly. Around £11.6 million has been invested in the facility since 2013, with a recent expansion providing the capacity for further growth.

The LED lighting market is growing rapidly at present, driven by advantages that the technology has over legacy lighting products (such as efficiency and longevity) and by a supportive regulatory environment. According to analysts at Frost & Sullivan the global LED lighting market will grow at a CAGR of 16.8% between 2014 and 2019 to a total size of approximately \$70 billion.

**LUCECO**

Under that backdrop, Luceco joined the Main Market of the LSE in October last year, raising a total of £26 million to pay down debt and strengthen the balance sheet. It came to market with a very strong track record of growth, with revenues growing at a CAGR of 25.3% to £103.1 million over the three years to December 2015. Profits also grew quickly, with EBITDA up by a CAGR of 38.5% to £14 million over the same period. Growth continued apace in the first six months of 2016, with revenues up by 25% and EBITDA up by 52.6%.

**“THE GLOBAL LED LIGHTING MARKET WILL GROW AT A CAGR OF 16.8% BETWEEN 2014 AND 2019.”**

The firm's only trading update to the markets so far was brief but positive, stating that the company traded well in 2016, with results expected to be in line with expectations. In addition, trading since the period end is said to have been strong, with the company having entered the new financial year with "significant momentum".



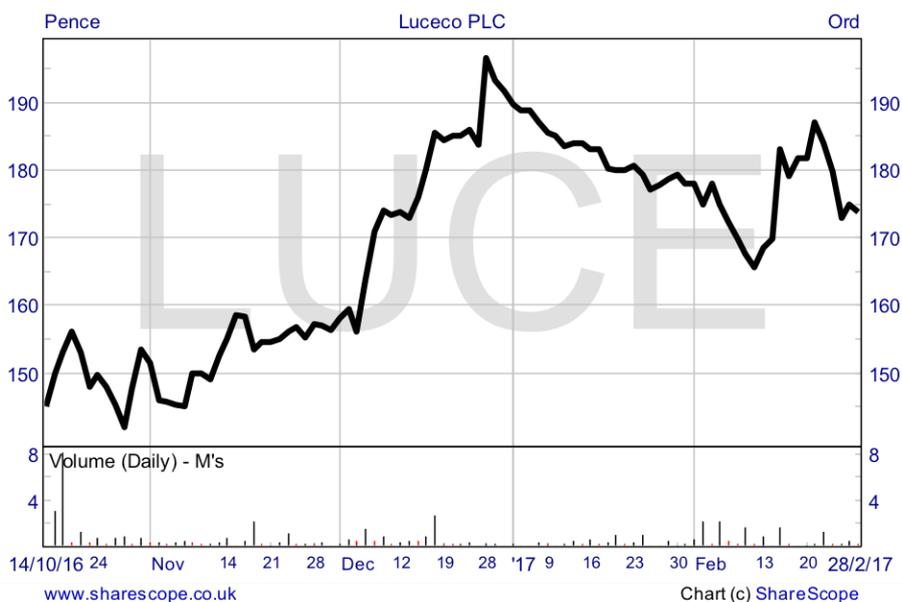
**“I BELIEVE THAT THE MARKET DOES NOT YET FULLY APPRECIATE THE GROWTH PROSPECTS HERE.”**

**Light up your portfolio**

At the current price of 173.75p Luceco shares are off highs of 196.5p seen just after Christmas but remain well ahead of the IPO price of 130p. Nevertheless, I believe that the market does not yet fully appreciate the growth prospects here.

Market forecasts for the current year put Luceco shares on an earnings multiple of 17.5 times, falling to 14.2 times in 2018. What is most attractive here in valuation terms is the price to earnings growth (PEG) ratio, which for 2018 stands at 0.6 times. **Assigning a PEG ratio of 1 to the shares (considered fair value for a growth company) would see a price of 284p by the end of next year (assuming forecasts are met), and implies 63% upside from the current price.**

Unlike Blue Prism and boohoo.com above, Luceco offers the prospect of a dividend in the near term. The policy set out at IPO is progressive and is targeting an initial payout of between 20% to 30% of adjusted net income, split one-third/two-thirds between the half and full year. Market forecasts for the current financial year are for a dividend of 2p per share, which equates to a modest yield of 1.15%.



A70 CLASSIC



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BY SAMUEL RAE

FORENSIC FOREX

# JAPAN'S FUTILE STIMULUS



Those who regularly follow this forex analysis will be aware that my standard approach is to take a broad look at various macroeconomic inputs, and apply these inputs to a more focused – implications driven – analysis of individual currencies. My currency trading strategy is one very much dictated by price action, and one only mildly influenced by the wider global economies and day-to-day economic news.

However, and by way of a brief introduction to how I approach the markets, my risk management is generally dictated by the latter – the wider economy. I enter based on price action signals, but I size my trades based on an underlying bias as to which direction I expect the currencies I am trading to move medium to long term. If I'm bullish on the base, I'll go after a little bit more reward and be willing to accept a

little bit more risk on a position. Bearish on the base, and the opposite is true.

Anyway, this time around, I am going to take a slightly different approach to Forensic Forex. I'm going to focus purely on one economy. It is one of my favorite economies to analyse, and one that I've spent a good deal of time considering over the past 10 years. The economy is that of Japan.



Most readers will be familiar with the last 30 years or so of Japanese economic activity, at least to some degree. To simplify by way of a brief introduction, and for those that are not up to speed with what has happened, things haven't been great. Basically, the country went through a rapid period of expansion, got hit with an oil price hike, was forced to technologically innovate (which is one of the primary drivers behind the technological and environmental disparity between Japan and many other developed nations today, with the former being leagues ahead of most others) and – post innovation – enjoyed a short period of relatively stable expansion.

For a little over two decades since, however, things have not been good. Japan has stagnated, deflated, and with a number of inputs exacerbating the situation (ageing population being a primary element) its government has racked up a huge deficit. Not quite to the degree of the American government over the last 15 years or so, but huge nonetheless.

Abenomics – the world's pet name for the economic stimulus policies of Japanese Prime Minister Shinzo Abe – came into force in 2013, and has had mixed effects. Depending on who you ask,



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**“EVEN THOUGH EXPORTS HAVE INCREASED, CONSUMERS AREN'T SPENDING ANY MORE INCREMENTALLY – THIS DECADES-OLD LINK HAS SIMPLY DRIED UP.”**



## “JAPANESE POLITICAL LEADERS WILL UNDOUBTEDLY REMAIN FOCUSED ON DEVALUING THE NATION’S CURRENCY IN AN ATTEMPT TO INCREASE ECONOMIC OUTPUT, AND MAY WELL SUCCEED.”

it has been successful or has failed/is failing. I tend towards the latter camp, and it is this opinion that is driving my long-term bias in the yen right now.

The thing is, standard economics suggests an economy can be controlled by altering various inputs to get varying outputs. Increase interest rates – reduce spending, increase saving, curb inflation. Print money – stimulate consumption, boost capital expenditure and job creation, increase economic output. That sort of thing. It is this input-output theory on which Abe has based his policies.

For an economy like Japan, however, things are just not that simple. Japan is what we might bill a very mature economy. It is technologically advanced; its individual constituents hold large amounts in savings and do not respond to fly-by-night consumption altering inputs (unless it's to the downside, of course, as illustrated by the 2014 sales tax hike); and politically, it is very stable. Individuals make their own decisions based on preference as to things like consumption, time of expenditure allocation, savings levels, employment aspirations, instead of basing these decisions on government intervention – at least, that is, not on a timeframe as short as three to five years.

Additionally, standard economic theory suggests that for a country like Japan, which relies heavily on exports, a weak currency is desirable. Many of the various initiatives put forward by the nation's politicians over the last few decades have been to this aim – weaken the yen, boost exports. For a less mature Japan, say one in the late '80s or early to mid '90s, this concept worked. Boost exports, and consumption will increase. These days, however, there is a disparity between a boosting of exports and an increase in individual consumption. As mentioned earlier, Japan has the highest level of cash and savings accounts savers in the world –



data just released puts it at the top the list once again. Even though exports have increased, consumers aren't spending any more incrementally – this decades-old link has simply dried up.

So what does this mean for my longer-term bias? Well, it points to a drawn out period of what I like to call stimulative futility. Japanese political leaders will undoubtedly remain focused on devaluing the nation's currency in an attempt to increase economic output,

and may well succeed. This doesn't necessarily mean, however, that consumer spending (probably the most important component of output here) will rise. With continued attempts to devalue the yen not being countered by an increase in individual consumption, I expect a long period of yen weakness. Not that we won't see short-term recoveries against other majors like the US dollar, but over the next decade, I predict a long-term decline in the value of the yen against its major counterparts.





BY DAVID JONES

## CHART NAVIGATOR

# CHARTING A PATH TO SUCCESS

**One of the many common criticisms that could be aimed at a charting approach to the market (and there are quite a few): *If it works, why aren't all chartists fabulously rich? It's a fair comment – but also one that could be levied at the fundamentalists' approach as well.***

The problem with most forms of market analysis, whether from a trading or investing point of view, is there is nearly always an element of subjectivity in the final call to buy, sell or do nothing. Arguably, if there wasn't this degree of (at least) a little freedom, market movements would be very boring. Everyone would agree a fair price for a share, currency pair or bond and the market would just sit there until some new information came out to change the collective opinion. The reality is of course the polar opposite of this. Markets are fluid and constantly changing – even sometimes only by little amounts – as the tug of war between people and institutions with differing opinions rages throughout the trading day.

All we can do as investors or traders is to try to make sense of this – to have some sort of structure or roadmap to help guide our decisions when it comes to what to buy or sell. For me this is where chart-

ing and technical analysis fit in. It is most definitely not a crystal ball that aims to predict the future. Rather, it gives a structure that helps you figure out whether it is buyers or sellers that have the dominant hand at the moment. On top of this, it can

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**“IT IS MUCH EASIER TO RUN A POSITION WHEN THE MARKET IS MOVING IN YOUR FAVOUR – RATHER THAN TRYING TO PICK THE BOTTOM IN A FALLING MARKET AND GETTING YOUR FINGERS (AND WALLET) BURNT TIME AND AGAIN.”**

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also help give an idea of where the market *might* get to and – the most important use – where to get out if it looks like things are changing. Bearing this in mind, I thought this month it would be useful to look at some recent applications of technical analysis in the real world – one from a shorter term trading point of view, and a couple of others with an investor's hat on.

The first example to be covered is the US dollar index or the dollar basket. Strictly speaking this isn't a "real" thing like the pound against the dollar or the price of gold. It is a synthetic market made up of the dollar's value relative to a selection of other currencies: euro; yen; sterling; Canadian dollar; Swedish krona; Swiss franc (thank you, Wikipedia). It is a way of trading what is arguably a more 'smoothed out' version of the US dollar than maybe just trading the more common currency pairs such as EUR/USD or GBP/USD etc.





A trader or an investor with a positive view on the US dollar could have checked the chart during January this year and seen the trend was not in their favour. Now, they may not have been bothered that the dollar had been in decline for a month if they had a view over the next few months and years – but for the shorter/medium-term focused trader, it should have suggested that a bit of patience in waiting for a turn may pay off. If they really wanted to be a buyer it may be wiser to

wait for the dominance of the sellers to start to fade at least a little.

That turn started to come in February. For the first time this year, that downtrend in the dollar had been broken. This was suggestion number one that maybe sentiment was on the turn. The USD Index also started making a succession of higher highs and higher lows – quite possibly the start of a new uptrend. Before this, any recovery had proved to be unsustainable and the

dollar rallies had previously run out of steam and slipped to fresh lows for the month.

Now, it is still early days for the turn, although at the time of writing the USD Index has rallied by another 70 points or so since the last chart. And let's not forget it is too optimistic to expect every reversal of trend to work every time. But I think for most traders it is much easier to run a position when the market is moving in your favour –

rather than trying to pick the bottom in a falling market and getting your fingers (and wallet) burnt time and again. This is just one example where some simple charting may encourage a little bit of patience and flag up a better time to enter the market.

Let's take a longer term example. FTSE 100 company **Rolls-Royce (LON:RR.)** was in the news in February, for all the wrong reasons. It reported a pre-tax loss for the year of £4.6 billion – a record for the company. The shares were down, but only by a few percent – after a series of profit warnings, bad news really was no surprise to the City and Rolls-Royce investors. But could this weakness actually be an opportunity? No market moves in a straight line – whether it is going up or down; markets take a while to get to their ultimate destination. So, moves against a broader trend can be opportunities to jump on board at a slightly better price. Below is the last year or so for Rolls-Royce.

It has been a little bit boring in terms of what the share price has done but

there has been something of a recovery following all of those profit warnings. There has been solid support underpinning Rolls-Royce at 600p since last summer and prior to those poor results, the shares were at their highest levels for a few months. So the one-

day wobble in the price, when viewed in the bigger picture of what the price has done over the longer term, could be viewed as a buying opportunity for many an investor – if they are banking on the worst being behind the company.



**“AS AN INVESTOR, I WANT TO BUY INTO COMPANIES THAT THE MARKET ALREADY LIKES. I HAVE LITTLE INTEREST IN BEING A PIONEER AND TRYING TO GUESS THE TURN – DON’T FORGET, PIONEERS USUALLY END UP WITH ARROWS IN THEIR BACK.”**

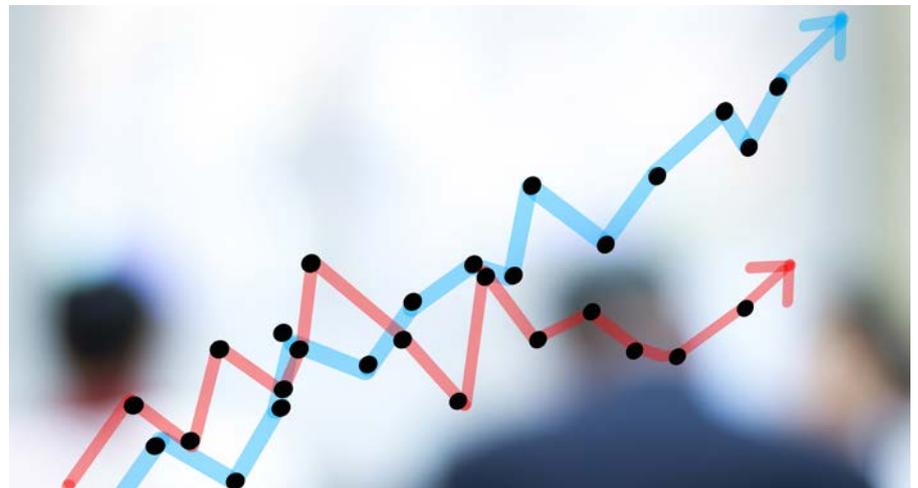




One last example. I spend far too much time looking at charts and watching numbers go up, down and sideways. If you have more useful things to do with your time – which shouldn't be hard – charts can still have their place for the longer-term investor. Just to recap, markets do trend. And there are plenty of shares out there that do have some impressive and sustained longer-term moves. As an investor, I want to buy into companies that the market already likes. I have little interest in being a pioneer and trying to guess the turn – don't forget, pioneers usually end up with arrows in their back. Here's an old favourite of mine that I have shares in: the FTSE 100 utilities business **National Grid (LON:NG).**

What a chart! All it has done for much of the last six years is go up. Now, there is no way of knowing how long this will carry on for. We may have already seen the top last year – or it could continue to rise for another six years and more. All the chart-focused investor is looking to do is follow the trend and use opportunities to buy in. The most recent one of these was towards the end of last year when the share price briefly slipped below 900p. It had another look at the 900p mark in early 2017 before recovering. There was also big support for the share price during the summer of 2015 ahead of the 800p level. If National Grid slips below here, it does start to look as if that longer term trend is in trouble. So our chart investor has some structure as to whether this is an investment risk worth taking. For the record, I did, and

**“FOR ME, THERE IS AN AWFUL LOT OF VALUE IN HIGHLIGHTING THE MARKETS I DON'T WANT TO INVEST OR TRADE IN JUST YET – AND HOPEFULLY GIVING MORE TIME TO FOCUS ON THE BETTER OPPORTUNITIES OUT THERE.”**



I'm expecting that trend to continue. Time will tell...

Hopefully, these few practical examples will show how charts can have their place – even for the most sceptical of traders or investors. With the growth in popularity of the likes of forex trading over the past few years amongst retail traders, it does sometimes feel that these days everyone is a chartist. But I think too many have an idealised version of just actually what it can deliver – and there are plenty more who have an opinion, but don't actually risk their money. Markets

analysis shouldn't be just an academic exercise or a way of showing how the theory would have worked perfectly in the past. Rather, it can give us a few practical tools that do not have to be overcomplicated. Using these we can help weigh up the probability of an investment, where we might change our mind if things don't turn out as planned – and if it is actually worth doing in the first place. For me, there is an awful lot of value in highlighting the markets I *don't* want to invest or trade in just yet – and hopefully giving more time to focus on the better opportunities out there.

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BY ALAN STEEL

## DEATH & TAXES

# MONEY FOR NOTHING

**In this new regular column for Master Investor, Alan Steel of Alan Steel Asset Management will be holding out a helping hand to readers trying to navigate the minefield of financial planning. This often misunderstood or overlooked area can have a big impact on your wealth, regardless of your investment performance.**

If you read the Sunday Times Money section you will be well aware of their "Fame and Fortune" feature. Every week a "celebrity" is grilled about their financial beliefs and habits. Whilst entertaining, it does lead you to wonder how they built a "fortune" in the first place.

Though the names change every week, the questions and answers remain the same. Do they invest in stocks and shares? Nope – they're far too complicated and dangerous. They just don't understand them, apparently. So what do they do? Deposits and National Savings appeal to them, and judging by recent reports from the sports community, so did exciting tax breaks like Film Partnerships, which have unfortunately helped to bankrupt more than a few of them. Ouch.

Next up it's the financial journalist's favourite tie breaker. Do they prefer pensions or property as an investment? Guess the answer? Yes, a cool 95% of the geniuses who don't understand stock markets, because

they're too 'dangerous' and 'complicated', plump for property.

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**“HMRC’S  
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BE ‘THE MORE  
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Do they take advice from experts? Nope. They don't see the point. Hmm... I suppose if they ever need surgery they'll have a go at it themselves then. A minority who admit to seeking advice say they have an accountant for that sort of thing or they read money sections. Well, that's just perfect. I haven't noticed

many millionaire accountants or journalists about lately, but that's another story...

Over the years since I became an IFA, in January 1973, it's always astonished me how many (otherwise intelligent) investors or business folk I've met who are baffled by, or allergic to, pensions. Take accountants. They're trained to wallow in small print. Yet I've not met one over all these years who really understood pensions. And as the years go by it's going to get so much worse.

### Ch-ch-ch-Changes

Go check how many changes that UK governments have chucked at pensions small print over the last twenty-five years. Fifty between 1992 and 1999. And over 300, would you believe, over the following six years. Then in April 2006 Chancellor Gordon Brown, the man convinced he could end Boom and Bust cycles and the architect behind the attack on Final Salary Pension Scheme effectiveness, brought in "Pensions Sim-



plification". Since then, no fewer than 200 more changes have been thrust upon us (his warped sense of humour I suppose). We now have no fewer than eight "Lifetime Allowance" tax/pension regimes. HMRC's mantra appears to be "the more complicated we make it, the more tax we'll collect".

If all that wasn't confusing enough to digest, George Osborne introduced Pensions Freedom two years ago. Supposedly created to give us greater control over our own money, it seems it has ended up giving the taxman greater access to it as well. Anybody notice that HMRC recently announced that more tax has been collected from pension withdrawals than they'd expected?

True to form, this vast increase in confusing small print coupled with sudden freedoms (an odd combination if you think about it) has created a taxation and security nightmare for the unwary. No wonder our "celebrities" stick to deposits and property!

But is there another way to look at pensions? How about "Money for Nothing – Cheques for Free" (assuming you remember Dire Straits – and cheques for that matter!)?

### That's the way to do it

It's true the original intention (allegedly) in April 2006 was to introduce a cap on how much of a pension fund you could build up that qualified for the special low tax treatments available to pension pots (25% tax free cash, freedom from Capital Gains Tax and Inheritance Tax etc.). This cap was retrospectively placed at £1.5 million and would increase over the following five years to £1.8 million. Gordon Brown then promised the cap would increase by inflation. To secure the deal you had to apply for a Lifetime Allowance Certificate. Far too many folks without knowledgeable advisers didn't bother.

Since then more promises have been broken. The inflation increases didn't happen. The cap itself has been reduced rather than increased, first down to £1.5 million, then £1.25 mil-

lion, and soon £1 million. Those well advised serious savers with a cap secured at £1.8 million can still encash £450,000 tax free through the 25% tax free lump sum withdrawal. Those who could have applied, but didn't because they didn't take advice, will be lumbered with a lower Lifetime Allowance of £1 million unless they pull their finger out. A quarter of that is £250,000. Those readers any good at arithmetic will spot the difference of a cool £200,000 of "money for nothing".

All is not lost however. If you haven't secured your Fixed Protection of £1.25 million to guarantee yourself an extra £62,500 tax free, it's not too late. Now that that's cleared up, to underline how complicated it can be to pocket extra money for nothing, it's possible you could qualify for "Individual Protection 2014" of £1.5 million cap. But this option **will disappear** on 5<sup>th</sup> April.

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**“IF YOU HAVEN’T SECURED YOUR  
FIXED PROTECTION OF £1.25 MILLION  
TO GUARANTEE YOURSELF AN EXTRA  
£62,500 TAX FREE, IT’S NOT TOO LATE.”**

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## “WHY IGNORE SOMETHING WHICH, WHEN YOU PUT MONEY INTO IT, GETS TOPPED UP TO THE TUNE OF ALMOST 82% IN YEAR ONE IF YOU PAY TAX AT 45%?”

It's certainly worth looking into – extra "money for nothing" of £125,000 is nothing to be sniffed at.

### All the best things in life are free

If you're still with me – and believe me, it's well worth it – try looking at "pensions" from a different perspective. For starters, why ignore something which, when you put money into it, gets topped up to the tune of almost 82% in year one if you pay tax at 45%? If you're a 40% taxpayer, why ignore the chance of getting a free 67% added in year one?

Then the whole shebang is invested in your own plan where you can invest in your favourite shares or funds, all rolling up free of Capital Gains Tax. It's free of Inheritance Tax at 40%, too. And should you pop your clogs before age 75 (yes, this column is called *Death & Taxes*), not only is it free of IHT and CGT, but with an up-to-date simple nomination form added your family can enjoy unlimited tax free income. If you're fortunate enough to survive beyond 75, you'll still avoid CGT and IHT. A pension fund is far more tax effective than property and much easier to offload.

### The price to pay

If you have already secured some Lifetime Allowance do be aware that if you make *any* pension contribution at all there's a stiff price to pay. Think of it like Snakes and Ladders (oldies like me will remember the board game). You throw a dice and move up ladders heading for the top. One wrong move and down you go. All that progress gone in an instant. Lifetime al-



lowance secured at £1.8 million? Make one stakeholder payment or join auto enrolment, for example, and you pay the price. Instead of £450,000 tax free cash, it's £250,000. Instead of £1.8 million free of IHT, it's £1 million. And so on.

And for those higher rate taxpayers who don't like the sound of missing out on tax breaks, and who are way short of £1 million pension kitties, if you don't act soon another opportunity will have passed you by. Right now you can take advantage of tax relief on

the higher contributions allowed in the 2013/14 tax year. That chance disappears on the 5th of April. Don't be an April fool.

If like Dobie Gray "day after day you're more confused", don't dismiss pensions as over complex and too expensive. With the right advice neither assumption is true. A pension pot is just a first class "money for nothing" investment with funny rules. Time is of the essence. Go talk to somebody who really does know how to avoid the snakes.

### About Alan

Alan Steel rose to prominence in the financial sector after being the first person to put pen to paper to accuse Equitable Life of rampant mis-selling. A true champion of the ordinary saver/investor, Alan founded Alan Steel Asset Management in 1975, and now has over £1 billion under management. Visit the company website at [www.alansteel.com](http://www.alansteel.com).





BY FILIPE R. COSTA

HOW TO INVEST LIKE...

# JOEL GREENBLATT

*"Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot".*

— Joel Greenblatt

**"The Little Book That Still Beats the Market", 2010**

## Finding a Magic Formula

Value investing consists of buying stakes in good businesses at bargain prices and then being patient enough to keep those investments over a prolonged period of time, until the market realises the value of those investments and is willing to buy them back from you at the right price. While portfolio management borrows a lot from the sciences, the act of finding good businesses at bargain prices is not an exact science; rather, it is exposed to the investor's judgement and to the ups and downs of the market. Most people just don't have the patience or the guts to deal with a sentiment-driven market that will often push their investments under water. They end up overtrading, selling at low prices and buying at high prices. There is also a whole industry devoted to trading that seeks to turn

investors into day traders. But, unlike long-term investment, day trading is heavily exposed to the market mood, which magnifies risk and pushes the returns for the average investor below market returns. But for those who can resist the short-term pressure, there is a magic formula that has been proven to deliver consistent above-average profits over time. This formula was developed by the fund manager (and academic) Joel Greenblatt.

Besides being a highly successful value investor, Greenblatt has spent the last few years teaching students and writing books in which he attempts to simplify the investment game into something that can be understood by everyone. In his book *The Little Book That Beats the Market*, Greenblatt outlines a simple strategy that can be used by everyone with relative ease – the

Greenblatt Magic Formula – which is based on the simple notion that value investing is about buying good businesses at bargain prices.

## From fund management to academia... and back again

Joel Greenblatt, 59, was born in New York and has been a hedge fund manager, an investor, a writer and an academic. He graduated from the Wharton School at the University of Pennsylvania in 1979 with a bachelor's degree, and completed an MBA in the following year. Just a few years later, Greenblatt founded Gotham Capital with \$7m, most of which came from the "Junk-Bond King" Michael Milken. From day one, Greenblatt embraced the value investing strategy first introduced by Benjamin Graham (issue 13 – April 2016). Greenblatt was able to

**“IN HIS BOOK *THE LITTLE BOOK THAT BEATS THE MARKET*, GREENBLATT OUTLINES A SIMPLE STRATEGY THAT CAN BE USED BY EVERYONE WITH RELATIVE EASE – THE GREENBLATT MAGIC FORMULA.”**



achieve an astounding annualised rate of return of around 40% between 1985 and 2006. Later on, the company became Gotham Funds, which currently offers five different funds, all of which are grounded in value investing and operate based on Greenblatt's Magic Formula.

Since 1996, Greenblatt has also been an adjunct professor at Columbia University Graduate School of Business, where he currently teaches "Value and Special Situation Investing". In 2005 he published *The Little Book That Beats the Market* where he advanced "Magic Formula Investing", which can be used by individual investors to beat the market. In contrast with his earlier foray into writing, *The Little Book That Beats the Market* achieved such a high success that it turned into a classic, selling more than 300,000 copies in just a few years. In 2010, the book was updated and sold under the revised title *The Little Book that Still Beats the Market*, adding another 100,000 copies in sales. Unlike the majority of investment books, Greenblatt's book is written with a refined sense of humour and can be understood by pretty much anyone, without the need for any pre-existing financial knowledge. Greenblatt's main goal is to teach any potential investor how to build a value portfolio without any need to make predictions about the future.



**“GREENBLATT’S MAIN GOAL IS TO TEACH ANY POTENTIAL INVESTOR HOW TO BUILD A VALUE PORTFOLIO WITHOUT ANY NEED TO MAKE PREDICTIONS ABOUT THE FUTURE.”**

As Greenblatt explains, the value investing strategy that results from applying his "magic formula" is very similar to what happens in the insurance business. When adding individual equities to the portfolio, the investor doesn't know how each of them will perform, nor is he in a position to make any reliable guesses about it. What he

knows is that on average that mix of equities will beat the market.

**Value is time independent**

A winning long-term investment strategy is all about figuring out how much a business is worth and then purchasing a piece of it for a lot less. It is about purchasing above-average companies at below-average prices, or in other words, buying good businesses at bargain prices.

A good business (an above-average company) is a business that can invest its own money at high rates of return – a business that earn a high return on capital. Purchasing a business at a bargain price (at a below-average price) involves purchasing a business that earns more relative to the price an investor is paying – a business with a higher earnings yield.

For the above strategy to be implemented, investors must find a way of ranking companies in terms of their return on capital and earnings, to then build a portfolio with the top ranking ones and keep them until their price goes up and they're no longer top ranking companies. But there's a problem here: the stock market is forward look-



TKY	95.37	-181	2492/T	2514/T	2528/T	2534/T	2541/T	2553/T	2567/T	2572/T
240 TP	7865.20	-51.50	TKY							
	142.30	136.89	2312	1651	1067	1929	27112	1721	1030	2469
	\$ 1991	-9.67	-09	-13	-32	-98	+65	-34	-87	+76
NY	37280	+1.89	4519/T	4542/T	4598/T	4602/T	4630/T	4698/T	4708/T	4751/T
95.7 TP	897.56	892.16	NY							
	351.79	326.51	1891	2019	1678	1254	1008	5761	1253	1875
	\$ 2312	-20.14	-25	-42	+16	-54	-12	-34	+46	+21
UK	31.25-29	29.45	1834/T	1865/T	1887/T	1899/T	1928/T	1945/T	1972/T	1991/T
225 TP	981.43	902.98	UK							
	103	-21.03	10879	10605	1762	2711	1535	1188	2423	2423
	5318	-3.40	-11	+0	-24	-87	+24	-3	-64	-64
CN	902	5.96	2519/T	2519/T	2519/T	2614/T	2614/T	2698/T	2711/T	2737/T
12.8 TP	821	821	CN							
	4861	96	4861	96	96	2726	3421	3421	2741	2741
	+25	3	+25	3	3	-15	-43	-43	+54	+54
RTS			4567/T	4567/T	4567/T	4567/T	4921/T	4921/T	4921/T	4921/T
850 TP			RTS							

ing. The price of a share should reflect the future prospects of that particular business. It involves predicting and discounting. If discounting can be done more or less safely, predicting means trouble for most individual investors. In fact, prediction means trouble for every investor and is one of the reasons why share prices vary so widely. No one knows the future and it is particularly difficult to make reliable predictions about the future prospects of a company. Some research analysts can do it, but they certainly can't do it for the full equities universe where there are thousands of different securities. A reliable investment strategy would mean not only predicting whether a business is undervalued or not, but also ranking the undervaluation.

In developing a strategy, Greenblatt departs from the view that the individual investor doesn't possess the tools to make predictions with an acceptable degree of confidence. While we can't say that past earnings yields and rates of return are good predictors for their future levels, we can say that those past numbers are *on average* very good indicators of their *average* future levels. If we can then use some simple rules to build an investment portfolio which *on average* holds good businesses at bargain prices, we will do well, Greenblatt believes.

This is the reasoning applied to the insurance business. They can't reliably guess the life expectancy of any

particular client. Sure they can ask for additional information from each policyholder and match the characteristics against a typical individual with those same characteristics to better guess the specific risks involved; but they can't estimate with a reasonable degree of certainty whether the individual will live longer or not. This is the main reason why they build a large portfolio of policyholders. Even though they're relatively uncertain about each individual policyholder, they know what the average life expectancy is. Let's say that the average life expectancy is 80 years. If they collect insurance premiums as if it were just 77 years, they should do rather well in the long term. Greenblatt's strategy is based on the same reasoning.

### Why is the market not always rational?

Value investing is based on the notion that financial markets aren't rational at all times, or at the very least they're not imbued with the kind of efficiency Professor Eugene Fama would like to believe. To explain short-term market inefficiency to his students, Greenblatt usually picks up a financial newspaper and asks them to look at securities prices. It is not only about looking at daily price changes but also looking at the 52-week highs and lows and how they compare to previous prices. He then asks his students, "*Why is a company worth \$30m one day, and \$60m just a couple of months later? Are they*

*selling twice as many cars, making twice as much money, or doing something drastically different in their business to justify such a large change in value?"*

It is hard to believe that the fundamentals behind any single business could change as much as prices do in the course of any and every single year. As Benjamin Graham pointed out in his "Intelligent Investor" published in 1949, "in the short run the market is a voting machine", it is unpredictable and sentimental. One day, Mr Market is in a good mood and therefore willing to purchase shares at very high prices. The next day, Mr Market is depressed and willing to pay too little for almost everything. In the short run, sentiment plays a huge role, making the outcome of any short-term investment very unpredictable.

In Greenblatt's words, the market is so volatile in the short run because "it's hard to predict future earnings... it's hard to decide what a fair rate of return on your purchase price is", and because "people go nuts a lot" and "get a little depressed sometimes and don't want to pay a lot for stuff". The short-term nature of Mr Market makes prices unreliable as a proxy for real value. The good news is that we really don't need to explain it; we just need to know this happens, and to then be able to buy from Mr Market when he is depressed. In the long term, Greenblatt assures his students that the market will prove them right if they're able to pick good



businesses. What he can't foresee is how long that will take, which is the main reason he believes that a reasonable investment horizon should be no less than three to five years, but preferably 10 to 20 years.

But picking good businesses is supposedly the tougher part. In Benjamin Graham's world, the answer is purchasing shares at such low prices that stocks sometimes trade below their net liquidation value, meaning that no matter what happens investors would always retain their initial capital even if the company were to be dismantled and sold off. But in Graham's world, discount rates were very high. Financial crashes and panics were frequent, interest rates were high, the population was younger, savings rates were lower, and accumulated capital was lower. In today's world, where interest rates are near zero, the perceived risk of any single stock is much lower than in the past and it is really difficult (if not impossible) to find a single equity trading below its net liquidation value. In Greenblatt's world (which is also our world), we need an alternative way to find value.

### How to find good businesses at bargain prices

Provided that most individual investors are unable to conduct a thorough analysis of the thousands of stocks that are available at the LSE or the NYSE, a simple way of picking value at low price needs to be found. Alternatively, investors may just place their funds in hedge funds, mutual funds, or rely on tips from stockbrokers. But, as Greenblatt claims, poor performance is likely because there are many more unreliable investment managers than above-average performers. Even in the case of those really good performers, most end up underperforming as their assets under management grow in

size. As for stockbrokers, they're paid to sell to investors whatever they can, and not on the performance of those investments.

Greenblatt claims that although we can't pick stocks the way Benjamin Graham did 70 years ago, the main concept behind Graham's strategy hasn't changed: we still want to find good companies at bargain prices. Good, as in high return on capital; and bargain, as in high earnings yield. Businesses with a high return on capital face the best opportunities to employ investors' money and contribute to a very high rate of earnings growth. Businesses with high earnings yields represent a higher return on the initial investment. The "Magic Formula" that Greenblatt talks about consists of selecting businesses with a high return on capital and then ranking them by earnings yield, and choosing the top ranked issues as investment candidates.

The simplest way to follow Greenblatt's magic formula is to use the website he created for it, [magicformulainvesting.com](http://magicformulainvesting.com), which he

created to ensure investors were getting it right. In his own words, "What if individual investors actually followed my advice? What if they believed and understood the logic of the "Magic Formula" provided in the book but then didn't calculate the formula correctly or used poor data sources found free on the Internet? I had visions of a dad or grandma I was trying to help actually ending up losing some of their hard-earned savings by not having the proper resources to implement the strategy. So, we quickly put together [magicformulainvesting.com](http://magicformulainvesting.com) as a free resource for readers of the book that both did the calculations correctly and used a high-quality source for the data"

For all those willing to select equities by themselves, Greenblatt's strategy can be replicated in the following simple steps:

#### (1) Keep in mind that you need at least 20-30 stocks in your portfolio

One of the key assumptions behind Greenblatt's strategy is that we really don't know which individual invest-



**“GREENBLATT CLAIMS THAT ALTHOUGH WE CAN’T PICK STOCKS THE WAY BENJAMIN GRAHAM DID 70 YEARS AGO, THE MAIN CONCEPT BEHIND GRAHAM’S STRATEGY HASN’T CHANGED: WE STILL WANT TO FIND GOOD COMPANIES AT BARGAIN PRICES. GOOD, AS IN HIGH RETURN ON CAPITAL; AND BARGAIN, AS IN HIGH EARNINGS YIELD.”**

ments will outperform and which will not, as in the insurance business. The way to protect risk is by diversifying and building a portfolio that is large enough for the averages to work.

## (2) Choose your desired universe of equities

While Greenblatt's work is centred on US equities, the concept behind the strategy should work in every market. Good stocks will always be good stocks, no matter which market they belong to. Nevertheless, the universe should be large enough for the formulas to work. The Dow Jones 30 isn't a broad enough universe, for example; the FTSE All-Share, the Wilshire 5000, and the FTSE 350 are.

## (3) Apply a few filters

Individual investors may only be willing to select stocks with a market cap above \$50 or \$100 million (or around the same in sterling), to avoid liquidity issues and a few other inefficiencies that may contribute to increase portfolio risk. Investors with larger sums of money may need to raise the minimum market cap to higher values. Greenblatt recommends eliminating financials and utilities. The main reason is because companies in these industries usually run higher levels of debt that may distort the measures used to pick securities. Investors may also wish to eliminate foreign equities (like ADRs in US markets).

## (4) Use a high return on capital as the first criteria

Greenblatt recommends investors select stocks with a return on capital of at least 25%. While this ratio should be widely available at any financial screener, it has a few shortcomings because it varies with financial gearing and the tax rate. If we considered the same business, with different levels of debt to equity, we would notice that the return on capital would be far greater for the more indebted version of the business. But, from the perspective of an investor, it shouldn't matter whether he is buying the business entirely from its owner or from the owner and creditors. With that in mind, Greenblatt suggests an alternative ratio:  $EBIT / (\text{Net Working Capital} + \text{Net}$

Fixed Assets), which is a kind of return on tangible capital employed, before taxes and interest payments.

## (5) Select businesses with the highest earnings yield

The earnings yield is the inverse of a P/E ratio. Investors may then rank companies in the screened list by P/E from lowest to highest and then select the stocks with the lowest P/E ratios (which are the ones with the highest earnings yield). But again, debt and taxes matter, and so there is an alternative selection criteria:  $EBIT / \text{Enterprise Value}$ . This is a pre-tax earnings yield which won't change with debt levels. Investors should rank companies from highest to lowest and then select those at the top.

**“THE S&P 500 SHOWS AN ANNUAL COMPOUND RETURN OF 9.6%, WHILE GREENBLATT'S SIMPLE STRATEGY SHOWS 23.9%, WHICH IS ALMOST 2.5X THE MARKET PERFORMANCE.”**

## (6) Select five to seven equities from the list and invest

After screening the stocks with the highest return on capital and earnings yield, investors should then invest in 20-30 stocks but shouldn't do it all at once. A good alternative is to start by selecting between five to seven equities and then adding another five to seven equities in three months' time. After nine months a portfolio of 20 – 28 equities is built.

## (7) Keep equities for periods of one year

After one year, investors should sell the holding and select a new one with the proceeds. The exact period should be strategically adjusted for taxes. In the US that means selling the losers at least one day before a one year holding period, and selling winners just after one year. This way investors can

reduce taxes paid. The system must be adapted for the exact jurisdiction.

## (8) Repeat the process for years

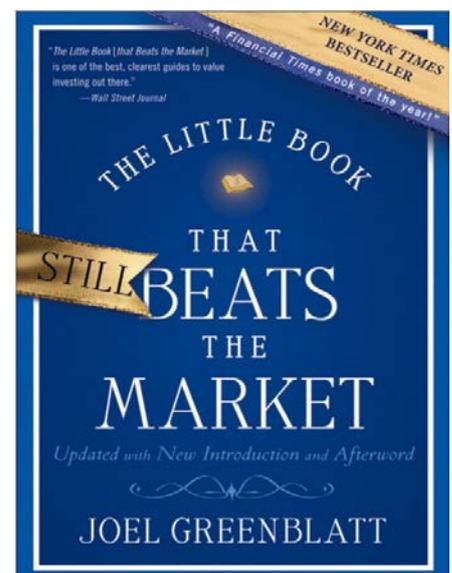
This is the most important part. A portfolio built in this way has outpaced the market over long periods of time, but not without underperforming the market in some shorter periods. Many investors jump from hedge fund to hedge fund and from security to security because they aren't patient, which usually exposes them to Mr Market's ups and downs. At the same time, this impatience is a fundamental reason why Greenblatt's strategy is able to deliver profits over time. Its ease of use may attract many people and then lead to a convergence of expected returns to market averages, but because it usually requires time and patience and goes through some periods of underperformance, many don't stick with it, making it a lot more useful.

## (9) A formula to rank stocks (optional)

An alternative way to rank stocks in just one step is to build a combined rank such that  $\text{Overall Rank} = (\text{Rank by Return on Capital} + \text{Rank by Earnings Yield})$ . If a stock ranks in 1st position by return on capital and in the 15th by earnings yield, it would be given an overall rank of 16.

## How has the strategy fared?

Greenblatt collected data for a period of 22 years between 1988 and 2009 to



**EXAMPLE OF GREENBLATT'S MAGIC FORMULA APPLIED TO LSE SHARES**

Company	Return on Capital (%)	Earnings Yield (%)	Market Cap. (in £ millions)	Industry
Wizz Air Holding PLC	36.5	45.4	944.5	Consumer Services
SCS Group PLC	32.7	24.8	66.5	Consumer Services
NAHL Group Ltd	669.4	23.7	57.6	Consumer Services
Sports Direct International PLC	29.6	23.3	1738.2	Consumer Services
Dart Group PLC	33.1	23.3	779.2	Consumer Services
Braemar Shipping Services PLC	39.5	18.7	81.8	Industrials
Serica Energy PLC	71.9	18.3	61.3	Oil & Gas
Cambria Automobiles PLC	27.8	16.6	65.0	Consumer Services
Ashley (Laura) Holdings PLC	30.8	16.2	140.1	Consumer Services
Motorpoint Group PLC	58.8	15.4	131.8	Consumer Services

**Filters applied:** Return on Capital >25%, Market Cap. > £50m, Industry: No Financials/No Utilities

**Source data:** Sharescope

**GREENBLATT'S MAGIC FORMULA CONSISTENTLY BEATS THE MARKET**

Year	Greenblatt's Magic Formula	S&P 500
1988	27.1	16.6
1989	44.6	31.7
1990	1.7	-3.1
1991	70.6	30.5
1992	32.4	7.6
1993	17.2	10.1
1994	22.0	1.3
1995	34.0	37.6
1996	17.3	23.0
1997	40.4	33.4
1998	25.5	28.6
1999	53.0	21.0
2000	7.9	-9.1
2001	69.6	-11.9
2002	-4.0	-22.1
2003	79.9	28.7
2004	19.3	10.9
2005	11.1	4.9
2006	28.5	15.8
2007	-8.8	5.5
2008	-39.3	-37.0
2009	42.9	26.5
<b>Average Compounded Returns</b>	<b>23.8</b>	<b>9.6</b>

**Source:** "The Little Book That Still Beats the Market"

**GREENBLATT'S MAGIC FORMULA BY DECILE**

Portfolios	Annualised Returns
Group 1	15.2
Group 2	12.7
Group 3	12.1
Group 4	11.5
Group 5	10.7
Group 6	10.2
Group 7	8.8
Group 8	7.1
Group 9	4.1
Group 10	-0.2

**Source:** "The Little Book That Still Beats the Market"

check how his strategy fared against the market. The idea was to simulate returns from portfolios built with 30 stocks which had the best combination of return on capital and earnings yield. During the period, the S&P 500 shows an annual compound return of 9.6%,

while Greenblatt's simple strategy shows 23.9%, which is almost 2.5x the market performance, and a very high long-term performance. Interestingly, these returns are not very sensitive to company size. In the tests conducted by Greenblatt, the high performance remained at similar levels even when he reduced the universe of investable stocks from the 3,500 to the 1,000 largest stocks by market cap.

When dividing stocks by deciles in which the highest decile is composed of the stocks with the highest combination of return on capital and earnings yield, it becomes clear that the abnormal returns reduce from decile to decile, evidencing the fact that Greenblatt's formula really identifies value.

However, the strategy doesn't work at all times. During certain periods it has underperformed the market for longer than a year. But, if it did great at all times, everyone would have jumped onboard and made prices converge to the average faster. "That's why we're so lucky the magic formula isn't that great", Greenblatt quips.

**A few final words**

To beat the market, an investor needs to do something different from the crowd. Value investing is about selecting what others won't and patiently waiting for them to perceive what they missed. Such a strategy won't work at all times and for every individual security. It won't deliver results in the short term either. That's why investors need to look for cheap companies with high potential and then acquire a basket of these. Over time, the portfolio will prove better than average and deliver

consistent returns for the patient investor.

Unlike technology that changes rapidly over time, the main precepts of value investing have remained mostly unchanged. A lack of patience and an orientation towards short-term performance are some of the reasons why the Greenblatt "Magic Formula" can deliver superior profits over time. Most people just don't have the time or patience to wait and will jump out of any investments that underperform the market for longer than a month. Even the fund management business is not immune to market herding. That is because there is a lot of pressure for short-term performance due to competition among funds. Additionally, from a fund manager's perspective, it is often better to fail when all others fail than to fail alone. As a result, many of them end up picking up the same securities as all the others and achieving average performance.

The patient investor will put money aside for periods of 5, 10 or even 20 years and use Mr Market's ups and downs to his advantage to purchase valuable stocks at bargain prices. Those brave enough to wait for prices to converge to true value will reap most of the rewards from investing.

As Greenblatt claims, in the long-term the market will correct to fair value because even if it fails to perceive value, undervalued companies would see their managers repurchase the firm's shares, or the company could be the target of a takeover bid.

In Greenblatt's "Magic Portfolio", investor expectations for the immediate future are pessimistic. It's very hard to be disappointed. If earnings come in on the low side, it is unlikely that price would fall much further because it is already depressed – most of the pessimism is already reflected in the price. But if earnings come in slightly above the pessimistic expectations, investors may enjoy a lot of outperformance from these companies. If an investor isn't expected to lose much from companies whose earnings won't be great and is expected to earn a lot from those whose earnings are slightly better, then, on average, Greenblatt's magic portfolio will outperform.

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BY CAROLINE DREWETT

## MILLENNIALS & MONEY

# HAS MILLENNIALS' REACTION TO TRUMP AND BREXIT MADE US UNEMPLOYABLE?

**Millennials have been out in force the past month to march against the Brexiteering momentum to trigger Article 50, and taking issue with Trump over women's rights, to name just two examples from a range of grievances. But is Millennials' behaviour harming their job prospects?**

Placards at the ready. The #FreeMelania campaign is empowering both men and women alike. Millennials have hit the frontline of politics. Life as a Millennial is tough, but I can't even begin to imagine just how difficult the life of a Millennial activist is – fighting for an ex-supermodel, who has graced the cover of Vogue, speaks six languages and is married to a man worth \$4.5 billion. And all because her husband once made a derogatory comment about women. Never mind Boko Haram, the sex-gangs of Rotherham, or the 200 million girls worldwide who have been forced or coerced into FGM. It's a six-foot supermodel who's more deserving of Millennials' energies and anger. Many well-established

older journalists have noted that marching against Trump is both insulting to those who are really in need, and just a 'show-mance' protest where most attendees can't wait to clock off to hit the local brasserie for an Aperol-Spritz as soon as they've Instagrammed a few photos of their moment of righteous indignation.

Maybe we shouldn't be surprised at this behaviour, given our Millennial role models. As was reported last month, Queen Millennial Emma Watson has found being an activist so difficult that she sometimes struggles to even get out of bed in the morning to take on the role. Stuck lying there, pondering a way

forward with £50 million in the bank, fame and fortune behind you, but with a Tory government that you can't be seen to agree with, clearly spells misery.

To 64 million Americans, voting Trump was the best option. For 17 million Brits, voting for Brexit was the best option. But for many Millennials, they have been unable to fathom a view from outside their own social media bubble. Rather than trying to work out why voters felt oppressed by the establishment, felt lied to by Hillary, and felt fed up with EU bureaucracy, they were so confident in their own pious views that they were celebrating victory before voting even began. When

BAN TRUMP  
NOT REFUGEE

REFUGEES & MUSLIMS  
WELCOME—  
THE ONLY ONE  
NOT WELCOMBOVER  
HERE IS



Time is always  
to DO RIGHT  
MANDELA  
RESIST TR  
RESIST HATE



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**“ALL THIS  
SIDE STEPPING  
AROUND REAL  
ISSUES IS SETTING  
MILLENNIALS  
UP FOR FAILURE  
WHERE IT  
MATTERS – THE  
WORKPLACE.”**

the results came flooding in, and their worlds crumbled, what did they do? They moaned, remoaned, and went on a march for a few hours. *How could we not have seen this coming? Surely everyone must be in agreement with our pseudo-liberal idealism about open borders and tolerance of the intolerant?*

Whether it's Millennials opposing grammar schools as they draw attention to the outrageous levels of intelligence inequality in the country, or Oxford University Student Union suggesting we use Ze instead of He or She to avoid transgender faux pas, all this side stepping around real issues is setting Millennials up for failure where it matters – the workplace. Moaning is what we do best; and no one can tell us otherwise. So we moan, we march, and we Instagram about it. And unsurprisingly, the effects are now being felt in our professional lives, leaving Millennials stranded in first gear. Most employers are starting to tire of self-obsessed Instaholics who can't make it past 10am without taking 800 iced-chai soy sugar-free latte photos on one of their four iPhones. It is estimated that Millennials will make up 50% of the global workforce by 2020, and 75% by 2025 according to accountancy firm Deloitte, yet settling down doesn't seem to be at the forefront of their minds. Forty percent of Londoners admit that they would defer buying a property in order to maintain a lifestyle that offered experiences.

A number of companies have recently claimed to be moving towards employing older, more reliable employees. Although the first Discrimination Act



Ms Jane Campbell / Shutterstock.com

was introduced to stop employees discriminating against elderly workers, who were traditionally more expensive and less efficient to employ, it seems the tables have now turned. Although they might be more expensive per hour, the impression is that they work harder and offer better value for money. Of course, there are the high profile tech companies which have turned their offices into a theme park – lunch time massages, yoga before work, endless popcorn to eat while playing PS4 – but should companies really need to provide these facilities just to convince Millennials to turn up to work every day? The cynics amongst us will also note the publicity from such workplace environments. Why has Google remained popular amidst its tax scandals, for example? Google regularly comes out on top for Amer-



Ms Jane Campbell / Shutterstock.com

ica's Best Employer and Employees' Choice Awards.

The shake-up of 2016 has created so many opportunities for Millennials. The political climate might not have been expected, but that's even more reason to rise up and make a difference. The low value of sterling has brought in huge investment to the UK. Tim Cook, the chief executive of Apple, has told Prime Minister Theresa May that he is "very optimistic" about the UK's future outside of the European Union, reiterating the tech giant's plans to build a new UK headquarters at the Battersea Power Station and moving 1,600 employees to the new office in 2021. As Bank of Mum and Dad has now entered the top 10 mortgage providers in the UK, maybe it's time to stand on our own two feet and make the most of the new jobs coming into Britain, and further afield. Australia, India and New Zealand are all queuing up to start trade talks with the UK, and Trump and May's talks aren't far behind. Yes, we might not be able to walk into Croatia or Poland without a working visa, but the benefits of expanding our horizons around the globe could be life-changing for those that go out and grab the opportunities. The woes of having Trump in power, or leaving the shackles of the EU shouldn't be depressing us; they should be exciting us. Moping around and taking hours out of the working day to join online petitions will only keep Millennials' minds closed and their careers stagnant. The rest of the world has realised the power of democracy and moved on. Let's do the same!

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FEBRUARY 2017

# BEST OF THE BLOG

## **Warning: Central banks to launch digital currencies**

### **The Illuminati are plotting...**

One of the themes I have returned to again and again over the last eighteen months has been how the priestly caste of the world's central bankers, disproportionately drawn from the upper echelons of Goldman Sachs – a kind of mysterious, self-perpetuating, secretive elite

which I (only half-jokingly) call the "Illuminati" – have taken control of global economic policy with almost no democratic accountability.

They have pursued a zero interest rate policy (ZIRP) and then a negative interest rate policy (NIRP) which ministries of finance (which are at least run by elected politicians) are powerless to undo. Despite the fact that NIRP has lowered rates of return – and therefore savings

and investment – to record lows. They have engaged in the dark arts of monetary manipulation – quantitative easing or QE – which have pushed up asset prices for their friends, the elite class of globalist billionaires – and with very little public scrutiny.

Now they want to abolish cash. The next step after that will give them a stranglehold over the global economy. They are planning to launch parallel digital currencies, even competing with

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**“IT IS NOT ONLY YOUR CASH  
THAT IS UNDER THREAT – BUT  
YOUR FREEDOM AS WELL.”**

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the conventional legal tender in circulation – using the same technology that powers Bitcoin. It is not only your cash that is under threat – but your freedom as well.

#### **Strange goings-on at the Fed**

It was reported in June last year that experts in Blockchain technology met with Chair of the Federal Reserve, Janet Yellen, during an event in Washington DC ostensibly to discuss ways in which the technology can improve the financial system

and strengthen cybersecurity. Central banks from over 90 countries participated at the event entitled *Finance in Flux: The Technological Transformation of the Financial Sector*, which was themed around blockchain and Fintech.

According to the speculator and guru, Doug Casey, *the real purpose* of this meeting was to discuss how state monopoly digital currencies could revolutionise the global monetary system. Mr Casey thinks this could be as big as the foundation of

the Federal Reserve back in 2013. There is now evidence that the Fed and other central banks are plotting to launch their own digital currencies.

**By Victor Hill**



**Click here  
to read the  
full article**



## Housing crisis makes this house builder a strong buy

In recent decades, house prices have become a national obsession. Other countries across Europe seem to lack this constant focus on how much house prices have changed in the last month, quarter or year. However, in the UK the love of rising house prices looks set to stay in the long run.

The reason for this is a continued imbalance between demand and supply. Put simply, there are not enough houses built each year to satisfy demand, so prices continue to rise. Therefore, buying a house or investing in companies which build them has proven to be a sound investment strategy in the past and is likely to continue to be so in the long run.

This year, though, looks set to be the exception. The Brexit effect on business confidence, inflation, and consumer confidence is yet to come in my view. As such, house prices could fail to march upwards this year, which I think makes now a good time to buy house builder **Taylor Wimpey (LON:TW)**.

### Brexit shock

Since the EU referendum, it's been a case of so far, so good for the UK economy. It's performing relatively well and apart from a weak pound and modestly higher inflation, nothing much has changed. However, I believe things *will* change and this could hurt house price growth in the short run.

Specifically, a weak pound is likely to cause significantly higher inflation. Already, inflation has risen from 0.5% in June 2016 to 1.6% in December 2016. The Bank of England expects it to hit 2.7% this year, but other forecasters are much more hawkish. In any case, there is a good chance inflation will surpass wage growth this year and cause consumers to have less disposable income in real terms than they had last year.

By Robert Stephens



[Click here to read the full article](#)

## The biggest investment trust winners and losers of 2017

It has been a decent start to the year on the markets with the FTSE 100 index up about 100 points (1.4%) year-to-date and the Dow climbing above 20,000 for the first time with a gain of over 600 points, or 3.1%.

The indices provide a good idea of the direction and speed of travel, but there is always a lot more turbulence in the market than the headline numbers suggest. Over any given period there will inevitably be a handful of securities



that experience extreme up or down movements and this is likely to include some of the more unusual investment trusts.

It can sometimes be useful to look at the biggest movers to help get an idea of where the momentum is strongest and also where you might be able to pick up a few bargains. When doing this you need to look at the underlying details to try and understand why the funds have performed the way they have.

The following analysis is based on calculations by Numis Securities that identified the top and bottom 15 investment trusts with the best and worst share price returns over the period from 2 January to 13 February. As you would expect, they are mainly the more specialist and least diversified funds.

### Everyone's a winner

Five of the fifteen biggest winners in the year-to-date were commodity-related investment trusts. These included **Global Resources (LON:GRIT)** and **Geiger Counter (LON:GCL)** with gains of 53.1% and 52.6% respectively, as well as **Baker Steel Resources (LON:BSRT)**, **Golden Prospect Precious Metals (LON:GPM)** and **BlackRock World Mining (LON:BRWN)** with returns of 29.6%, 27.6% and 19.8%.

GCL invests in companies involved in the exploration, development and production of energy, predominantly





## “HEDGE FUNDS AND THE ‘SMART MONEY’ IN GENERAL HAVE POURED INCREDIBLE SUMS OF MONEY INTO OIL LATELY.”

an 80-year high at 508 million barrels. Despite the agreement reached at the end of November by OPEC members (and later also followed by non-members), oil is still stockpiling, as demand is weaker than expected and oversupply has led to the accumulation of inventories. Despite the data being bearish for oil prices, investors are ignoring the information and keeping oil prices above \$50 and way above the prices recorded in February 2016 (below \$30).

By Filipe R. Costa



within the uranium industry, which is obviously a highly focused mandate, and the same goes for GPM, which concentrates on the precious metals sector. BRWN and BSRT are more mainstream natural resources funds, while GRIT is a special situation.

The natural resources funds have clearly benefited from an improvement in sentiment across the sector, but that is not the case with **Prospect Japan (LON:PJF)**, which is the only Japanese fund in the top 15 with a gain of 30.9%. This fantastic return was partly due to a narrowing of the discount that closed from 26.7% to 7.5% over the same period.

By Nick Sudbury



### There is too much optimism in oil markets

While acknowledging the 'Trump pump' to the oil industry, I have always been sceptical about the long-term prospects for the industry because I believe prices are capped at a much lower level than they were ten years ago. Any excessive enthusiasm is doomed to revert to an even more ex-

treme pessimism in ever shorter periods, as the OPEC cartel's past excesses have led to the rise of a whole new hydraulic fracking industry that is always waiting in the sidelines for opportunities to pump oil into the market.

Not sharing my lack of enthusiasm, hedge funds and the "smart money" in general have poured incredible sums of money into oil lately, so high is their optimism. Currently, the ratio of long to short bets on oil is at a record 9 to 1, which is an indicator of how sentiment is tilted towards the bullish side. But for those who follow the precepts of value investing, this scenario alone is enough to make the alarm bells ring; when there is excess optimism, future returns tend to be poor. Compounding the behavioural argument is a fundamental reasoning showing the oil market may be softer than it seems.

The latest data on oil inventories, released last week, showed that inventories rose a near record 13.8 million barrels, pushing inventories close to





BY RICHARD GILL, CFA

READ TO SUCCEED

# THE RETREAT OF GLOBALISATION

## ANTICIPATING RADICAL CHANGE IN THE CULTURE OF FINANCIAL MARKETS

BY GERVAIS WILLIAMS

Whenever I hear the word "globalisation" the first thing that comes to mind is how Western brands have been spread around the world by multi-national corporations. For example, whether in the US, UK, Japan or the Philippines, consumers can always find a McDonalds "restaurant" in any major town or city and have the same soulless and tasteless dining experience.

But globalisation – the process of national, or local, economies becoming more integrated with one another – is about much more than just the spread of products to other countries – and it does have its benefits along with its downsides. As well as the export of goods and services, globalisation also involves the movement of people/labour (mainly from low income to high income countries), the movement of capital (from countries with excess funds to those looking for investment) and the sharing of knowledge/technology (between everyone).

### Small world

Depending on how you define it, globalisation has arguably been around ever since the earliest human civilisations – as communities began to develop they interacted and traded with other groups close by. The process then saw several notable waves of growth in the last millennium.

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**“INVESTORS SHOULD COME OUT THE OTHER SIDE BETTER OFF BY FOLLOWING THE ADVICE IN GERVAIS WILLIAMS’ LATEST INTELLIGENTLY WRITTEN AND HIGHLY READABLE BOOK.”**

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To give an extremely potted history, in the 15th to 18th centuries the so-called Age of Discovery saw European empires explore the planet by sea and establish trading routes between the "Old World" and the "New World". Modern globalisation then kicked off in the 19th century after technological advancement during the industrial revolution, namely in manufacturing and transport, allowed for further penetration and expansion of trade around the world. After a blip during the two world wars, globalisation then ramped up again in the latter half of the 20th century on the back of politicians promoting free trade agreements and further technological advancements, particularly in the area of communications.

### Building boundaries

The overall result of centuries of globalisation is that we now live in a highly inter-connected and integrated world economy. But, mainly set in mo-

tion by social and political upheaval, in recent years there have been hints that the world has begun to enter into a period of *de-globalisation*, with the links between the economies of certain nations beginning to break apart rather than come closer together. The zeitgeist has been especially notable in the recent decisions made by the UK and US electorates, which have respectively decided to exit a local trading group and vote in a protectionist head of state with a plan to build physical walls with a neighbouring country.

De-globalisation and how it affects financial markets is the main topic of *The Retreat of Globalisation*, the third book within five years from author and fund manager Gervais Williams. It follows up on 2011's *Slow Finance* and 2014's *The Future is Small*, which discussed the state of the financial markets following the 2008/09 financial crisis and argued the case for long-term investing and the virtues of small cap companies. For those who haven't heard of Williams before, he is probably best known for his role as a small cap fund manager and Managing Director of asset management group Miton. Over a 30+ year career in the City he has won a raft of

awards for his knack of being able to outperform the market on a regular basis – see chart below – so his views on investment are definitely worth paying attention to.

*The Retreat of Globalisation* serves up 12 thought-provoking chapters divided into two halves. In the first half, over six chapters, Williams discusses in detail the long-term economic trends which have been shaped by globalisation over the past few decades. The rise of credit, a common topic in Williams' books, is also discussed as being just as important as globalisation in creating the financial world as we know it.

Chapter Two begins with the story of corporate profits, discussing how the globalisation of trade, combined with the availability of cheap credit and higher valuations attributed to equities, saw the total value of FTSE 100 companies soar from £165 billion to £1.6 trillion in the 30 years to 2015. High profit margins, which you would expect to have been eroded by increased competition, have been sustained, inflated in Williams' view mainly due to increased consumer spending driven by the credit boom.

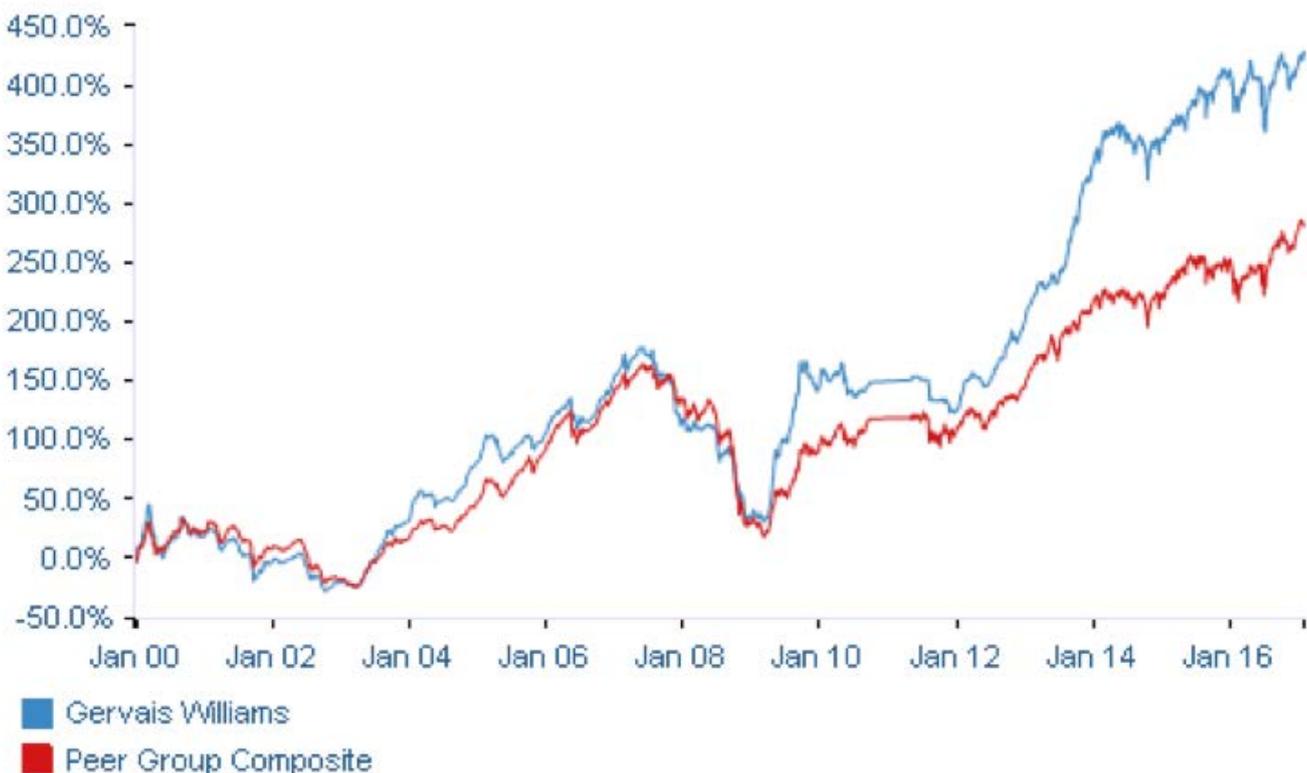
So, as corporate profits have continued to grow over the past three decades, investors have got used to enjoying, over the long-term, steadily rising equity prices.

Further chapters cover a range of other market characteristics shaped by globalisation including the rise of imprudence amongst company management, the Chinese credit expansion, quantitative easing and ultra-low interest rate policies set by central banks.

### Biggest change in a generation

With social attitudes towards globalisation trending towards negative, Williams argues that the resulting economic changes will have a profound effect on our financial futures – perhaps more so in the UK, which has embraced globalisation more than most countries. Specifically, he thinks that the move towards de-globalisation will see changes including slowing productivity, pressure on corporate profits and cashflows, a halt to improvement in equity valuations and less risky corporate strategies being implemented by management.

### Total return for Gervais Williams



Source: Trustnet



**“INVESTORS WILL NEED TO CHANGE THEIR STRATEGIES MORE OVER THE NEXT THREE YEARS THAN THEY HAVE OVER THE LAST THREE DECADES.”**

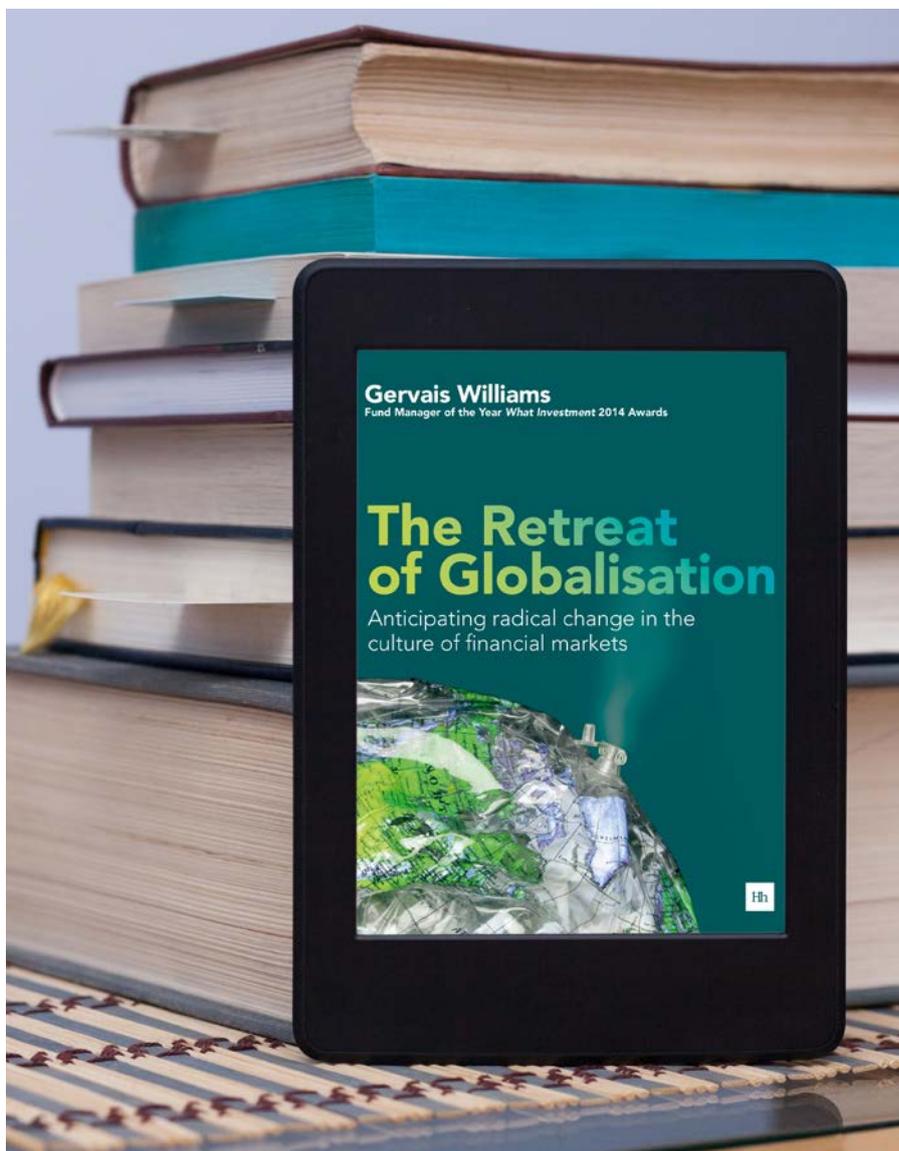
The second half of the book then looks at how investors can respond to these challenges. No stranger to controversy, Williams suggests that investors will need to change their strategies more over the next three years than they have over the last three decades if they want to survive peak globalisation with their assets intact.

Over the final five chapters readers are given practical advice on how to cope with the expected changes and how to identify the metrics which will drive successful future investment strategies. Instead of chasing risky capital gains in the future Williams suggests that underlying income and cashflow will be much more important for long-term returns, with strategies based on maximising dividend growth likely to be popular – as the rise of globalisation rewarded those investors that were impulsive and risk seeking, its retreat will start to create an environment which will reward the prudent.

He also advocates investing in companies which address niche areas and can thus resist margin pressures, those which can boost their margins by focusing on operational efficiency and firms offering superior standards of service. The final chapter looks at three ways to minimise risk in what is expected to be a smaller universe of premium stocks to invest in.

### A timely tome

This has been an appropriate time to review *The Retreat of Globalisation* given that the themes covered have frequently been in the news and high on the agenda of politicians and corporations alike.



For example, in an essay released in mid-February this year Facebook founder and CEO Mark Zuckerberg felt the need to trumpet the benefits of a more connected world, proclaiming, "Our greatest opportunities are now global". And following its recent 62% slump in annual profits HSBC reassured investors, "If globalisation continues to retreat, as seems likely, we are in a strong position to capitalise on the regional opportunities that this will present." Perhaps more concerningly, in a recent interview with Sky News, histo-

rian Prof. Harold James of Princeton University suggested that the collapse in support for globalisation could be a precursor to another world war!

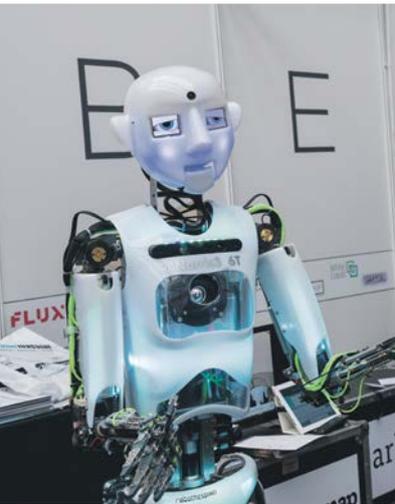
Whatever outcomes we see in the coming years and decades as a result of de-globalisation, whether war, walls or other woes, investors should come out the other side better off by following the advice in Gervais Williams' latest intelligently written and highly readable book.

### EXCLUSIVE BOOK OFFER

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BY TIM PRICE

## THE FINAL WORD

# THE SLOW DEATH OF THE ANGLO-SAXON STOCKBROKER

Back in 1998, the author Michael Lewis, then a columnist for Bloomberg, wrote as follows:

**"When historians of everyday life look back on 20th-century American capitalism they will be astonished by the role played by our stockbrokers. Certainly, it will be hard for them to explain to their readers the willingness of a prosperous American to hand his life savings over to a more or less perfect stranger in the mistaken belief that a) their interests are identical and b) the stranger has some special insight into the stock market. The reader will regard us with the same awe that we now regard those brave and seemingly mad souls who rode in wagon trains and fought Indians simply to get to California."**

When Michael Lewis wrote that piece I was working for Merrill Lynch (Private Banking) and my role was not altogether dissimilar to that of a stockbroker – I was being paid to advise private clients about the management of their portfolios. At around the same time, the market capitalisation of Merrill Lynch – the largest "full-service" stockbroker in the US – had just been overtaken by that of Charles Schwab, a discount stockbroker operating largely online. It was clear to me that the tectonic plates of the financial services world were starting to slide. Within a year or so, I had elected to move on, leav-

ing large banking institutions behind me forever.

I have long been amazed at the resilience of stockbrokers. There was once a time – say, the late 1980s – when a private investor who wanted to buy stock was obligated to deal with a member of the Stock Exchange, and had to pay a pretty hefty price for the service. There was also once a time – say, the 1970s – when brokerage commissions were fixed and for stockbrokers, at least, the living was easy.

And then the markets changed. In

the United States on 1st May 1975 – a date that would be called either May Day or Mayday depending on how badly you were affected – the era of fixed commissions for stock transactions ended.

Britain being Britain, it took us a little longer to get there. The British equivalent to May Day took place on 27th October 1986 – Big Bang – during which fixed commission charges were abolished, along with the distinction between stockbrokers and stockjobbers, and after which the open outcry model was replaced by screen-based trading.

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**“THE ROLE OF THE WALL STREET RESEARCH ANALYST IS UNDERGOING AN EXISTENTIAL CRISIS, THE LIKE OF WHICH THE INDUSTRY HAS NEVER SEEN BEFORE.”**

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In earlier (pre-millennial) incarnations of the stockbroking model, the cost of execution – of direct stock exchange access – was comparatively high. Partly as a result of this and partly to disguise it, research was 'bundled' into the service as part of the offering to clients (of "full-service" houses, like Merrill Lynch, at any rate).

But as the triple forces of technology, competition and deregulation worked their magic, assisted by the internet, the cost of simple market execution soon fell to more or less zero. This pushed into sharp relief the questionable value-add of research provided by sell-side institutions.

Anyone who has read a financial newspaper or magazine over recent months will be no stranger to this phenomenon. The role of the Wall Street research analyst is undergoing an existential crisis, the like of which the industry has never seen before. An example: The Financial Times of 8 February devoted a page of its 'Big Read' column to City research:

"Final call for the research analyst?" it asked;

"Under pressure to cut costs and meet new regulations, banks and brokerages are shedding research analysts as the industry wakes up to the fact that the vast majority of what it produces is never read."

This is not a new development. The debatable value of City research has been a topic of discussion for at least as long as the quarter century that I have been working in the City, but the nature of the 'crisis' has suddenly become a lot more acute, as investment banks dealing with the aftermath of the Global Fi-

**“NOW THAT STOCK EXECUTION IS SO COMPETITIVE AND VISIBLY EFFICIENT, IT HAS MADE THE VALUE OF EQUITY RESEARCH MORE APPARENT. IN MANY CASES IT IS WORTH NOTHING AND AT EVEN THAT LEVEL IT MAY BE OVERPRICED.”**

ancial Crisis have been obliged to cut costs wherever possible.

Regulation is also taking its inevitable toll.

The first time I became conscious of the essential absurdity of sell-side research – and the regulatory response that arrived in its wake – was during the first dotcom boom. Unless you were too young to be a part of that scene, or were living under a rock at the time, you will likely remember Merrill Lynch's head of internet research, Henry Blodget.

Blodget, a ginger-haired chap with somewhat cadaverous features, had previously been an internet research analyst at CIBC Oppenheimer. In October 1998 he made his reputation by predicting that Amazon stock, then



trading at \$240, would reach \$400 within a year. It actually took just three weeks, helped by Blodget's highly publicised little push.

Merrill Lynch, which badly needed to boost its own internet research resources, hired Blodget. But Blodget soon became a victim of the conflicts of interest that beset any high profile research analyst working at an institution that also conducts investment banking business – notably the provision of corporate advice, underwritings, and mergers and acquisitions. Underwriting public offerings can be hugely profitable business. The provision of stock research – less so. Regardless of so-called 'Chinese walls' designed to corral information and opinions about companies within individual business lines, it soon became clear that some of Merrill Lynch's research staff were essentially pimping out corporate clients for the investment banking division. You can read the full text of the Securities and Exchange Commission's legal action against Blodget [here](#).

It transpired that internet companies that Blodget or his team were publicly recommending to clients were internally regarded as "pieces of shit". In a July 2000 email, a junior research analyst in Blodget's team confessed that if there were banking revenue attached to pursuing research coverage of a certain internet stock, "I imagine we will pick it up".





Although the implosion of the first dotcom bubble was a product of mass insanity, it would be left to Blodget to act as the scapegoat. In 2003 he was charged with securities fraud and barred from the securities industry for life.

The Blodget case laundered all of Wall Street's dirty washing. It made it abundantly clear that supposedly objective research was little more than huckstering for business, PR, or both.

In the pre-millennial stockbrokerage model, research came bundled up with stock execution so that it was difficult to know precisely what the client was paying for in each case. Now that stock execution is so competitive and visibly efficient, it has made the value of eq-

uity research more apparent. In many cases it is worth nothing and at even that level it may be overpriced.

So it should come as no particular surprise that the FT found in its February article that only between 2% and 5% of research emails sent out by banks and brokerage firms are read each week.

Another factor that has extended the shelf-life of the research analyst has been the opaque way in which Wall Street and the City 'sells' its research to the fund management community. Hitherto, research was provided *en masse* to buy side firms (institutional asset managers) who would then reward those research providers with trading business, replete with trading commissions. The requirement for brokerage counterparties to provide so-called 'best execution' means that the days of 'bundled' research are likely on the way out forever.

Lest this piece seem like a hatchet job exclusively aimed at investment banks, we should also ask ourselves why asset managers have allowed themselves to drift into a situation where they are expected to compensate research firms (opaquely) for providing them with trading or investment ideas. Isn't it *their* job to come up with investment ideas in the first place?

In any event, sunlight acts as the best disinfectant. For far too long, vested interests and obsolete business models have allowed sub-optimal business structures to perpetuate themselves at the expense of the paying client. Lest there be any misunderstanding, the paying and long-suffering client is *you*.

All of which is not to denigrate the genuinely hard-working and ethical research analyst or stockbroker. But the financial services arena has been an Augean stables for far too long. Its practitioners can hardly rail at the negative impact of otherwise well-intended regulatory interference because they have been getting away with murder for decades.

For the individual investor, and for the asset manager, there is also light at the end of this particular tunnel. For anybody willing to do their own research, the retrenchment of investment banks from research coverage of, in particular, small and mid-cap stocks, globally, represents a huge opportunity for other players in the capital markets. An example: In one of the specialist Japanese equity funds with which we invest, the companies within their portfolio are followed, on average, by just half an analyst – i.e. between zero and one analyst per company. Essentially, Wall Street has abandoned the small and mid-cap markets around the world, on the basis that they stand to earn more by way of underwriting, corporate consulting and M&A business from the mega-cap companies instead. They are probably right.

What that means is that anyone willing to do their legwork and homework in less closely followed sectors has those markets more or less to themselves. The fund manager of the Japanese fund I just mentioned recently went to visit a specialist manufacturer of screws for mobile phone covers. Having finally managed to find the headquarters of the company in question, he was bemused to see a welcome banner naming his fund draped across the entire front of the building in question. The reason for the welcome banner? He was the first fund manager and research analyst to visit that company for 60 years.

The slow death of the stockbroker, and of the research analyst, offers up tremendous opportunities for the rest of us, and not least for the disciplined and self-directed investor. Happy hunting.

**“THE RETRENCHMENT OF INVESTMENT BANKS FROM RESEARCH COVERAGE OF, IN PARTICULAR, SMALL AND MID-CAP STOCKS, GLOBALLY, REPRESENTS A HUGE OPPORTUNITY FOR OTHER PLAYERS IN THE CAPITAL MARKETS.”**

#### About Tim

Tim Price is manager of the VT Price Value Portfolio and author of 'Investing Through the Looking Glass: a rational guide to irrational financial markets'. To find out more, visit [www.pricevaluepartners.com](http://www.pricevaluepartners.com).



## MARKETS IN FOCUS

# FEBRUARY 2017

### GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
Bovespa	3.1	7.9	
CAC 40	2.3	2.0	
DAX Xetra	2.6	5.1	
Dow Jones	4.8	6.9	
Euronext 100	2.9	2.8	
FTSE 100	2.3	3.4	
Hang Seng	1.6	8.1	
IBEX 35	1.7	4.3	
NASDAQ 100	4.2	10.8	
Nikkei 225	0.4	1.5	
Russian Trading System	-6.2	-3.2	
S&P 500	3.7	7.0	
S&P/ASX 200	0.9	0.7	

### COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Cocoa	-8.1	-12.8	
Coffee	-5.7	6.9	
Copper	2.1	10.0	
Crude oil (Brent)	0.3	-1.1	
Crude oil (Light Sweet)	0.9	-0.3	
Gold	2.8	8.3	
Iron Ore	5.3	13.4	
Natural Gas	-11.9	-25.3	
Palladium	2.4	14.2	
Platinum	2.6	12.4	
Silver	4.8	15.5	
Soybean	2.7	4.7	
Sugar (No. 11)	-5.3	-0.1	

### FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
AUD/USD	0.8	6.3	
EUR/CHF	-0.4	-0.6	
EUR/GBP	-0.5	0.7	
EUR/JPY	-1.9	-2.3	
EUR/USD	-2.1	0.2	
GBP/AUD	-2.5	-6.5	
GBP/USD	-1.7	-0.6	
USD/CAD	2.1	-0.6	
USD/CHF	1.8	-0.8	
USD/JPY	0.3	-2.4	

### CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	Mar 16	May 11
ECB	0.00%	Mar 09	Apr 27
FED	0.75%	Mar 15	May 03
BOJ	-0.10%	Mar 16	Apr 27
SNB	-0.75%	Mar 16	Jun 15
BOC	0.50%	Apr 12	May 24
RBA	1.50%	Mar 07	Apr 04
RBNZ	1.75%	Mar 23	May 11
BOS	-0.50%	Apr 26	Jul 03
BON	0.50%	Mar 16	May 04



**FTSE 350 TOP**

Sector	Last Month %	YTD %	Proximity to 52w High*
Essentra PLC	32.8	16.3	
Acacia Mining PLC	24.5	44.5	
Bodycote PLC	18.6	24.5	
Indivior PLC	18.3	20.2	
Unilever PLC	18.3	17.4	

**FTSE 350 BOTTOM**

Sector	Last Month %	YTD %	Proximity to 52w High*
Serco Group PLC	-18.2	-17.9	
Vedanta Resources PLC	-17.7	3.8	
IP Group PLC	-17.1	-11.3	
Go-Ahead Group PLC	-12.2	-10.7	
Cobham PLC	-11.7	-25.4	

**FTSE 350 SECTORS TOP**

Sector	Last Month %	YTD %	Proximity to 52w High*
Personal Goods	15.6	16.5	
Aerospace & Defense	9.6	7.0	
Pharma & Biotechnology	9.6	6.3	
Food Producers	8.5	-1.2	
Fixed Line Telecom	7.6	-9.9	

**FTSE 350 SECTORS BOTTOM**

Sector	Last Month %	YTD %	Proximity to 52w High*
Oil Equip, Serv & Dist	-5.2	-8.1	
Mining	-4.0	12.5	
Oil & Gas Producers	-3.4	-6.6	
Banks	-1.3	4.1	
General Industrials	-1.0	8.3	





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