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MAGAZINE

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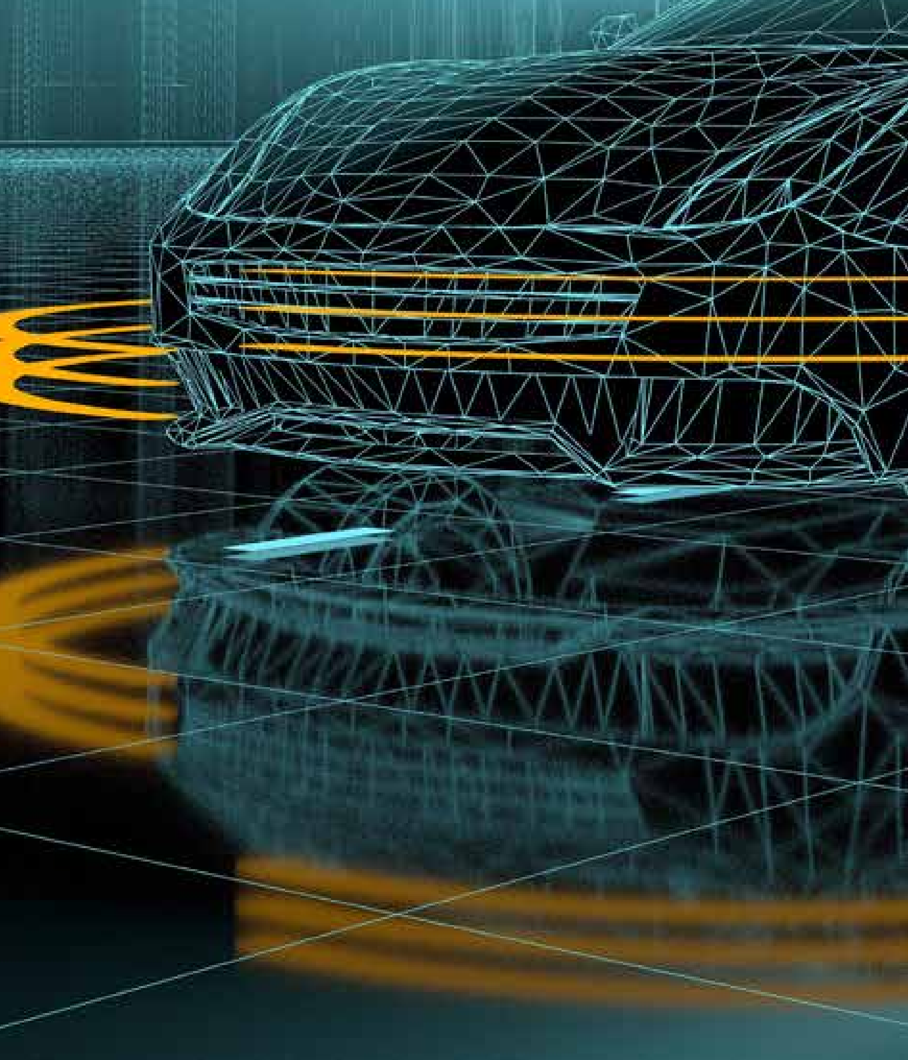

PLUS...

HIGH INCOME

THE FUNDS THAT PAY A 5% INCOME

JIM SLATER

THE SECRETS TO SUCCESS OF THE MAN BEHIND THE 'ZULU PRINCIPLE'

THE DOGS OF AIM

HOW TO PROFIT FROM HIGH-YIELDING SMALL CAPS

JIM MELLON

THE MASTER INVESTOR REVEALS HIS NEXT 'MONEY FOUNTAIN'

WELCOME

Dear Reader,

Many of you attended our yearly flagship event, the Master Investor Show. If you weren't able to participate in person, I urge you to watch some of the videos we produced of the presentations given at the event:

- Jim Mellon spoke about new breakthroughs in longevity-related science, and how private investors can profit from the extension of the human life-span.
- Justin Urquhart Stewart warned investors about the new financial reality that retirees are facing. Back in the old days, retiring meant switching to more conservative investments. However, with extended life-spans and retirement periods of 30 or 40 years, can retirees afford not to be invested in growth areas?
- Tom Stevenson of Fidelity Personal Investing, also a regular contributor to the Daily Telegraph, explained why anyone who thought 2016 was a disruptive year will have a few lessons to learn in 2017. Fasten your seat belt!
- Alex Wright, manager of the Fidelity Special Situations Fund, helped our delegates to understand how he locates undervalued shares for his investment funds at Fidelity.
- Gonçalo de Vasconcelos from SyndicateRoom inspired our audience to look beyond public companies. With the right kind of diversification, superior returns can be achieved from early-stage ventures. He also introduced his new fund, Fund Twenty8.

All of these presentations are available to watch on our website, as well as on our YouTube channel. That's in addition to the 40 presentations given by companies on the Rising Star Stage, in the Gallery Suite, and in the Auditorium – all of which we have available for you as video. (This includes a talk by Evil Knievil, who remains one of our most popular contributors. At one point, we had a queue 50 yards long to get into the venue where Evil spoke.)

If you prefer to first watch a three-minute summary of our event, please click here. Or why not listen to the 24 minute show that Share Radio produced about the event?

If you haven't attended, we hope that the material we are making available on our digital channels will be useful, inspiring and entertaining for you. Even better, join us in person at next year's show!

Best regards,

Swen Lorenz
Editor, Master Investor Magazine

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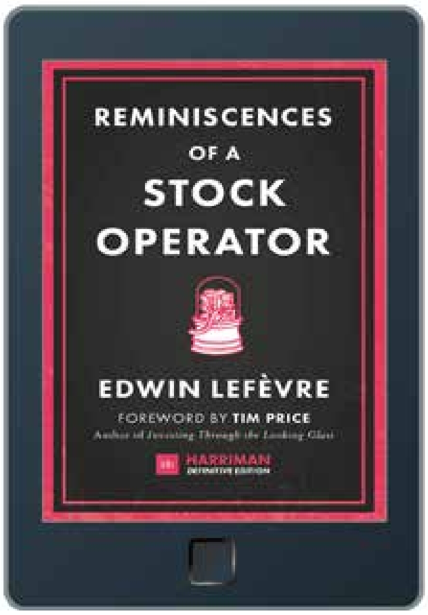

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BY JIM MELLON

MELLON ON THE MARKETS

THE NEXT MONEY FOUNTAIN

Another Master Investor done! A huge crowd, impressive companies, great speakers and an engaged audience. Well done Swen and team!

I must say I always feel wrung out afterwards, as it takes weeks to prepare my speech and develop my theme. Luckily, this year, I think we are onto a new *money fountain* centred on the New Age of Longevity – or *Juvenescence*, the title of our new book.

I am writing this from the Babraham Institute at Cambridge, where I am attending a conference on the Ageing Cell with my colleague Anthony Chow. We are the only ones in the audience without PhDs, and it's quite hard to follow – but very worthwhile. We also got to have a drink with our friend Aubrey de Grey, the rock star of the anti-ageing space and someone everyone should watch online – and also contribute to his SENS foundation.

The information I am getting here at Cambridge will allow me to fit all the pieces of the book into place, and I intend to do that over the next ten days or so, with a publication date sometime late May.

I am super excited to be moderating the ageing panel at the upcoming Milken Institute conference in LA in May, the world's most prestigious forum of its type.

I am also really looking forward to meeting the famous John Mauldin and Patrick Cox in Florida later in April, where we are going to drill down into the longevity space and come up with some ideas.

All in all, this is shaping up to be a busy year, and I am really positive about the returns we can make in the best anti-ageing companies.

All will be revealed in the book, but in the meantime I want to talk about the more prosaic business of making money in 2017.

I am absolutely convinced that gold and silver are necessary in the current environment. As regular readers know, the precious metals "complex", as it is known, is normally only a small part of my portfolio, more for insurance and diversification.

Last year, I turned bullish on the prospects for inflation – which favours precious metals – and today, that inflation is seeping in everywhere. Even in moribund Europe, and in nothing-seems-to-work Japan, inflation is creeping in.

I actually don't think this inflation is price driven (goods), in a canonical sense – I think it is the result of some improvement in monetary velocity, coupled with a recognition that the workers at the lower end of the pay scale need (/deserve/are due/won't work without) more money. The share of wages in developed countries has been falling for years, and I suspect that is reversing, as full or close to full employment is reached in many countries.

In the UK, labour participation rates are high, and unemployment is low, and we are seeing the beginnings of "revolt" against the excess profits of corporations at the expense

"I THINK WE ARE ONTO A NEW MONEY FOUNTAIN CENTRED ON THE NEW AGE OF LONGEVITY – OR JUVENESCENCE, THE TITLE OF OUR NEW BOOK."

"IF WE CAN IDENTIFY SOME ANTI-AGEING COMPANIES THAT HAVE HIGH POTENTIAL, THEY WILL SURELY HAVE A MUCH BIGGER MARKET FOR THEIR PRODUCTS THAN ANY INTERNET 'PLATFORM'."

of workers' wages. In the US, labour participation has been declining, but unemployment in a true sense is low, and the same pressures are emerging. It's the same in Germany and Japan. And Chinese wages are rising at a rate that is eroding the country's competitiveness.

The so-called gig economy sounds fun, but it really isn't if most of your income is consumed by rent, there is no prospect of saving, and your employment is non-contractual and perilous.

So, even though oil prices are falling, and food prices are mostly under control, wages are now improving and that is where inflationary pressures are emerging.

Central banks are always behind the curve on this, and although the Fed is tightening, the BOJ and BOE are still pursuing excessively loose monetary policies, and as for the ECB, well it really doesn't know what it is doing. Plus ça change.

So, in inflationary circumstances, you get inflation. I like Amanda Van Dyke's Peterhouse Gold Fund, and I like ETFs. I like **Condor Gold (LON:CNR)** in London, and **Hecla Mining (NYSE:HL)** in Canada. Do your research here and it should work out.

Gold should go to at least US $1,800 per oz. this cycle, and silver to US$30.

Meanwhile, most markets (with the exception of Japan and Korea) are priced to perfection. Japan is overall at 14 times earnings, and that's about half the US, with better growth prospects especially since US earnings are fundamentally overstated by inadequate depreciation and corporate buybacks. So I'd load up on Japan, and I like **Hitachi (TYO:6501)** and **Sony (TYO:6758)** among the bigger companies, and in Korea, **Samsung Electronics (KRX:005930)** is a buy.

I turned negative on **Alphabet (NASDAQ:GOOGL)** a couple of months ago, and I think it is a screaming sell. Advertisers are deserting it, because of YouTube issues, and management are wasting money at an enormous rate on moon shots to nowhere. When corporate hubris sets in, head for the exits.

It's the same story with **Facebook (NASDAQ:FB)** and **Snap (NYSE:SNAP)** – both frivolous, both transient and both overvalued.

Amazon (NAZDAQ:AMZN) is a hard one, but it requires perfect execution to make its current valuation one worth considering so it too is a sell.

If we can identify some anti-ageing companies that have high potential, they will surely have a much bigger market for their products than any internet "platform". And watch out for those platforms being increasingly regulated. Their glory days are over.

In currencies, I'd buy the Polish zloty against the Euro, the Malaysian Ringgit against the USD, and the Mexican Peso against the USD. Exotic but likely to be profitable.

Meantime, I'm back to book writing. Six days in Austria, head down, coffee jug at my side. It's hard work this Juvenescence!

Happy hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter

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BY VICTOR HILL

OPPORTUNITIES IN FOCUS

THE AUTOMOTIVE GIANTS DRIVING TOWARDS THE FUTURE

In this month's *Opportunities in Focus* column I want to discuss why the global automotive industry is at a critical juncture in its evolution. After more than a century of reliance on fossil fuels, the electrification of vehicular transport is going to be huge. Only one car in a hundred today is powered by electricity, but some forecasts reckon that that could be nearly one in ten by 2025 – and that more than half the cars on our planet will be electric-powered within just 15 years. And many – possibly most – of those cars in 2032 will be *self-driving*.

This month I want to ask: *Which of the current players in this mature global industry are best placed to ride these trends and profit best?*

What is clear is that a number of major automotive manufacturers are becoming leaders in new technologies. Some might even shift away from making cars as such to focus on *automotive technology*. And everywhere we see the coming together of automotive technology with information technology. It turns out that the cars of the future will be robots on which we shall hitch rides...

Electrification

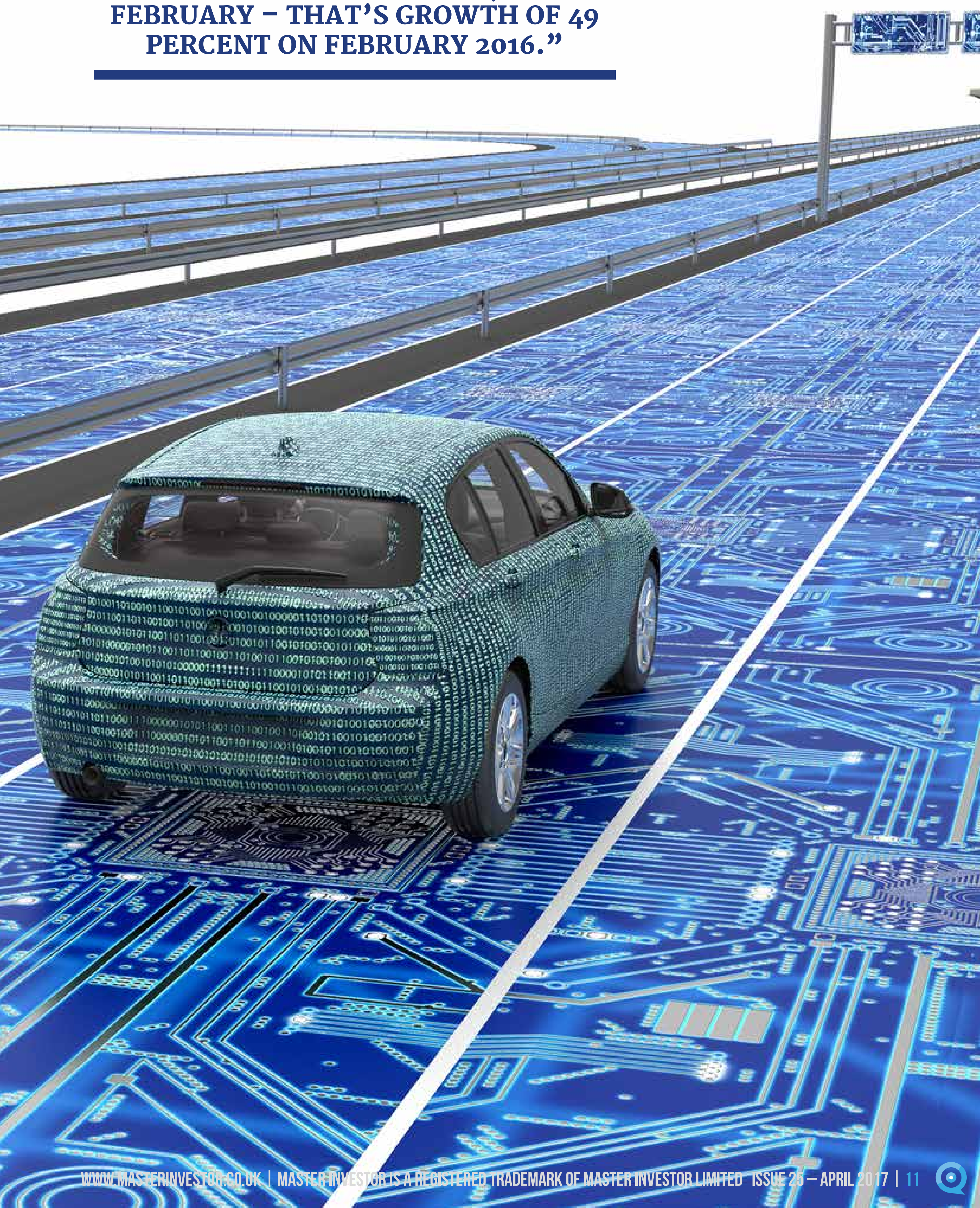
The electrification of the automotive industry – the spread of electric cars in plain English – relies on two technology platforms: Pure Electric Vehicles (PEVs) and Hybrid Electric Vehicles (HEVs). Both technologies require an efficient infrastructure or "smart grid" providing a wide network of easily accessible charging stations. The roll-out of such a network will be costly. That said, the number of charging stations in the USA grew by almost a quarter last year, to nearly 40,000.

Manufacturers need to continue to develop battery technology in order to increase driving range and to reduce production costs. Both public and private support of research and development programmes, along with increased industry collaboration, will be needed in order to bring costs and range into an acceptable customer proposition for mainstream consumers. As a result of all this, electric vehicles might take longer to become predominant than some analysts suggest.

PwC Autofacts estimates that in 2017, annual production of Electric Vehicles (EVs) could reach 1.4 million units globally, which will represent approximately 1.5 percent of global vehicle assembly. More than 400,000 electric vehicles were sold in China last year, making it the world's largest market. And electric cars accounted for a remarkable 29 percent of all cars sold in Norway last year. Indeed, Norway's current count of 100,000 electric cars is expected to quadruple by 2020.

Sales of electric vehicles in the UK increased to 3,300 in February –

"SALES OF ELECTRIC VEHICLES IN THE UK INCREASED TO 3,300 IN FEBRUARY – THAT'S GROWTH OF 49 PERCENT ON FEBRUARY 2016."



"THE HYDROGEN COUNCIL WAS LAUNCHED AT DAVOS IN JANUARY THIS YEAR AS A GLOBAL INITIATIVE TO FORMULATE A LONG-TERM VISION OF USING HYDROGEN TO FOSTER THE 'ENERGY TRANSITION' TO A MORE SUSTAINABLE ECONOMY."

that's growth of 49 percent on February 2016. In contrast, there were almost 43,000 new registrations of petrol cars and 37,000 diesels, which are now evidently in decline (see below)[i].

There are basically two key forces pushing electrification. The first is air pollution. In Britain alone there were an estimated 40,000 deaths last year attributed to air pollution, diesels being mostly to blame here. And the second reason is, of course, climate change. Carbon dioxide emissions from cars and trucks account for a significant percentage of total world emissions. In addition to these environmental factors, there is increasing consensus that electric cars will be more efficient and therefore more economical to run. Lastly, they might also be safer.

Hydrogen power

Hydrogen fuel cell electric vehicles work by chemically combining hydrogen and oxygen to generate electricity. When you combine H_2 with O you get – well done – H_2O – water. So the only waste products are water and heat – zero carbon emissions and no mess. Hydrogen can be compressed into fuel tanks such that these vehicles often have a longer range than so-called Pure Electric Vehicles (which store electricity in batteries which are frequently re-charged). Hydrogen provides an ownership experience more akin to that of a petrol-powered car. It takes between three and five minutes to fill up a hydrogen car such as the Honda *Clarity* as compared with half an hour or so to charge a Tesla *Model 3*.

In terms of range, the Toyota Mirai is said to have a range of about 350 miles. (And I note it currently comes new with three years of complimentary fuel!). Honda's hydrogen car, the Honda Clarity (a space age analogue to the Honda Accord), has the longest range of any zero-emission vehicle today at 366 miles. The problem is of course – where does one fill up the tank?

In February, **Royal Dutch Shell (LON:RDSA)** opened Britain's first public filling-station for hydrogen powered cars at Cobham Services on the M25 London Orbital motorway. This is the first of three that Shell is planning to open this year. The oil major has already opened hydrogen re-fuelling stations in California and Germany and is reportedly assessing the potential in the USA, Canada, Switzerland, France and the Netherlands[ii].

Shell was a founding member of the Hydrogen Council along with other giants such as **Hyundai Motor Co. (KRX:005380)**, **Anglo American (LON:AAL)** and **Total SA (EPA:FP)**. The Hydrogen Council was launched at Davos in January this year as a global initiative to formulate a long-term vision of using hydrogen to foster the "energy transition" to a more sustainable economy. The Council will work with – and provide recommendations to – key stakeholders such as policy makers, business and hydrogen players, international agencies, and the wider public to this end[iii].

General Motors (NYSE:GM) and **Honda Motor Co. Ltd. (TYO:7267)** are also investing US$85 million as part of a joint venture to mass produce hydrogen fuel cells in 2020. The [Chevrolet *Bolt*] is one of the cheapest electric cars, on sale for about US$30,000 in the USA. It has a range of 238 miles. However, GM is reportedly losing money on these models right now to the tune of about US$9,000 per car[iv].

Hydrogen cars: technical configuration

The Honda *Clarity* has been enthusiastically reviewed by motor heads[v]. It uses a so-called *Fuel Cell Voltage Control Unit* (FCVCU) which helps to maintain the traditional configuration of a conventional petrol car.

In previous Honda electric car models, the electric motor, gearbox, and power control lay under the bonnet, while the fuel cell was located vertically between the driver and passenger seats. And a large hydrogen tank resided in the boot. This meant that space and comfort in the passenger compartment were compromised.

In the Honda *Clarity* all the machinery previously under the hood has been tilted forwards by 90 degrees, allowing for a new and more compact fuel cell to be sandwiched horizontally between the motor and the FCVCU. Altogether, it takes up about the same amount of room as the Honda Accord's V6 petrol engine. Although the small lithium-ion battery pack technically still resides under the front seats, the cabin is no longer compromised. The driving position is at a normal height and there are five seats, rather than the four offered by the previous *Clarity* and the Toyota *Mirai*.

The problem of the massive hydrogen tank was dealt with in two ways. First, the *Clarity* utilises the H70 system – a newer standard that compresses hydrogen to 10,000 pounds per square inch (psi). The old *Clarity* used H35 hydrogen compressed to 5,000 psi. This means it can carry more hydrogen fuel despite having a smaller tank. Or, in the case of the 2017 *Clarity*, two smaller tanks: one under the back seat and another in the forward portion of the boot. It still takes up luggage space, but the 11.8 cubic feet of boot space is similar to what you would find in a mid-size hybrid saloon.

The finished product is said to be quieter and smoother – though still more expensive – than its petrol analogue.

Tax perks for electric vehicles

In many countries there are voices now arguing that the process of electrification should be accelerated by the tax system, and Norway is a case in point.

Norway first introduced tax perks for electric cars in the 1990s, long before the technology became an attractive alternative to the internal combustion engine. Norway now levies swingeing purchase taxes on high-emissions cars; and drivers of electric vehicles pay lower road tolls, ferry charges (a big deal in the land of the fjords) and car parking charges. Norway is also giving tax incentives to firms that construct and manage charge points. (Note that Norway has abundant cheap electricity thanks to an unrivalled network of hydropower plants.)

In the UK Car Tax has been levied in accordance with CO_2 emissions for some time. From 01 April 2017 there is a new regime of Vehicle Excise Duty (VED) under which PEVs and HEVs will be exempt; while the highest emitting petrol cars (of over 173 grams per kilometre) will pay £800 in the first year of registration and £360 per year thereafter. This will not affect cars registered before 01 April 2017 which will continue to be taxed under the old regime.

"IN MANY COUNTRIES THERE ARE VOICES NOW ARGUING THAT THE PROCESS OF ELECTRIFICATION SHOULD BE ACCELERATED BY THE TAX SYSTEM."

"SINCE OCTOBER 2016, ALL TESLA CARS HAVE BEEN BUILT WITH THE NECESSARY HARDWARE TO ALLOW FULL SELF-DRIVING CAPABILITY."

Sergey Kohl / Shutterstock.com

We can expect governments to tax carbon dioxide-emitting cars at increasingly higher rates as the infrastructure for electric vehicles is rolled out further. They will of course claim that they are trying to encourage electrification for environmental reasons – but at the same time they regard conventional cars as legitimate soft targets for much needed tax revenue. This will further erode the effective cost differential between electric and conventional internal combustion powered vehicles.

Driverless cars go forth

As I wrote back in the January MI magazine, Google's (**Alphabet Inc. (NASDAQ:GOOGL)**) driverless car project has finally graduated from Alphabet's research lab to become a stand-alone company called **Waymo**. But while Google expects Waymo to become a revenue source soon, it has been slow to articulate Waymo's revenue model. What is clear is that Waymo, unlike **Tesla (NASDAQ:TSLA)**, is not going to make cars. Rather, it will license technology to automobile manufacturers.

Tesla's *AutoPilot* provides semi-autonomous driver assistance in all Tesla vehicles manufactured since late September 2014. These vehicles are equipped with a camera mounted at the top of the windscreen, a forward looking radar in the lower grill and ultrasonic acoustic location sensors in the front and rear bumpers. Collectively, they provide a 360-degree buffer zone around the car. These systems enable Tesla's cars to detect road signs, lane markings and so forth, as well as obstacles and other vehicles.

Tesla also offers a "Tech Package" for an extra US$2,500. This package includes *adaptive cruise control* and a lane departure warning system to facilitate semi-autonomous driving (*Summon*) and parking capabilities (*AutoPark*). Since October 2015 these features may be activated by means of downloadable software updates. The *AutoPilot* system as of Version 8 uses the radar as the primary sensor instead of the camera.

Since October 2016, all Tesla cars have been built with the necessary hardware to allow full self-driving capability. The hardware includes eight surround cameras and twelve ultrasonic sensors, in addition to the forward-facing radar. The system will operate in "shadow mode" for the time being (processing without taking action) and send data back to Tesla to improve its abilities until the software is ready for final deployment via internet updates.

Tesla cars with the new hardware will not have automatic emergency braking, collision warning, lane-holding and active cruise control initially; but the plan is that these will be activated after the features are validated during the required testing phase. Tesla's *AutoPilot* system has apparently clocked up more hours of driverless travel than Google/Waymo's system. Tesla expects that its latest models will be fully self-driving by the end of this year. Whether it will be legal to take a self-driving car out onto the roads by the end of 2017 is another question!

There is certainly competition in this space. For one, **General Motors (NYSE:GM)** recently acquired **Cruise Automation.** For another, **Toyota Motor Corp (TYO:7203)** has over 1,000 patents outstanding relating to self-driving cars whereas Google has "only" a few hundred.

On 16 March Toyota announced its intention to invest £240 million in upgrading its UK factory that makes the *Auris* – one of the best-selling British-made cars in the world – and *Avensis* models at Burnaston near Derby. The plant upgrade will allow production of vehicles using its competitive global manufacturing system. The factory employs about 2,500 people, while another 590 work at Toyota's engine plant at Deeside, North Wales.

There is speculation that Toyota may make the UK a base for the production of electric and self-driving vehicles – depending, of course, on the vagaries of Brexit. The UK government will provide £21.3 million for training, research and development, and improving the Burnaston plant's environmental footprint. Toyota also has a track record of developing lower emission hybrid electric-petrol vehicles. So the firm may have been encouraged by the government's ambition, outlined in its *Building Our Industrial Strategy* green paper published in January, to make the UK a hub for next generation electric cars and battery technology.

Everybody happy?

As I explained recently, not everyone thinks driverless cars will make life better. *The Spectator*'s Toby Young has argued that driverless cars will promote a shift away from public transport towards more car and lorry journeys. He quotes Dr Zia Wadud of the Faculty of Engineering at the University of Leeds who estimates that once driverless cars become fully operational in about 20 years' time we will see a 60 percent increase in road usage. That means we will have to build even more roads. Good news, perhaps for the likes of **Balfour Beatty (LON:BBY)**.

Driverless cars will be slower, more expensive and socially divisive, says Toby. But with Google, **Apple (NASDAQ:AAPL)**, Tesla, **Toyota (TYO:7203)**, Daimler and others investing like crazy in this technology, whatever our objections, it's bound to happen anyway.

Battery technology advances...

The cost of efficient batteries is falling, and not just for cars.

The key technological competitive advantage of **Tesla Inc. (NASDAQ: TSLA)** – of which Elon Musk is founder and CEO – is in car batteries. On 10 March Mr Musk promised to install 100 megawatt hours (MWh) of battery storage in South Australia in 100 days – for free, if behind schedule! This was to solve that Australian state's current energy crisis. South Australia's premier, Jay Weatherill, announced his own AUD550 million state-financed battery system a few days later.

Whether Mr Musk was bluffing or not, the fact is that battery prices for large electrical utilities have plummeted to an estimated US$250 per KWh, though there are distribution and connection costs on top of that. Battery installations in America, led by major utility companies to guarantee supply, doubled to 336 MWh in 2016[vi]. It is surely no coincidence that electricity storage stations are becoming more widespread at exactly the moment that the roll-out of electric vehicle charging stations is about to take off.

Unlike other makers of electric vehicles, Tesla does not use single-purpose, large battery cells, but thousands of small, cylindrical, lithium-ion cells – similar to those used in laptops and other consumer electronics devices. Such batteries are cheaper to manufacture and lighter than standard cells – although some industry insiders have raised concerns about safety. According to Tesla, the batteries use an advanced thermal management system which employs an intumescent chemical (that is, one which swells as it heats) in the battery to prevent fires.

Electric trucks too?

The haulage industry, currently a huge consumer of hydrocarbons, could also be about to undergo a transformation. **Tesla (NADAQ:TSLA)** and Nikola Motor, are both working on electric-powered trucks. In December 2016 Nikola (pronounced *Neek-oh-la*) Motor Company unveiled its highly anticipated *Nikola One* electric semi-truck at its Salt Lake City headquarters.

Four niche players which will profit from electrification

Fortum Oy (HEL:FORTUM) is a Finnish power firm which is currently rolling out a network of electric vehicle charging stations across Scandinavia. It has even teamed up with Swedish giant IKEA to offer charging stations at their household hyper-stores. The business logic is compelling: motorists are prepared to pay more for electricity per KWh than home-owners. Fortum can therefore sell electricity at a premium price at these outlets.

Panasonic Corporation (TYO:6752) is the only supplier of the battery cells used by **Tesla Inc.** for its unique car battery arrays. Panasonic has cooperated with Tesla in the development of the "21-70" lithium-ion battery cells. These batteries have an estimated life of 10-15 years, so many of Tesla's cars will require only one battery throughout their economic life.

LiTHIUM X (TSXV:LIX) is a lithium resource explorer and developer, the corporate strategy of which is to become one of the major low-cost suppliers for the burgeoning lithium battery industry. LiTHIUM X has acquired the option to acquire a 100 percent interest in the Clayton Valley North Claims Group in northern Clayton Valley, Nevada. The project is contiguous to the only lithium producing mining operation in North America – Silver Peak, owned and operated by **Albemarle (NYSE: ALB)**, the world's largest lithium producer. As I have speculated previously, when lithium supplies run out on planet Earth, we shall almost certainly be obliged to go in search of it on Mars. No doubt Tesla's sister company SpaceX (another of Mr Musk's brainchildren) will be happy to oblige.

Bosch GMBH, a private German company with a long history, currently supplies the forward-looking radar system on the latest version of the Tesla. That is a technology sector that will undoubtedly grow – and which might quite possibly be spun off.

Emissions regulations

European manufacturers have to comply with EU regulations aimed at reducing greenhouse gases. Since 2015 new cars registered in the EU may not emit more than an average of 130 grams of CO_2 per kilometre. The average emissions level of a new car sold in 2014 was 123.4 grams of CO_2 per kilometre.

The ACEA believes that Europe's cars are now the *cleanest in the world*, with the average car engine emitting 28 times less carbon monoxide than 20 years ago. Moreover, the average new car today has become much more fuel efficient, consuming 15 percent less fuel per 100 kilometres than 10 years ago[vii]. However, another environmental issue has now eclipsed all others.

The demonization of diesel

The cost of emissions regulations is driving the development of technology – and one engine technology in particular is in the frame. Diesel engines are rapidly falling out of favour.

Although diesel engines compare favourably with petrol engines in terms of CO_2 emissions (they are more fuel efficient) they are dirtier as they produce particulates, especially nitrous oxide (NO) which is harmful to human and animal health. New European regulations limit NO emissions to just 80 mg per kilometre – down from 180.

Many European cities, not least London, are planning to introduce *toxicity charges* and there is talk of a government scrappage scheme in the UK for diesel cars in order to incentivise owners to drive greener cars. UK Transport Secretary Chris Grayling has warned motorists to "be wary" of buying diesel cars and according to one estimate sales of new diesel cars in the UK are down by nearly 10 percent over the last year as a result of growing awareness of their "dirty" status. In February 2017, 37,000 new diesel cars were sold – down 9.2 percent on the same month last year.

A substantial proportion of **Peugeot SA (EPA:UG)** Group's car output is diesel-powered. In France, diesel was favoured by the tax system for many years, though no longer. Reconfiguring its engine mix will be a huge headache for PSA, as for other automotive giants. On the plus side, PSA has been innovating in engine design. At the 2013 Geneva Motor Show, the Group unveiled an experimental petro-hydraulic hybrid engine.

As we know, it was revealed in the autumn of 2015 that VW was cheating on its emissions data and this has cost the world's leading car-maker dear. It may now be in recovery mode.

The future of petrol-driven cars

If diesels may be on the way out, the efficiency of petrol-powered internal combustion engines continues to increase and they are emitting less carbon dioxide. Some commentators believe that the average carbon emissions from a petrol-powered vehicle could be reduced to as little as 68 grams per kilometre – down from about 130 grams per kilometre today. Obviously that is still a lot more than zero-emissions vehicles which, by definition, produce no CO_2 at all – although purists will argue that, for pure electric vehicles, the electricity used will not have been generated entirely from renewables.

On the other side of the Pond, even if President Trump goes in the other direction and relaxes US emissions standards, one must remember that California, which accounts for one in eight cars sold in America, is allowed to set its own emissions standards. These are likely to be more rigorous than the USA as a whole.

Thinking ahead

There are massive forces of change at work in the global automotive industry as the technology changes. One can foresee all kinds of spin-off opportunities and strategic alliances. One

Six automotive giants leading the engine technology revolution

Toyota Motor Corp. (TYO:7203) has developed a range of hybrid engines and is also a leader in self-driving technology. It is now the second largest automotive manufacturer in the world, having been overtaken in 2016 by VW.

Ford Motor Company (NYSE:F) has promised a range of 13 new electric cars over the next five years. Ford CEO Mark Fields recently announced that "the era of the electric vehicle is dawning".

Volkswagen AG (ETR:VOW3), the world's biggest carmaker, announced last year that it would launch up to 30 new battery-powered models by 2025 – by which point electric vehicles will account for one quarter of its sales.

Daimler AG (ETR:DAI) the group that owns the Mercedes-Benz range and Daimler trucks and busses recently set an ambitious target, like VW, for one quarter of its total output of vehicles to be electric by 2025.

Tesla Inc. (NASDAQ:TSLA) is still the darling of the electric car cognoscenti – but be aware that it has not yet turned a profit. The pace of product development has been exciting. In July 2015 it was announced that a successor to the *Roadster* would debut in 2019. In October 2015 Mr Musk revealed a future "Model Y" that will be similar to the Model 3/Model X but will be a cheaper crossover utility vehicle with falcon-wing doors. In July 2016 Mr Musk set out his master plan for Tesla. It includes the manufacturing of more affordable cars produced in higher volumes, solar power roofs, mid-size vehicles, SUVs and pickup trucks.

Tata Motors (BOM:500570) is the Indian motor giant, headquartered in Mumbai, that owns Jaguar Land Rover (JLR). On the domestic front it enjoys the advantage of serving one of the most rapidly growing automotive markets in the world. Last November, Jaguar announced the launch of its new luxury electronic concept car, the *I-Pace* which will have a range of 500 kilometres. It is expected to hit the roads by the end of 2018[viii].

can equally imagine artificial intelligence systems developed by Google being used in cars with batteries supplied by Tesla and manufactured by Honda. Existing players may seek to specialise and to become suppliers to downstream manufacturers. Or then again, we may witness some colossal mega-mergers and acquisitions – just as we have already seen in Europe recently with the acquisition of Opel from General Motors by **Peugeot SA (EPA:UG)**.

We may have to change the way that we think about cars altogether. Rather than being something we *own* – often the largest purchase we make bar house purchases – they could become something that we *use*, as and when required. Tesla is already producing vehicles on the assumption that they will become "autonomous" – i.e. self-driving vehicles available to the *sharing economy* in which cars can be requested and driven while the owner is not using them.

Indeed, if you do buy a car, you might instruct it to earn its keep by ferrying around passengers while you sleep. Don't worry about finding customers – it will be pre-plugged in to **Uber** and the rest. In this scenario, the whole concept of car hire may be disrupted to the core. Be very afraid, **Avis (NASDAQ:CAR), Hertz (NYSE:HTZ)** and **Europcar (EPA:EUCAR)**!

For those of you with a charitable disposition, you may instruct your self-driving, intelligent car to go out and whisk old ladies to their hospital appointments *pro bono*; or to despatch the marauding midnight drunks outside your local pub. And when self-driving ambulances become the norm, no doubt intelligent health monitoring systems which can identify that you are about to have a heart attack will send the ambulance in anticipation of need. So that the ambulance arrives a few moments *before* you keel over.

And then there will be numerous derivative opportunities. Savvy motorists might be able to charge their electric vehicles at non-peak times and sell the electricity stored in their batteries back to utilities (or to other motorists) while their vehicles are parked. We can be sure that somebody, somewhere is going to make a killing.

Action

The automotive giants have been doing reasonably well over the last year as growth in Europe has picked up and demand has pepped. Also, re-focusing strategy benefits valuations. **Peugeot SA**'s share price reacted favourably to the finalisation of the acquisition of Opel on 06 March, rising to €19.60. Overall, the shares are up nearly 25 percent over twelve months. In contrast, **General Motors**' shares have eased since then though the share price is similarly up 20 percent in a year.

Any large diversified equity portfolio is likely to contain automotive stocks, which generally pay dividends in good times. General Motors, which was nearly wiped off the map in 2008, and which did not pay a dividend for years thereafter, now offers a dividend yield of 4 percent and according to some analysts this payout may have further to go[ix].

You should, however, favour automotive companies that have articulated a clear strategy to surf the waves of electrification and automation. And don't forget the opportunities down the supply chains to these new industries from lithium battery producers to radar manufacturers (see panels). Keep awake: opportunities abound.

- i Figures from Society of Motor Manufacturers and Traders.
- ii Reported in article by Sam Dean, The Daily Telegraph, 23 February 2017.
- iii See: http://www.renewableenergyfocus.com/view/45310/hydrogen-council-launched-in-davos-as-13-major-companies-join-to-promote-hydrogen
- iv The Economist, 18 February 2017, page 60.
- v See, for example, the review by *autoblog* at: http://www.autoblog.com/2017/03/20/2017-honda-clarity-fuel-cell-first-drive-review
- vi The Economist, 18 March 2017, page 64.
- vii See: http://www.cnbc.com/2016/04/18/driving-growth-the-future-of-europes-car-industry.html
- viii See: http://economictimes.indiatimes.com/industry/auto/news/passenger-vehicle/cars/tata-motors-jaguar-drives-new-electric-car-concept/articleshow/55441092.cms
- ix See: http://seekingalpha.com/article/4056072-general-motors-4_1-percent-yield

BY JOHN KINGHAM

DIVIDEND HUNTER

HOW TO AVOID YIELD TRAPS – PART 2

In last month's Master Investor magazine I outlined six questions designed to uncover potential yield traps. These are relatively qualitative questions which I ask of every investment candidate, but only after I've already crunched the financial numbers looking positive features such as long-term growth, good profitability and low debt levels.

The questions focused on a range of features which are often found in potential yield traps, such as bad management, high costs and dangerously large or risky projects. Although it can be difficult to define exactly what "bad management" is, for example, investigating these issues and drawing conclusions is still a very worthwhile activity, because it builds up a nicely rounded picture of a company, far beyond what you'll get from just looking at financial statements.

In this second and final part I'll cover four more questions, this time looking at other factors which can lead to corporate and dividend declines, such as excessive acquisitions, highly cyclical markets and markets that are likely to decline over the next decade.

Avoiding highly acquisitive companies

7. Has the company avoided large acquisitions that have little to do with its existing core business?

In many ways a large acquisition is like a large meal. It can take a lot of work to digest and absorb, which in turn can lead to a long period of sluggishness. Even worse, it can take a very long time for negative side-effects to become apparent, and by that stage they're as unavoidable as they are unpleasant. Even worse than a meal which is too large is one which is both too large and

unfamiliar. A large and unfamiliar meal (or acquisition) is a potentially catastrophic combination.

On the other hand, acquisitions can be a legitimate use of shareholder capital, so I don't automatically avoid companies just because they've made large acquisitions in recent years. Instead I'm just more careful with them, especially when the acquired businesses have little in common with the acquirer's core business.

So what exactly is a large acquisition? For me, large acquisitions occur when a company spends more on acquisitions in a single year than it made in profit that year (or more than average recent profits if profits in that particular year were unusually low or negative). When I'm analysing a company, if I see a large acquisition in the last ten years then I'll look at what was acquired and how the acquisition panned out.

I don't have any hard rules about how to treat companies that have made large acquisitions, but in general the larger the acquisition, and the further it is from the acquirer's core business, the more risk averse I'll be. In extreme cases I might insist on the company having smaller financial obligations than I would otherwise accept, or higher profitability or a more defensive core business, or I might simply avoid investing in the company altogether.

> **"IN MANY WAYS A LARGE ACQUISITION IS LIKE A LARGE MEAL. IT CAN TAKE A LOT OF WORK TO DIGEST AND ABSORB, WHICH IN TURN CAN LEAD TO A LONG PERIOD OF SLUGGISHNESS."**

However, one thing I will automatically avoid is a company where the total spent on acquisitions over the last ten years is greater than the total profits generated over those ten years. In my experience this sort of prolonged acquisition spree is a very risky strategy. It can produce a debt-laden company made up of dozens of unrelated businesses – which are difficult to manage and of unknown quality – and which is dependent on ever more acquisitions to drive future growth.

A good example of this situation was Chemring, a leading supplier of missiles, bullets and other military consumables. I was a Chemring shareholder between 2011 and 2016, during which time the share price fell by 73%, so this was obviously a very bad investment. There were many problems with this company, but one that stood out (in hindsight) was its record of aggressive expansion through debt-fuelled acquisitions.

In the ten years leading up to 2011, Chemring spent 40% more in total on acquisitions than it made in profits. As a result, Chemring transformed itself into a collection of largely separate businesses. This approach worked fine when the economic environment was supportive, and in fact Chemring's share price went from 50p to over 700p during this intensely acquisitive period. But from 2011 onwards, Governments began to cut their defence budgets. In this less benign environment, Chemring's sprawling mass of businesses soon turned out to be a delicately balanced house of cards, rather than the robust business its track record of spectacular growth suggested.

Of course, it was that track record of success that drew me in, but it's a mistake I only intend to make once, so for the last few years I have been deeply interested in the acquisition history of any company I'm thinking of investing in.

Avoiding companies that operate in volatile markets

8. Does the company operate in defensive markets?

Investing in companies that operate in defensive markets is not a guaranteed way to avoid dividend cuts, but it can help. These companies are, in theory, less affected by the ups and downs of the economy, which means they're less likely to cut their dividends than companies which operate in more cyclical markets.

There are various ways to define companies or sectors as defensive or cyclical, and personally I use the definitions given in the Capita Dividend Monitor. The quarterly Dividend Monitor is well worth a read, and it lists all of the FTSE Industry Classification Benchmark (ICB) sub-sectors and defines them as either defensive or cyclical.

Although I prefer defensive companies, I'm also happy to invest in cyclical companies because they can sometimes generate much higher returns than defensives. However, the more cyclical a company is, the more cautious I'll be with other factors such as its debts, profitability or dividend cover. For example, I would invest in a housebuilder (a very cyclical business), but only if it had much lower levels of debt and a higher degree of dividend cover than a company selling soap and toothpaste (a very defensive business).

"MY RULE IS TO HAVE AT LEAST A THIRD OF MY PORTFOLIO IN DEFENSIVES, ALTHOUGH CURRENTLY THE ACTUAL PERCENTAGE IS MUCH CLOSER TO 50%."

What I definitely don't want to do is fill my portfolio with cyclical companies, so I have a rule which limits my exposure to them. I want my portfolio to be less cyclical and more defensive than the FTSE 100, and about one third of the FTSE 100 is made up of defensive sector stocks. So my rule is to have at least a third of my portfolio in defensives, although currently the actual percentage is much closer to 50%.

9. Is the company relatively immune from commodity price movements?

Commodity prices are notoriously volatile, and companies that operate in commodity-related sectors are prone to massive booms and busts.

The most commodity-related sectors are: 1) Industrial Metals & Mining; 2) Mining; 3) Oil & Gas Producers and 4) Oil Equipment, Services & Distribution. These are all defined as cyclical sectors in the Capital Dividend Monitor and – as with other cyclical sectors – I will invest in them, but with an even higher degree of caution.

As before, this caution mostly shows up as a demand for lower debt levels and higher dividend cover, perhaps insisting on debts of less than three-times the company's average recent profits and a ten-year capex to depreciation ratio of considerably less than two (excessive investment in supply – capex – is often a big problem for these companies).

For many dividend investors it may be easier to just ignore these sectors because reliable and progressive dividends are few and far between. Perhaps the only exception is the oil majors, whose diverse businesses have so far enabled their dividends to withstand the recent oil price collapse.

Another option could be to limit exposure to these super-cyclical companies, perhaps limiting their weighting in a portfolio to no more than 10% of the total. I don't use this rule at present, but it's something I'm thinking about.

Avoiding companies that operate in declining markets

10. Is demand for the company's core products or services expected to grow over the next decade?

As we've just seen, the dividends of companies operating in commodity-related markets or other cyclical markets are at risk from short-term factors which reduce demand (such as recessions) or reduce margins (such as excessive investment in oil exploration and production, which increases supply and reduces prices). However, another risk to dividends is the risk of operating in markets which are likely to decline either permanently, or for at least the next ten years.

There are lots of different ways in which market demand can decline over the longer-term. It can happen quickly or slowly, and it can lead to corporate death or just a permanently smaller company in the future than in the past.

One example of a rapid but non-terminal decline in demand occurred quite

"RISK BLINDNESS TURNED OUT TO BE A SERIOUS MISTAKE WITH SERIOUS CONSEQUENCES FOR TESCO, ITS DIVIDEND AND ITS SHARE PRICE."

recently, when millions of middle class shoppers switched from Tesco, Sainsbury's and ASDA to the discounters, Aldi and Lidl. Before the Great Recession, I doubt Tesco's management seriously thought Aldi and Lidl could pull off the seemingly impossible trick of convincing middle class shoppers that shopping at discount food stores was not only economically rational, but socially acceptable (and even fashionable) as well. I also doubt many Tesco shareholders considered the discounters a serious threat either (I know I didn't). But they were wrong, and that risk blindness turned out to be a serious mistake with serious consequences for Tesco, its dividend and its share price.

Sometimes though, these rapid declines in demand are terminal, and these are the situations that dividend investors should really try to avoid. Technology is often the driving force of terminal decline, and examples of companies whose existing business models were rendered obsolete include Kodak, Blockbuster and HMV. Unfortunately for these companies, their management failed to sufficiently realise that photos (Kodak), videos (Blockbuster) and music (HMV) are essentially immaterial products, which can be beamed through a wire or through the air using modern technology, negating the need for customers to buy photo film from Kodak, or visit a Blockbuster video store or a HMV music store. As with climate change, it is often necessary to begin the task of avoiding an impending threat many years before that threat begins to have any significant impact. This sort of proactive behaviour is difficult to pull off however, especially if it means reducing profits today in order to boost profits ten or twenty years from now. It is far easier for most people to tell themselves that the threat is not real, and that no dramatic action is required.

For an example of a very slow and non-terminal decline in demand, I would choose the oil market. I think it is likely that demand for oil will be in permanent decline by the second half of this century, thanks to climate-related government policy and dramatic declines in the cost of renewable energy. With permanently declining demand for oil, companies focused primarily on selling oil (such as BP and Shell) would be fighting over a slowly shrinking market characterised by excess supply and very low prices. In that scenario the oil majors would be forced to either transform their businesses to sell something other than oil, or switch into run-off mode, where the emphasis would be on returning as much cash as possible to investors, rather than reinvesting it in the search for yet more oil, which almost nobody would need.

In terms of how I apply this future demand analysis to investment decisions, it mostly depends on the time horizon. For example, although I think BP and Shell are likely to be in decline by the middle of this century, my investment time horizon is short enough so that I'm still happy to invest in them today (in fact I do currently own shares in BP). On the other hand, I can remember looking at HMV towards the end of its life and deciding that I wouldn't touch it with a bargepole, no matter how low the share price. I thought it was obvious that the future market for high street music stores was going to be tiny compared to the heady days of the 80s and 90s. And even if your opinion about a company's longer-term future doesn't change your investment decision, creating some plausible future scenarios is still a very worthwhile activity.

So there you have it; ten questions (six last month, four this month) designed to uncover some of the major causes of corporate and dividend decline. They might not be perfect and they might not spot every single yield trap, but I find them incredibly useful and hopefully you'll find some value in them too.

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About John

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

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

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

BY FIDELITY INTERNATIONAL

A SPECIAL OPPORTUNITY: FIDELITY SPECIAL SITUATIONS FUND

Fidelity Special Situations is one of the best-known funds in the UK. Its current manager, Alex Wright, follows the same contrarian approach to investing in UK shares that was pioneered by the fund's first manager, Anthony Bolton. In this interview, Alex talks more about how he manages this fund.

Master Investor: First things first, what does 'contrarian investing' mean?

Alex Wright: *To be a contrarian investor means to focus your attention on stocks and sectors that have fallen out of fashion in the market and have cheap prices due to a lack of demand. The big advantage of this approach is that, if you do it well, it improves the balance of risks and rewards by limiting your downside and maximising potential upside. This is because companies that are out of favour have probably disappointed investors in the past, so current expectations are likely to be low, as are the chances of further disappointment leading to steep falls in share prices. On the other hand, if things improve, the share price can rise significantly as the market responds to this better-than-expected news.*

MI: That sounds great. So why isn't everyone doing it?

AW: *Investing against the tide is a psychologically difficult thing to do. Humans are social animals and behave socially when making investment decisions. It takes a particular mind-set and a highly disciplined approach to execute a contrarian investment process successfully. What's more, you need more, and better, information to find these opportunities. Fidelity's investment team spends many thousands of hours meeting company management and speaking to suppliers, competitors and customers in order to build up a picture of each prospect's true state. It is this work that allows me to form a view of the company's future profitability and, ultimately, whether it is an attractive investment. This is known as 'bottom-up' research and it lies at the heart of Fidelity's investment philosophy. All the managers, not just the contrarians, base their investment decisions on company fundamentals such as competitive position, management strength, growth opportunities, valuation and so on. Overarching trends in the economy (so called 'top-down' factors) only play a supporting role in decisions.*

> **"FIDELITY'S INVESTMENT TEAM SPENDS MANY THOUSANDS OF HOURS MEETING COMPANY MANAGEMENT AND SPEAKING TO SUPPLIERS, COMPETITORS AND CUSTOMERS."**

MI: What do you look for in a company?

AW: *There are a number of things I want to see in an investment opportunity, but the first is very straightforward – a period of poor performance in its shares. This will generally mean that the investors who want out will have already sold their holdings, while the experts are likely to be paying little attention to the company. This should reduce the prospect of the shares falling further. I then search for some kind of asset or feature of the business*

> **“MY INTEREST IN UNLOVED STOCKS MEANS I OFTEN FIND OPPORTUNITIES IN THE MORE BEATEN UP SECTORS OF THE MARKET – THOSE THAT OTHER INVESTORS ARE NERVOUS ABOUT.”**

that will support its valuation. This could be something like a cash balance, plant or machinery, or something less tangible, such as intellectual property or high barriers to entry. It could even be a reliable cash flow from a 'sticky' customer base. Finally, I want to find some kind of unrecognised growth potential. This can cover a wide range of opportunities, such as a new product launch or a move into a new country. If it proves successful, there can be a significant boost to the share price.

MI: How do you decide when to sell your holdings?

AW: *My investment process is based on a three stage cycle. In stage one, I aim to buy into a company when it is out of favour. During stage two, the perception changes and the shares start to outperform. Finally, I sell my stock in stage three when the market consensus has caught up with my view of the company and the performance potential is, therefore, reduced. Of course, I will also sell stocks if something happens to undermine the original reasons I bought them.*

MI: How much contact do you have with the companies you invest in?

AW: *I meet company managements on a regular basis, as the insights I gain from these meetings are a crucial part of my investment process. They help me work out whether the company has growth options that the market has not recognised. I have met nearly all of the companies that are currently in the fund and, of course, I have met a lot of others that I am not invested in.*

MI: Are there any sectors you are focusing on at the moment?

AW: *I am not someone who focuses on sectors as such. I prefer to look at individual companies on a 'bottom up' basis. That said, my interest in unloved stocks means I often find opportunities in the more beaten up sectors of the market – those that other investors are nervous about. For example, many investors are focusing on companies that can provide reliable dividend payments. However, these stocks have performed well and now trade at high valuations. In comparison, banking stands out as a sector that is cheap and unloved, but I believe a number of banks are in a stronger position than many realise. The oil sector is in a similar position. There's a lot of negativity around it, but I have a positive outlook. Falling prices mean that the growth in supply from US shale companies is slowing down. This should allow the oil price to stabilise, which would be very positive for a company such as Shell.*

MI: Is this a difficult time to be an investor?

AW: *Volatile markets, plus political and economic uncertainty, can make life very difficult for some types of investors. But for contrarians, there is a wealth of opportunity on offer in the UK market at the moment. In these conditions, many people shy away from what they perceive to be riskier investments, which can mean some very good companies are available at extremely attractive valuations. Warren Buffet has given us many pearls of wisdom, but perhaps the most useful in times like this is his observation that investors should 'be fearful when others are greedy, and greedy when others are fearful'.*

IMPORTANT INFORMATION

BY NICK SUDBURY

FUNDS IN FOCUS

THE UK FUNDS THAT PAY A 5% INCOME

On 5th March 2009 the Bank of England reduced interest rates to the supposedly emergency level of 0.5%, and then cut them again last August to restore confidence after the Brexit referendum. The accommodative monetary policy has provided enormous support for those looking for capital growth, but it's been a torrid time for income investors who have seen yields collapse across the board.

There is a huge investor appetite for reliable sources of high income, some of which will have been appeased by the launch of the new CF Woodford Income Focus fund. Neil Woodford is aiming to deliver an income of 5p per share in 2018 and if he succeeds it would be equivalent to a yield of 5% on the launch price of a pound a share.

The new fund will be more concentrated than his equity income portfolio with around 50 holdings. It will operate in the specialist sector to give Woodford the freedom to invest more than 20% of the assets overseas, although the initial allocation is unlikely to exceed this figure.

His £10bn CF Woodford Equity Income fund targets both capital growth and income and has a historic yield of 3.2%. It has had a poor year and is near the bottom of its sector with a return of 14.4%, although it is the best performer over the period since launch.

Income at the expense of capital growth

The risk of investing in a high yield fund is that the extra income comes at the expense of capital growth. We have seen this in the UK Equity Income sector, where a number of well-known funds have decided to leave because they were unwilling to target the required yield of 110% of that of the FTSE All-Share index. The hurdle rate has now been reduced to 100% and it is expected that many of them will return.

There are only four open-ended funds in the UK Equity Income sector that have yields in excess of 5%. They are: Premier Optimum Income, Schroder Income Maximiser, Insight Equity Income Booster and Fidelity Enhanced Income.

The reason that these funds are able to pay between 6% and 7% while all the others languish below 4% or 5% is that they use derivatives. In most cases the managers will write 'covered call options' on the shares in their portfolio. The buyers of these contracts pay an upfront fee that can be added to the income in the fund.

These sorts of strategies enhance the yield, but limit the potential capital growth as the buyers of the options are entitled to receive some of the gains. Research by Hargreaves Lansdown shows that the products that use these strategies have typically generated the highest levels of income in the sector, but many have also made a sizeable capital loss that has detracted from their overall performance.

The top three funds for income in the sector over the last 10 years were: RWC Enhanced Income, Insight Equity Income Booster and Fidelity Enhanced Income. Based on an investment of £10,000 these would have paid out £5,649, £5,463 and £5,180 respectively. Their total returns ranged from 49.4% to 59.1%,

"THE RISK OF INVESTING IN A HIGH YIELD FUND IS THAT THE EXTRA INCOME COMES AT THE EXPENSE OF CAPITAL GROWTH."

but the capital element varied between a loss of 11.2% and a loss of 24.4%.

The best funds on a total return basis were: Trojan Income, SLI UK Equity Income Unconstrained and Invesco Perpetual High Income. These produced a total return of between 117.1% and 127%, with the income over the period ranging from £3,685 to £4,549.

Higher yielding investment trusts

There are far fewer UK Equity Income investment trusts, but according to data from FE Trustnet, five of them have an historic yield of more than 5%, which may be partly a result of a structural advantage over their open-ended counterparts.

Investment trusts have the flexibility to retain up to 15% of their annual income. This is added to their revenue reserves, which can be used to smooth the annual dividend payments from one year to the next so as to produce a steadily increasing stream of income.

"THOSE LOOKING FOR A 5% YIELD MAY ALSO WANT TO CONSIDER THE UK EQUITY AND BOND INCOME SECTOR."

UK domiciled OEICs and unit trusts are much more constrained as they are legally required to pay out all of the income that accrues in the fund over the course of their accounting year.

The £520m **Merchants Trust (LON:MRCH)** aims to provide an above average level of income and long-term capital growth by investing in high yield FTSE 100 companies. Simon Gergel, the manager, has put together a concentrated portfolio of 44 holdings with the largest including the likes of Royal Dutch Shell, Glaxo, HSBC, BP, Lloyds and Centrica.

MRCH is yielding 5% with quarterly dividends and is trading at a 4% discount

to NAV, but it is towards the bottom of the sector in terms of its 5-year total return of 64.2%.

It is a similar picture with **Shires Income (LON:SHRS)**. The £73m investment trust aims to provide a high level of income together with growth of both income and capital from a portfolio substantially invested in UK equities.

SHRS is managed by Ed Beal of Aberdeen fund managers, who has invested about a quarter of the portfolio in fixed interest securities to boost the income. The shares are yielding just over 5% with quarterly distributions, although the 5-year total return of 60.9% is relatively modest compared to his lower yielding peers.

UK equity and bond income funds

Those looking for a 5% yield may also want to consider the UK Equity and Bond Income sector. The investment trusts that operate in this area have to invest at least 80% of their assets in equities and fixed interest securities in the UK, and must aim to generate dividend growth. They will typically have a yield on the underlying portfolio above 150% of that of the FTSE All-Share index.

Two of these funds are currently yielding more than 5%. They are **CQS**

"WHEN INVESTING IN ANY OF THESE AREAS IT IS WELL WORTH SHELTERING THE FUNDS IN AN ISA OR PENSION WHEREVER POSSIBLE SO THAT THE INCOME AND GAINS WOULD BE TAX-FREE."

New City High Yield (LON:NCYF) and **City Merchants High Yield Trust (LON:CMHY).**

NCYF aims to provide investors with a high gross dividend yield and the potential for capital growth by investing in high yielding fixed interest securities. It has a market value of £226m and has 80% of its portfolio in fixed interest securities issued by companies such as Unique Pub Finance, Pizza Express Financing, Barclays and Matalan Finance.

The shares are yielding 7.2% with quarterly distributions and they have generated a five-year total return of 39.6%. It is also worth noting that they are trading on a 3.5% premium to NAV. CMHY is run by Paul Read and Paul Causer, the highly regarded fixed income team from Invesco Asset Management. It aims to obtain both high income and capital growth by investing predominantly in high-yielding fixed interest securities.

The £180m fund has just 3.4% in equities, with the bulk of the portfolio invested in bonds from companies including Lloyds, Aviva, Societe Generale, Credit Agricole and Standard Chartered. It is yielding 5.1% with quarterly distributions and has generated a 5-year total return of 60.4%.

There is also a UK Equity and Bond Income sector for open-ended funds, but none of its twelve funds are currently yielding more than 4.5%.

Open-ended fixed income funds

The other main option would be to invest in one of the UK fixed income sectors, although these normally provide less scope for capital growth and could be vulnerable when the Bank of England finally starts to raise interest rates.

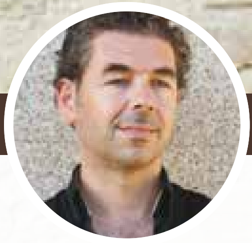
There is only one open-ended fund in the Sterling Corporate Bond sector that is yielding more than 5% and that is the Alliance Trust Monthly Income Bond. This £229m fund has a historic yield of 5.7% with monthly distributions and has generated a five-year total return of 36.8%, which represents mid table performance.

Funds in the Sterling Strategic Bond sector have more investment flexibility as they can invest anywhere in the fixed interest spectrum and change the asset allocation to take advantage of the prevailing conditions.

There are nine funds in the sector with yields in excess of 5%. The two with the best total returns are: Royal London Sterling Extra Yield, which is yielding 6.1% and has a five-year return of 66.2%; and Artemis High Income that has a yield of 5.5% and a total return of 55.2%.

If you are willing to take more risk with your capital there are fourteen Sterling High Yield Bond funds that are yielding more than 5% with some of them paying well above 6%. Those with the best five-year total returns include Schroder High Yield Opportunities and Invesco Perpetual High Yield.

When investing in any of these areas it is well worth sheltering the funds in an ISA or pension wherever possible so that the income and gains would be tax-free. This is especially worthwhile given the reduction in the annual dividend allowance from £5,000 to £2,000 in April 2018 that will increase the tax burden on equity dividends from holdings held outside of these wrappers.



BY FILIPE R. COSTA

THE MACRO INVESTOR

SWEETEN YOUR PORTFOLIO WITH COCOA

"God gave the angels wings, and he gave humans chocolate."

- Author unknown

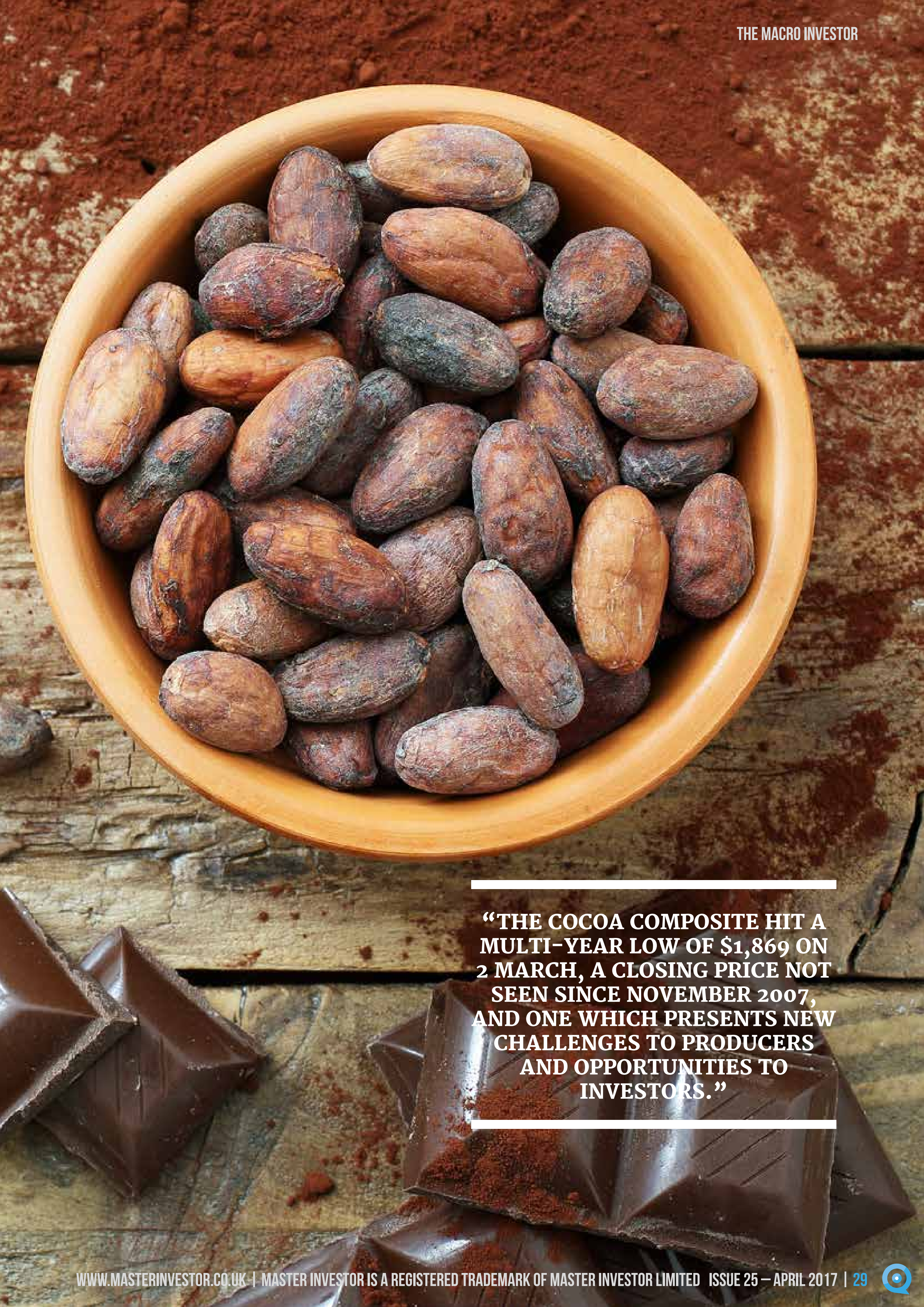
A bitter blow

In this instalment of *The Macro Investor*, I'm going to lay the foundations for a long position in cocoa. A solitary undertaking, sound investment comes from developing an alternative, contrarian, view and opposing the crowd when sentiment is extreme. When everybody is pessimistic about the prospects for a market, we hit ground zero. From that point on there's relatively little that can bring about a more bearish attitude; but the slightest sniff of a change in sentiment is enough to set prices racing higher. Opportunities arise when the market consensus is strong; when everybody agrees on some particular outcome; or when sentiment is too high or too low. The cocoa market is a particular case in point right now. The commodity has been on a bitter downtrend that has dragged its price down to ten-year lows, and sentiment is extremely poor.

Good weather, sluggish demand growth, improved crop yields, high historical prices, a declining pound, and massive speculative short positions taken by hedge funds have all contributed to an accelerated price decline. But, while these factors have colluded to force prices into a bearish trend, they have also laid the foundations for a nascent bull market, as they have helped supply to adjust quickly to market conditions. It is on these grounds that I believe there is a strong case in favour of a long position in cocoa.

A sticky situation

The cocoa composite hit a multi-year low of $1,869 on 2 March, a closing price not seen since November 2007, and one which presents new challenges to producers and opportunities to investors. On March 2011, cocoa hit a record high of $3,788 on the back of strong demand prospects coming from emerging markets and supply problems in West Africa. But it ended up retreating for the rest of that year, reaching a price near $2,000 by year-end. Prices then moved sideways until March 2013, when a bullish trend was re-established and prices rose to a high of $3,677 in October 2015. While the commodity complex entered a strong bear market in mid-2014, cocoa temporarily retained a strong uptrend. As measured by the **GSCI Commodity Index trust ETF (NYSEARCA:GSG)**, the decline in commodities prices between 20 June 2014 and 20 January 2016 was around 65%, while



"THE COCOA COMPOSITE HIT A MULTI-YEAR LOW OF $1,869 ON 2 MARCH, A CLOSING PRICE NOT SEEN SINCE NOVEMBER 2007, AND ONE WHICH PRESENTS NEW CHALLENGES TO PRODUCERS AND OPPORTUNITIES TO INVESTORS."

cocoa lost just 10% in the same period.

But then, particularly after the Brexit vote, price action gathered pace and cocoa hit the ground. From a price of $3,138 recorded in 18 August 2016, cocoa slumped to a multi-year low of $1,869 in 2 March 2017. After dropping $1,269, or 40%, in little more than half a year, prices stabilised and recovered to $2,150. Whether the multi-year low recorded last month is going to hold or not remains to be seen. But at this point, the market is worth a deeper look in order to evaluate the odds of a new uptrend emerging.

The world has a sweet tooth

Demand for agricultural products has been rising at a rapid pace over the years as the world's population has tripled since the end of World War II. Demand for chocolate and chocolate-products has been rising even faster than other food products, as chocolate is a very peculiar product that brings both joy and social status. People consume chocolate because they love its taste and because it seems to possess some strong mood-improving abilities. But one particular characteristic is even more important in driving demand higher: its connection with personal income and social status levels. Chocolate is heavily demanded in the developed world (6.8 kg per capita in the UK in 2015) but still a rare luxury commodity in emerging markets (0.2kg per capita in China in 2015). But, as income increases in these markets, people start demanding distinctive products like chocolate. Brazil, Russia and China are some examples where chocolate has a bright future ahead. Statistics regarding global chocolate demand show that the share of emerging markets in global chocolate demand has risen from 30% to 50% in the last decade.

It is true that chocolate has sometimes been linked with diseases like diabetes. A rising awareness of health problems related to obesity and to excess ingestion of sugar weighs negatively on the demand for chocolate stemming from the developed world. But cocoa, the main ingredient behind chocolate, doesn't contain any sugar and it is usually seen as a healthy product. Demand for chocolate in the developed world will certainly change, but that doesn't mean it will shrink. People will just look for the best chocolate products, demanding more cocoa in chocolate composition and healthier derivatives.

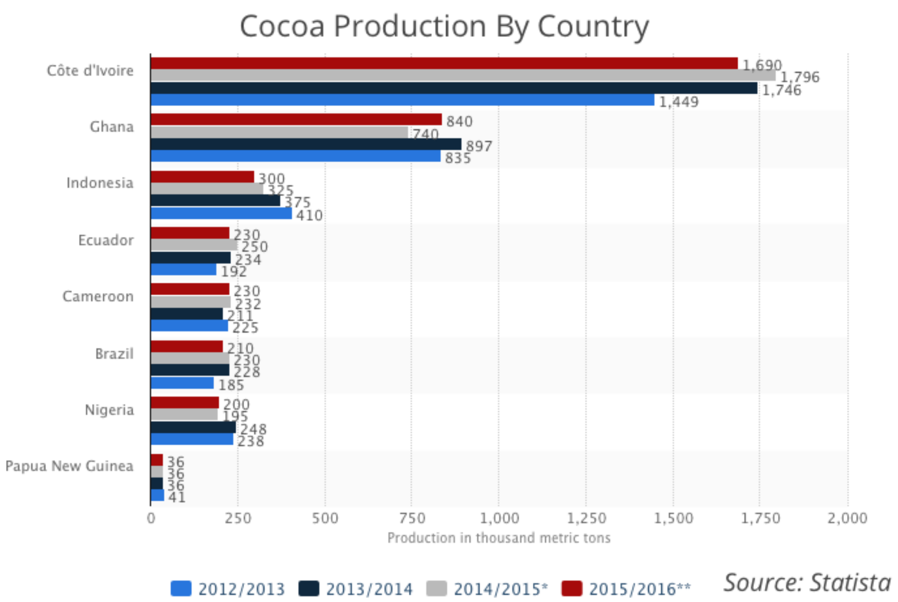
While demand for chocolate and chocolate products has struggled to grow in the past year, the numbers hardly represent a change in trend. Demand is on a long-term growth trajectory, and unless chocolate makers find a replacement for cocoa in the chocolate-making process, the beans will continue to be in heavy demand.

Too much of a good thing

A few years ago, chocolate makers were concerned about existing cocoa production not being sufficient to meet the rising demand for chocolate. Production of cocoa is heavily concentrated in West Africa, which accounts for two-thirds of global production, with the Ivory Coast and Ghana in particular being major players. The tropical conditions needed to produce cocoa are only met by a select group of countries. Besides depending heavily on the production of just two countries and on some peculiar climate conditions, chocolate makers are also exposed to the risks arising from an agricultural sector that is in the hands of a very large number of small farmers, usually just family businesses. Such concerns were valid and very well reflected in the $3,788 price cocoa hit on March 2011.

With prices being so high and the future looking so uncertain, many programmes were put in place to improve crop yields and to replace some very old trees in West Africa. At the same time, there was a massive deforestation in Ivory Coast, as farmers were trying to extend their crops and benefit from the bull market. Because of the nature of agricultural production, where it takes time to raise output, there is a significant time-lag between an increase in production (as a response to greater demand) and the point where supply meets that demand. Price is therefore the main short-term adjustment mechanism, which makes it volatile. When past production decisions come to fruition, the market may become unbalanced again with excess supply, which would eventually put pressure on prices.

The programmes put in place in West Africa improved yields in existing plantations and boosted new plantations, both of which led to an increase in



production. This boost coincided with a handful of unfortunate events, all of which pressed prices down and culminated in the price crash observed between mid-2016 and March 2017. Sluggish global demand during 2015/16 led to growth in the demand for chocolate that has been milder than expected, in particular because incomes have not been rising in any significant way; weather conditions in the Ivory Coast were too good during the last crop, which culminated in larger quantities produced; and the projected surplus in cocoa production attracted a battalion of short-sellers that accelerated price action.

Time for a nibble?

The International Cocoa Organisation (ICCO) projected a 264,000 metric tonne surplus net of 4,552,000 produced for the current season, and many analysts and traders are betting the numbers will come bigger. But, Ghana's Governmental Cocoa regulator – COCOBOD – slashed its forecast for 2016/17 production from 850,000 – 900,000 metric tonnes to 800,000, as the lower price induces changes in supply.

Cocoa farmers are poor. They aren't paid the full international cocoa price for the beans they produce, but rather something between 40% and 60%. In the Ivory Coast, the government attempts to fix the price at the beginning of the season and forbids farmers from taking less than that. But the biggest problem this year is that prices have declined significantly since the beginning of the last quarter of

2016, which makes wholesalers and exporters unwilling to pay farmers the price set by the government. Consequently, stocks are accumulating outside plants waiting for international prices to rise and prompt wholesalers to buy. If that doesn't happen, farmers will end up settling for any price as they have no other option in order to feed their families.

"ONE WAY OR ANOTHER, A PRICE DECLINE WILL ACT AS A DIRECT OR INDIRECT INCENTIVE TO CUT PRODUCTION OF COCOA AND THE CURRENT EXPECTED OVERSUPPLY WON'T LAST MUCH LONGER."

But while wholesalers may be happy with paying lower prices, farmers won't have enough money to raise the next crop, as their incomes will be squeezed. They will buy fewer fertilisers, which may lead to a significant drop in crop yields and to a decline in quality. Others will switch production from cocoa to palm and rubber, which have been doing much better in terms of price lately. One way or another, a price decline will act as a direct or indirect incentive to cut production of cocoa and the current expected oversupply won't last much longer.

At the same time, the last crop was boosted by optimal weather conditions that may or may not be present for the current and subsequent crop. While rain is rare during the November – March period, current conditions are too hot, at a time approaching the end of the season and the beginning of a new one. If these weather conditions persist into April, the mid-crop production may be damaged, which would boost prices.

While the low price is an incentive for farmers to reduce production, it is a great incentive for those relying on cocoa to increase purchases. That is the case for chocolate producers and bean processors, which have a great opportunity to boost their profits, as they can buy cocoa at lower prices while keeping consumer prices steady. This is probably the best time to purchase cocoa or to hedge future purchases through long futures contracts. The rise in cocoa prices from $1,869 to $2,150 during the last month may be a sign that the low recorded on 2 March was a bottom and that prices are going to increase from here. At these prices, many are happy to purchase, which will trap short-sellers and further boost prices during the year. Because overall sentiment in the market is really low and we are near a 10-year low in price, this may be the best time to buy from a pessimistic *Mr. Market* and wait for the effects of a shrinking supply to materialise. After all, at these pessimistic levels, all that is required is for the weak outlook to become a little less negative.

One way of acquiring a long position in the cocoa market without engaging in the risks deriving from futures and options contracts is through the **iPath DJ-AIG Cocoa Total Return Sub-Index ETN (NIB)**, which invests in a single futures contract on cocoa but trades as an exchange-traded note. Contracts are rolled on a monthly basis, which exposes traders to the impact of *contango* or *backwardation* on returns. With the goal of minimising such impact, readers may wish to take a look at the **iPath Pure Beta Cocoa ETN (CHOC)**, which rolls over its holdings in a way that minimises costs.

In terms of risk, the NIB ETN shows a correlation with the S&P 500 of just 0.2042 and a beta of 0.2847 for the period between 26 June 2008 and 21 March 2017. If we consider only the last year, the correlation is 0.1228 while beta is 0.0449 – very low numbers indeed. From the perspective of risk management, this means that the NIB ETN offers great diversification, as it seems uncorrelated with the broader market.

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Personal Investing

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BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

THE DOGS OF AIM

PROFIT FROM THESE HIGH YIELDING SMALL-CAPS

There are hundreds, if not thousands, of investment strategies in existence which proclaim to be the best for maximising returns. From broad policies such as value or growth investing, to more quirky approaches such as astronomical cyclical analysis, investors are spoilt for choice when it comes to selecting a set of rules or procedures on which to base their stock-picking strategies.

One of the most well-known strategies, popularised by fund manager Michael B. O'Higgins in his 1991 book, *Beating the Dow*, is the Dogs of the Dow. This simple and easily implemented investment method sees investors put equal amounts of money into ten individual companies, otherwise known as "dogs", which are constituents of the blue-chip focussed Dow Jones Industrial Average index. The term "dogs" in this context specifically refers to the companies with the highest historic dividend yields.

The thinking behind this strategy is based on the notion that dividends paid by blue-chip firms are relatively stable throughout the business cycle. So companies which exhibit high dividend yields are likely to be out of favour in the market, perhaps due to a downturn in the wider sector in which they operate, and thus have low share prices. However, due to their inclusion in the Dow index the companies, by definition, should still be quality, well run businesses, able to quickly recover from tough trading conditions.

Dogs of the Dow focussed investors are hoping that the market will eventually recognise this quality so that over time the ten shares will recover, rising in value to generate a return above that of the wider index. The portfolio is periodically rebalanced, typically annually, with the previous year's dogs replaced with a new, but again, equally weighted, selection based on the same criteria.

"IT REMAINS A POPULAR APPROACH, LARGELY DUE TO ITS SUCCESS AT GENERATING DECENT RETURNS."

Diamond dogs

Over the years the Dogs of the Dow strategy has come under criticism for a number of reasons, including its being too simple and ignorant of important factors such as risk, company growth prospects and financial stability. But it remains a popular approach, largely due to its success at generating decent returns. In *Beating the Dow* O'Higgins back-tested the strategy from 1991 to the 1920s and found that it consistently outperformed the market as a whole.

The website dogsofthedow.com maintains more up to date statistics of the Dogs' performance. It finds that from 2000 up to the end of 2016 the average annual total return (a measure which includes reinvested dividends) has been 8.6%. This compares favourably against a 6.9% gain for the Dow as a whole and 6.2% for the S&P 500.

Given these decent returns it's no surprise that investors have brought the strategy over to the UK markets – typically in the form of buying shares in the top 10 highest yielding FTSE 100 companies. The personal finance website Money Observer claims that its own "Dogs of the Footsie" portfolio has delivered an average annual total return of 14% since 2001. This compares to an equivalent gain of just 5.9% for the FTSE 100 index over the same period.

"IN THIS ISSUE I AM LAUNCHING THE DOGS OF AIM PORTFOLIO."

Small dogs

Surprisingly, I have not come across any credible source which has attempted to replicate the Dogs of the Dow using AIM as its source market. While its constituents may be smaller in size and its dividend payers less common, the basic concept underlying the approach can still be applied. While AIM shares might trade at a low price for many reasons other than a market downturn, investors should reprice high yielding stocks eventually regardless of their size if they are of sufficient quality. So there should be a decent chance of the method working in a small-cap context and there might also be the opportunity for enhanced gains given the higher growth potential of smaller companies.

On that note, in this issue I am launching the Dogs of AIM portfolio. Using the FTSE AIM 100 index, to ensure that constituents are of a decent size and sufficient quality, the first ten holdings are:

Name	EPIC	Capital (£m)	Yield (%)	Sector
Plus500	PLUS	500.3	11.06	Financial Services
Polar Capital Holdings	POLR	317.2	7.2	Financial Services
Redde	REDD	457.5	6.41	Financial Services
Central Asia Metals	CAML	234.3	5.95	Mining
Pan African Resources	PAF	301.2	5.66	Mining
Manx Telecom	MANX	223.7	5.55	Fixed Line Telecoms
XLMedia	XLM	216.4	5.48	Media
Andrews Sykes	ASY	186	5.41	Support Services
SafeCharge International	SCH	382.7	5.06	Support Services
Numis Corporation	NUM	289.5	4.71	Financial Services

Data Source: Sharescope

As per the original Dogs method, this portfolio of pups will be held on to for one year before being switched for a new set of investment hounds. So I will provide another update in the April 2018 edition of Master Investor magazine, measuring performance on the total return basis. For now, for those investors who don't have the capital to invest in all ten companies, or who want to invest in a few stocks only, here are three of the most interesting:

MANX TELECOM

As its name suggests, **Manx Telecom (LON:MANX)** is a provider of telecoms services on the Isle of Man. Originally part of BT but spun off in 2001 as part of its mmO2 business, Manx was acquired by Telefonica in 2006 before being bought in June 2010 by private equity firms HgCapital and CPS Partners. Manx then listed on AIM in February 2014 raising £89.2 million for itself and £67.2 million for selling shareholders.

As of today the company's core business is the provision of Fixed, Broadband and Data Services on the Isle of Man. This division currently represents around 39% of revenues, with 37,000 homes and 4,000 businesses being customers. Manx is the only operator of a fixed line network on the island and has a c.95% market share, although this has recently been opened up on a wholesale basis to competitors. High speed VDSL broadband service (Ultima) is available to 93% of homes on the Island.

The second largest division, making up just under a quarter of revenues is Mobile. The firm's 4G network provides 99% population coverage, with revenues coming from pre-paid and post-paid contracts, as well as roaming charges – the latter often seeing a boost during the annual TT motorcycle race.

Making up the balance of revenues, Global Solutions generates income from services which run under the company's mobile technology platform and use its international roaming agreements; the Data Centre business offers managed hosting, cloud and disaster recovery services; and other revenues include telephone directory advertising, hardware equipment sales, interconnection fees and managed services.

All these services are provided under the backdrop of a growing and resilient economy on the Isle of Man. The most recently published national income accounts by the island's Cabinet Office reported growth in GDP of 4.5% for the year 2014/15, or 5% in real terms. Notably for Manx Telecom, growth in the ICT sector was an impressive 9%, with e-gaming firms and insurance being notable drivers.

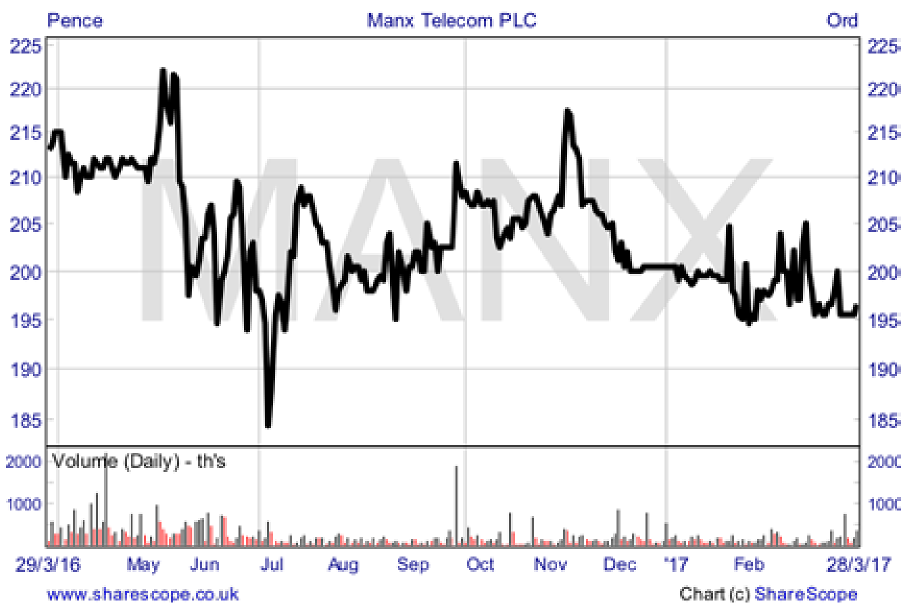
Talking telephone numbers

Steady and solid is perhaps the best way to describe financial results from Manx Telecom over the past three years, with the most recent figures, for the 12 months to December 2016, showing revenues edging up by 1.5% to £80.8 million. The numbers were skewed by a number of exceptional and non-cash expenses, but on an underlying basis net profits were up by 0.6% at £16.3 million – being domiciled on the Isle of Man means that the company pays zero corporation tax.

manx telecom

One of the financial highlights of the year was a solid cash flow performance, with underlying free cash flow growing by 5.1% to £16.4 million. Net debt at the period end was relatively flat at £52.4 million, with interest payments on borrowings covered a comfortable 13.5 times by underlying operating profits.

"THIS IS A SOLID AND RELIABLE BUSINESS WHICH SHOULD CONTINUE TO GENERATE DECENT LEVELS OF CASH IN THE COMING YEARS."



Operational highlights of the year included revenues in the Global Solutions division rising by 10%, offsetting a 26% fall in the Data Centre business which saw occupancy reduce after the loss of a large client. The core Fixed, Broadband and Data Services business put in a solid performance, with revenues edging down by 1.2% to £31.6 million as fixed line voice income reduced. However, to improve competitiveness and customer experience £4.3 million has been spent on a transformation programme and to further boost growth a new subsidiary, Vannin Ventures, was launched to identify new business opportunities.

Worth dialling into?

Having been a public company for just over three years now, Manx Telecom has performed well for investors. At the current 196.5p the shares are up by 38% from the IPO price of 142p, with an additional 24p per share of dividends taking the total return to 55%.

Overall, this is a solid and reliable business which should continue to generate decent levels of cash in the coming years, even if earnings growth remains unremarkable. The historic free cash flow yield of 7.33% is attractive and should continue to support the company's progressive dividend policy. For 2017 the markets are looking for a dividend payment of around 11.5p per share, equating to a yield of 5.85%.

Should earnings grow to 15.5p in 2018, as forecast by broker Liberum, I also see the potential for further modest capital gains. Putting the shares on a reasonable multiple of 15 times gives a price target of 232.5p. **Manx Telecom is a long-term buy and hold.**

ANDREWS SYKES

You would have thought that a c.£200 million market cap company with the eighth highest dividend yield in the AIM 100 would be better known. But Wolverhampton based **Andrews Sykes (LON:ASY)** is a very discreet, family owned business which typically only announces a few statements to the stock market every year.

With a history going back to 1857, Andrews Sykes has grown to become a highly profitable specialist in the rental of climate control products such as air conditioning and chillers, heating and boilers, de-humidifiers and ventilation, along with an extensive range of pumping equipment. In addition to renting its products the company provides its equipment for sale along with a full service and repair back-up. Its main area of operation is the UK but it has also been operating successfully in mainland Europe for over 40 years and in the Middle East since the 1970s.

A key date in the company's long history was in 1994 when major shareholder and current Chairman Jacques Gaston Murray took control of the business. Following a series of large share buybacks Murray (who is 97 this year!) and his family have built up their beneficial stake in the company to over 90%. Murray has declared some sizeable but erratic dividends over his years in charge, some seemingly to fund his external business empire, but a certain level of consistency has been established since 2014.

Blowing hot and cold

Financial results from Andrews Sykes have been steady if not inspirational over the past five years, with revenues consistently in a range between £54 million to £61 million since 2011. Similarly, pre-tax profits have been within a broadly narrow range of £11.8 million to £15 million. What has remained con-

ANDREWS SYKES GROUP PLC

sistent however is the company's ability to blame the weather when trading isn't as good as expected – hot weather in summer stimulates demand for its air conditioning business, while cold weather in winter drives heating.

The company's last announcement to the stock market, released as far back as September last year, reported that revenues grew by 7% to £30.3 million in the six months to June 2016, with net profits up by a more pronounced 66% to £6.2 million. The real highlight of the accounts was the balance sheet, which showed net cash of £15.4 million at the period end (boosted by a £5.8 million net inflow from operations) and a pension fund *surplus* of £1.5 million.

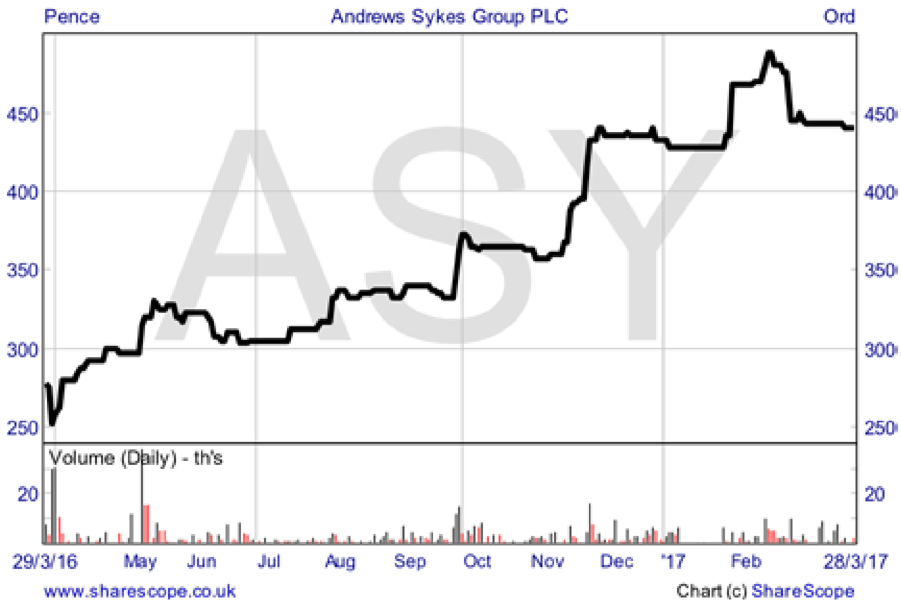
The most up to date news we have is that trading in the third quarter was positive after above average temperatures in Europe stimulated demand for air conditioning, with management being cautiously optimistic of an improved performance for the full year.

Pump the shares?

Despite the lack of newsflow over the years, shares in Andrews Sykes have performed very well since the stock market hit its nadir of early 2009. Reaching a low of 54p exactly eight years ago, the shares are up by 715% since then and up by 59% in the last 12 months alone.

As mentioned above, the dividend has been erratic in the past, with the current policy being to *"return value to shareholders whenever possible"*. But with the interim dividend having been maintained, the company remaining cash generative and the balance sheet in excellent shape, it looks reasonably probable that the dividend for the 2016 full year will be at least 23.8p per share, as it was in both 2014 and 2015. That equates to a very decent yield of 5.4%.

The big caveat here of course is that the Murray family could take the business private. But with the share price currently at near all-time highs you could question why this wasn't done a long time ago. **Andrews Sykes is a buy and hold.**



PAN AFRICAN RESOURCES

We finish in the mining sector with **Pan African Resources (LON:PAF)**, one of the better quality resources companies listed on AIM. Based in South Africa the company is mainly focussed on gold production but also has producing coal and platinum assets. In the last financial year, to June 2016, Pan African produced a record 204,928 ounces of gold from its operations and is looking to grow this to 250,000 ounces per annum within the next two years. Notably, the company is one of a rare breed of AIM listed miners which pays a consistent and attractive dividend.

Pan African made the move from being a junior explorer to a mid-tier gold producer in 2007 after it acquired the Barberton Mines. Consisting of the Fairview, Sheba and New Consort mines and the Barberton Tailings Retreatment Plant, this remains the company's flagship asset, with 113,281 ounces of gold produced in the last financial year. The company then effectively doubled the size of its operations in 2013 after buying the Evander gold mine from Harmony Gold for $176.71 million. Also supported by a tailings retreatment plant, commissioned in February 2015, Evander produced 91,647 ounces of gold last year.

Complementing the gold operations, Pan African acquired Phoenix Platinum in 2009 with production commencing in 2011. The operation is a Chrome Tailings Retreatment Plant which recovers platinum group metals from tailing dumps and other feedstock. Finally, the Uitkomst Colliery is a profitable, high-grade thermal export quality coal deposit bought by the business in March 2016. Uitkomst produced 87,538 tonnes of coal from its underground operations in the year to June 2016 and acquired 48,564 tonnes of coal for further processing and blending.

Golden opportunities

Results for the six months to December 2016 from Pan African were good on the whole, with pre-tax profits in sterling terms soaring by 28.4% to £14 million, being boosted by a rise in the value of the South African rand and an initial half year contribution from the Uitkomst Colliery. This was despite gold production falling by 10% to 91,613 ounces, with the rand gold price received increasing by 16.5%. While no interim dividend was declared, Pan African guided towards an annual target pay-out ratio of 40% of net cash generated from operating activities to follow-up on 2016's record payment of 0.88p per share.

The main news from Pan African over the past few weeks has centered on the Evander operations where a fatality occurred during the refurbishment of a mine shaft. Following an investigation the decision was made to suspend Evander's underground mining operations for up to 55 days while infrastructure issues are addressed. While the tailings and surface operations will be unaffected, Pan African has been forced to revise down its production guidance for the year to June 2017 from 195,000 ounces of gold to 181,000 ounces.

Despite this temporary setback, in the short- to medium-term production is expected to be boosted from the commissioning of the Elikhulu tailings retreatment project at Evander. With first gold forecast for the final quarter of the 2018 calendar year, annual recoverable gold production of c.56,000 ounces is expected in the first eight years of operation, falling to 45,000 ounces for the remaining five years. Funding plans for the project, which has a net present value of $75.9 million assuming a $1,180/oz gold price, are currently being finalised.

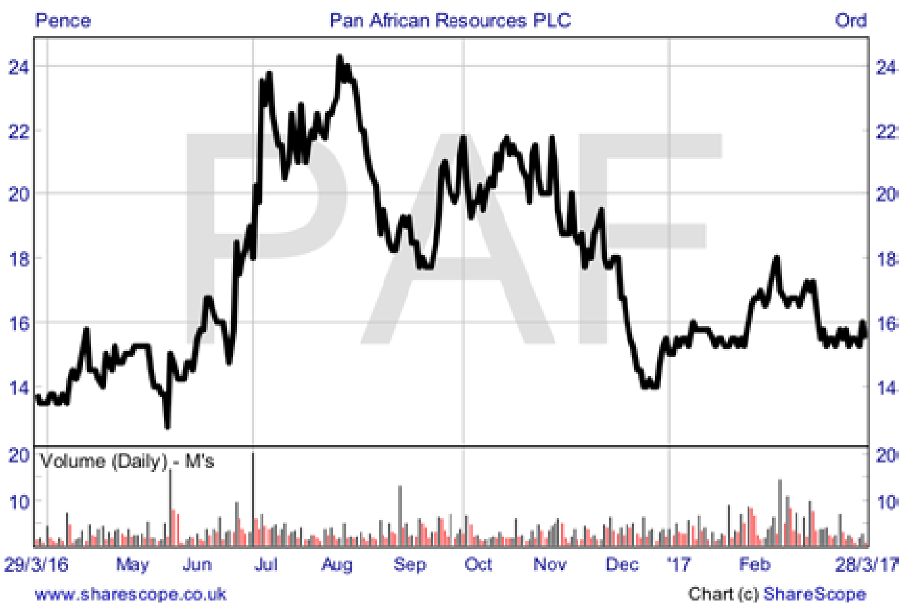
“PAN AFRICAN PRODUCED A RECORD 204,928 OUNCES OF GOLD FROM ITS OPERATIONS.”

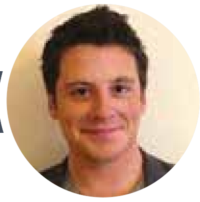
Make a mint?

Pan African investors had an excellent time in 2016, with the shares recovering from a low of around 8p at the start of the year to a peak of 24.25p as a result of the gold price rally. They have since come down to the current 16.75p, capitalising the business at just over £300 million.

Analysts at Numis have a 32p target for the shares, implying upside of 91% from the current price. While the shares carry an extra degree of risk given the exposure to changes in the gold price as well as fluctuations in the value of the rand against sterling, the diversified nature of the business along with an attractive dividend policy make them look worthy of a **speculative buy.**

PAN AFRICAN RESOURCES PLC





BY SAMUEL RAE

FORENSIC FOREX

TIME TO RETHINK THE REFLATION TRADE

The reflation trade has been a much used term over the last six months or so. The potential for economic stimulus under a Trump term, and the implications that a Republican controlled Congress might have of the breadth, depth and speed of said stimulus, had many thinking that runaway CPI was an inevitability. This, of course, in turn, served up a longer-term bullish outlook for the US dollar. High and rising inflation would spell a nail in the coffin for accommodative monetary policy from the Federal Reserve, and we'd see a swift return to regular interest rate hikes. Interest rate hikes mean only one thing for an underlying currency, and in this instance, the US dollar – strength. Increased overnight rates draw increased capital allocation, and increased capital allocation translates to appreciation.

For currency traders, the reflation trade served up a number of what we might call no-brainer long-term positions. Throw in a backdrop of continuing economic weakness in Europe, uncertainty around Brexit execution in the UK and mounting geopolitical tension between North Korea, Japan, China and – ahead of the Trump and Chinese President Xi meeting in early April – the US, and these no brainers become sure things.

Short EURUSD. Long USDJPY. Long USDCAD. Short GBPUSD. The Aussie's not quite so clear, but with the potential for a (second) withdrawal of capital infrastructure in China looming, despite the seeming pick-up in output seen earlier this year, short AUDUSD made for an intriguing secondary play.

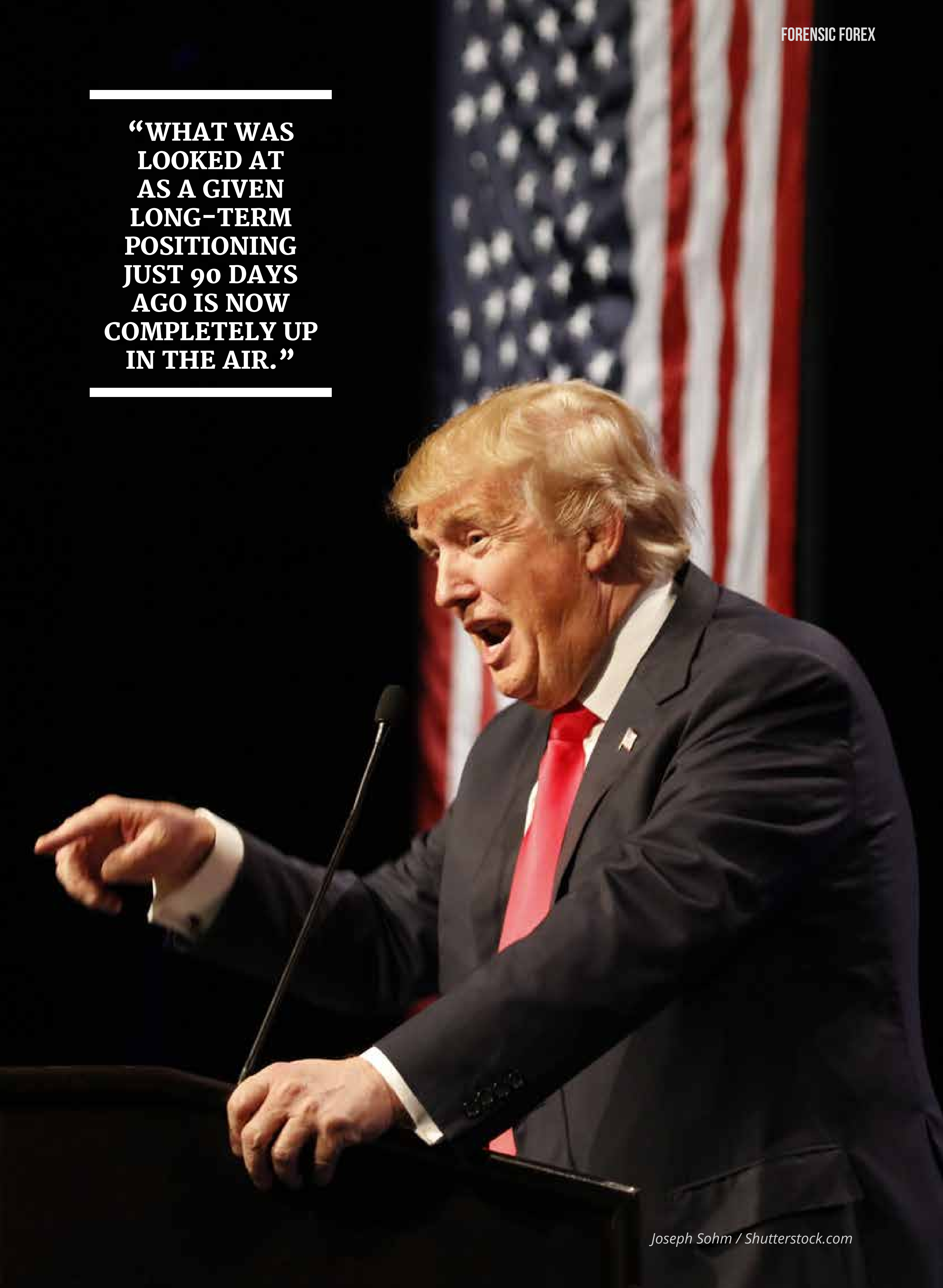
As we head into the close of the first quarter of the year, however, things aren't quite as clear as they initially seemed.

The situation that has unfolded on the back of Trump's efforts to bring his own healthcare policy into force has demonstrated that majority Republican control in the House and the Senate doesn't necessarily translate to a Trump majority in said Congress constituents. This, in turn, suggests that some of the stimulus efforts that underpinned the justification for a reflation trade on the various tradable financial assets that offer exposure to the US's underlying economic conditions (of which the greenback is one), may not play out as quickly as expected, if at all.

For inflation plays, then, that's a problem.

So the question now becomes this: *Can we position ourselves in line with*

"WHAT WAS LOOKED AT AS A GIVEN LONG-TERM POSITIONING JUST 90 DAYS AGO IS NOW COMPLETELY UP IN THE AIR."



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a revised outlook for inflation, based on the potential for a series of challenges to the inputs that markets previously took for granted as valid?

Yes, and no.

Yes, in the sense that longer term, we are probably going to see some degree of reflation in the United States over the coming 24 months. The various factors that play into capacity equation are nearing threshold, and the US economy is nearing the point at which employers are going to have to start raising wages to attract workers. The phase of employer control over who they want to hire is pretty much over, and employees are gaining the upper hand. This isn't anything new in the highly skilled, specialised side of the workforce, of course. When we see it in the lower skilled end of the market, however, it marks a transition; an inflection point, if you will. When employers have to pay more to attract even lower-skilled workers, it's a leading indicator of prices rising, and by proxy, inflation.

No, in the sense that this inflation may not necessarily lead to an ending of accommodative policy. Nobody can argue right now that there's extreme uncertainty over the future direction of the US equities markets. Even if the US is at capacity, and output and inflation ramps up, the Fed, or more accurately, the FOMC, is going to take this uncertainty into consideration when it votes on rates.

"WE MIGHT GET A PROLONGED PERIOD OF INFLATION AT OR ABOVE 2%, BUT THIS MIGHT NOT AUTOMATICALLY TRANSLATE TO A RATE HIKE."

What this means, is that we might get a prolonged period of inflation at or above 2%, but this might not automatically translate to a rate hike, or a series thereof. It's the rate hike side of the equation that strengthens the underlying currency (when all is said and done, that is) and so this may mean we get the reflation, but not the response in the tradable assets that validate the reflation trade.

Sure, longer term, things will balance. Whatever the risk of a rate hike translating to a tanking US equities market, Yellen isn't going to allow prices to rise indefinitely. When things get too hot, she'll cool them. The point is, however, that what was looked at as a given long-term positioning just 90 days ago is now completely up in the air.

On a personal note, I'm still long the greenback. Especially against the euro and sterling. That said, not with quite as much certainty, and in turn, nowhere near as aggressively.

Now we sit back and see how it all plays out...

BY DAVID JONES

CHART NAVIGATOR

HOW TO MAKE MONEY IN A QUIET MARKET

For this month I thought we could look at a way of using charts to set up trading opportunities – but with a little bit of a twist from the usual approach. Normally, when you read a chartist's view on a market it tends to be along the lines of "buy here, put a stop loss there, and the expectation is for the market to get to here". That's all well and good – but if you have ever done any research on the performance of the average short-term trader you will know that most of them lose. And that is because it is not easy!

But let's try turning the situation a little on its head. What if there was a way of profiting from a market NOT going somewhere? Let's say your outlook for a market over the next few days, weeks and even months was boring – can you profit from this? The simple answer is: yes you can. Of course, the market will still go up and down day to day but if your outlook, combined with the charts, suggests little to no change overall you can structure a trade that makes money if this proves to be true.

Let's take a look at a chart. We will use the US stock market index, the Dow Jones Industrial Average.

"THIS IS DEFINITELY NOT A STRATEGY FOR THE NOVICE INVESTOR OR TRADER."

This has had an incredible performance since the US election – it's been the so-called "Trump Trade" as shares in the US (and everywhere else, mostly) have powered higher. But during March some of that momentum faded and we finally had a drop of more than 1% in one day, on 21 March. This was the first time this had happened in more than 100 days and may have been something of a wake-up call for investors lulled into thinking that markets just went up!

> **"THIS IS WHY OPTIONS APPEAL TO SOME PEOPLE WHEN TRADING – THEY ABSOLUTELY KNOW THEIR TOTAL RISK RIGHT FROM THE START, WITH NO NASTY SURPRISES."**

After looking at the chart, your view may be that this is a market that is going to trade sideways and you identify a couple of important levels. The all time high is an obvious one at 21,170 and the mid February low ahead of 20,300 as the market took off higher once again.

You take the view that whilst there could still be plenty of volatility day to day, this is a market that is well overdue a correction and is likely to stay trapped between these two levels. You feel there is a good chance that the price towards the end of April is going to be roughly where the market is now. To the trade!

This can be structured using options. I appreciate that plenty of investors won't be familiar with these so let's do a quick crash course.

As an owner of an option, this gives you the right (but not the obligation) to buy or sell a market at a certain level, before the option expires. If you thought the market was going to rise, you would buy a "call" option; if you thought the market was going to fall you would buy a "put" option.

At the time of writing, with the Dow at 20,650, the Dow 20,500 April call was trading at 365 to buy. This gives you the right to buy the Dow at 20,500 any time between now and April expiry (17 April). Let's say you were positive on the Dow and bought the option. Fast forward to the day of expiry and the Dow has rallied and is trading at 21,000. Your option gives you the right to buy at 20,500 – the market is at 21,000. Your option is worth 500 points. Your profit in this example is 500 minus your purchase price (365). So your option has increased in value by 135 points – you have made money from the Dow rising. If the market had crashed by an outrageous amount – let's say 2,000 points – the most you would lose is the price paid for the option. Your risk would be limited to 365 points. This is why options appeal to some people when trading – they absolutely know their total risk right from the start, with no nasty surprises.

But there is a big downside with buying options. If the market *doesn't* move much – or doesn't move quick enough – you can be RIGHT on market direction and still LOSE money. Every day your option is getting closer to its expiry, so a little bit of its value gets chipped away. This is where our strategy for taking advantage of a sideways market comes in.

It involves SELLING options rather than buying them. Before we get into this: a word of warning. If you have a problem with managing risk and hesitate to get out when a trade is obviously going wrong, this is not an approach for you! Selling options can be a more considered approach to trading – but when it goes wrong it can go wrong very, very quickly. You need to have the discipline to exit the trade and take the loss – not stick your head in the sand and hope it comes back.

So let's get onto the trading idea. You think the market is going to go sideways and want to profit. The 20,700 call option (makes money if the market goes up) is trading at 220. The 20,700 put option (makes money if the market goes down) is also trading at 220. You decide to sell both of these – you can do this using spread betting or contracts for difference or through a specialised options broker. Let's use spread betting, and sell both options at £1 per point. To use the jargon, this is known as a "short straddle". We have sold this for a total of 440 points (220 + 220).

Look at this next chart and I will explain what this is showing us.

The absolutely best outcome for this idea is the Dow trading dead on 20,700 when the options expire. If that was the case, then the put option is worth zero, and the call option also has no value. The straddle was sold at 440 at £1 per point and expires at 0. The profit on the trade is £440 – all made from the market going sideways. This is the ideal outcome – and also unlikely! It would be a major fluke if the market ended dead on the price we wanted. But we don't need to precisely nail the value of the Dow at expiry to still make a profit. Selling the straddle at 440 gives us a large band of potential profit, and that's what the chart above shows.

As long as the market does not expire 440 points higher than 20,700, or 440 points lower than 20,700 – the lines show on the above chart – then the trade will make some sort of profit. Let's say the Dow is at 20,900 on expiry day. The put option giving the right to sell at 20,700 will be worthless. The option gives the right to sell at 20,700 – but with the market trading at 20,900 there is no value. The call option gave the right to buy at 20,700 so with the market at 20,900 that will be worth 200 points. The total trade expires worth 200 points. It was sold at 440 points so still makes a profit of 240 points. The market did move higher – but not drastically – so you still have made money from your view on a quiet market overall.

Let's say the market had a massive move higher – and here is a chart to remind ourselves just how the Dow can move when it really gets going.

At expiry the market has gained more than 1,000 points and is trading at 21,700. The put is still worthless but the call option, giving the right to buy at 20,700, is now worth 1,000. This means that the short straddle, which was sold for 440, now expires at 1,000. This is a loss of 560 points – the expectation was for the market to go sideways – that was proved wrong and the Dow had a significant directional move.

This is why it is imperative to manage the risk. Large directional moves are Kryptonite for options sellers. If your view on the market has changed then it is time to take the loss, buy the straddle back and look for other opportunities.

As mentioned at the beginning, this is definitely not a strategy for the novice investor or trader. The further the market moves away from where the trade was opened, the quicker the losses will mount. But, if you are comfortable with managing risk and disciplined enough to take losses on the chin when they occur, then allocating a portion of your investing or trading funds to this approach can be an interesting way to try and profit if you think a certain market is set for a somewhat dull time.

BY ALAN STEEL

DEATH & TAXES

SPRING CLEANING:

WHY IT'S TIME TO OVERHAUL YOUR FINANCIAL FUTURE

In my second article for Master Investor readers I want to raise some questions that hopefully will help improve your long-term real returns and planning. Unless of course Financial Independence doesn't float your boat. And if it doesn't why are you bothering to invest at all?

Many years ago, when we used to talk to one another instead of staring at smartphones, there were adverts on coal fired Scottish Television featuring Rikki Fulton, star of cult comedy series "Scotch and Wry" and "Rev I.M. Jolly". One ad featured him as an old chap in a bunnet wandering into a Painter and Decorator's shop. When asked by the shop assistant if she could help he'd say "I'm looking for a tin of paint please". When she asked "What colour?" he replied "Any colour".

Another ad saw him in a Travel Agent's enquiring about a holiday, and when asked where he wanted to go he'd say "Anywhere will do". Imagine that. I can't recall what was being advertised, but the message stuck with me over all these years. How can you advise people who don't know what they want?

Take investing, for example. Despite having been in the financial advice business for 44 years, it still amazes me that so many invest in a haphazard manner. For a few years now I've been asked by a couple of "money mags" to comment on reader investment portfolios. Typically they'd written in laying out some concerns about how they invest, or seeking comments on what they have. Or perhaps simply requesting a fresh eye, usually on the back of unsatisfactory returns or maybe in response to facing a change in their circumstances such as imminent retirement.

Remarkably, and without exception, no matter the age of investor or their circumstances, the portfolio was a dog's dinner. Far too many holdings, from overweight in one stock to having almost zilch in, say, a top performing fund. No obvious strategy (a nice way of saying they're all over the place), too much trading, short-term thinking, looking for a quick fortune or obvious signs of herding, and typically with a "watch list" which included funds or stocks that had outperformed their investments over the previous three or five years. But still being watched. Doh!

Oh, did I forget a widespread obsession with costs rather than added value? I respond by asking the obvious: "What are you trying to achieve? What's your long-term goal? Why aren't you taking tax into account? Why do you think you're better at investing than the best fund managers? Why do you have so many itsy bitsy holdings? What attracted you to these investments in the first place?" And so on.

Fail to plan: plan to fail

We have used the same approach here for over 30 years since a couple of clients asked me a stupidly simple question. Every year I'd sat down with them and we'd work out how much they could invest to build

"DESPITE HAVING BEEN IN THE FINANCIAL ADVICE BUSINESS FOR 44 YEARS, IT STILL AMAZES ME THAT SO MANY INVEST IN A HAPHAZARD MANNER."

long-term wealth. One year, although they admitted to being delighted with their returns, they said they had no idea if they were on track to achieve the financial independence they were hoping for. How could we fix that?

Financial Independence means different things to different people, but in their case the goal was to be able to just walk away from their family business leaving it to their son. But they wanted to keep the same standard of living in real terms from their after-tax investment returns.

We agreed a net income goal, taking account of inflation, sensible returns, and timeframe, then tweaked the tax planning and revisited their master plan twice a year. Given investors are pressured to take short-term emotional (i.e. bad) decisions they need an "Emotion Blocker" to stay on track. I find a good adviser helps. Even I have one. (Yes, really.)

When new clients come to us, typically by referral, they tend already to have a jumble of savings plans and investment "products". Fortunately IFAs are required by law to complete full fact finds on income, assets, attitude to risk, and objectives. And we ask other simple questions: "What are you trying to achieve? Why do you have this investment? What attracted you to it? What will happen to all this when you die? Do you have a will? Is your pension plan written in trust? Why do you have so much in cash? Why are you paying so much tax? Does financial independence appeal to you, or not?"

"THE UK TAX SYSTEM IS DESIGNED TO TAX INCOME WHEN YOU'RE LIVING AND CAPITAL WHEN YOU DIE. SO ALL YOU NEED TO DO IS REVERSE THEM."

Instead of chasing one media tip or "great opportunity" after another and ending up with a shapeless mess after only a few years, why not begin with a detailed goal in mind, and then a plan. Work out in real terms how much you want to have amassed and by when. When doing so, do remember what Professor Parkinson said about Tax Planning. It's crucial as part of the plan.

Parkinson said (over 30 years ago) the UK tax system is designed to tax income when you're living and capital when you die. So all you need to do is reverse them. Create only capital when you live, only income when you die and BINGO... no tax. (Then he moved to Jersey and the Isle of Man. Maybe he couldn't find a good adviser.)

But despite the UK tax code being over 10 million words and 21,000 pages long these days – 12 times longer than the complete works of Shakespeare... (Alas poor Taxpayer)... and 66 times the tax code of Hong Kong – the Parkinson "move" still works. Earning more income and ignoring Parkinson's advice doesn't work very well. Today the top 10% of UK income earners pay 60% of all income tax, up by 70% in forty years. That doesn't need to be the case.

So it stands to reason if you have a money goal it will be easier to reach it by concentrating first on minimising tax and pocketing extra through tax reliefs while they last. And move income stocks into your tax friendly ISAs. Fast.

It doesn't pay to follow the herd

Next up go check out the Dalbar Survey findings (US investors but we're just the same). Dalbar reports on the short- and long-term returns of equity, bond and deposit investors. Cutting a long story short they found that private "active" investors consistently underperformed "buy and hold index" investors by between about 4% and 6% compound over the last 30 years. And the gap is widening since the financial crisis.

Because of fees? Nope. By far the biggest reason for performance drag, the report finds, is investor behaviour. Chasing the latest hot stock or fund. Buying high then selling low. Repeat that enough times and you're broke. As I've said for many years now our brains weren't wired for such times. A key feature is our "panic button" deep in the brain. It's there to save us from "danger" thousands of years ago. Over time we learned the safest place was with the herd. It worked back then: contrarians got eaten. Nowadays stubborn contrarians are the winners.

If you want to beat the herd you have to be different. You have to buy low and sell high. That means doing the opposite of simply tracking a Capital Weighted Index. Especially here in the UK. So if you are tempted to pack in your "fun" portfolios don't follow the herd or opt for the "you can't beat a cheap index tracker" cult.

Think of it this way: Investing in a Capital Weighted Index is like driving along a road you've never been on before by looking only in the rear view mirror.

The 25-year average total return of the FTSE 100 is 8% per annum compound. Now consider Invesco Perpetual High Income's total return after all charges over the same period... 12% per annum. That's only a 50% higher annual return, but thanks to the miracle of compound interest it outperformed the FTSE 100 by *threefold* (source: Lipper Stats). Hold it in a pension plan as a 40% taxpayer and the outperformance jumps to almost *five times* greater. Magic. (Past performance is no guide to the future though.)

I'm well aware Index Trackers and Absolute Return funds are attracting both the headlines and the net inflows, but do remember all the "surefire" investments over the last 100 years that attracted the herd. This mania for passive funds looks increasingly like a bubble according to legendary US analyst Ned Davis, a man well worth listening to.

As to the latest wheeze, ETFs – basically cheap mini trackers – Vanguard's John Bogle says "An ETF is like handing an arsonist a match", while successful value investor Neil Woodford likened them to derivatives. "Toxic", is his description. Beware.

Pick a winning team

Assuming you've agreed the goals and fixed your tax planning strategy, it's time to try to bank positive returns by minimising the possibility of loss. When it comes to portfolio composition, it's useful to draw the analogy of a world-class football team.

Winning teams build their defence first – the best goalkeepers, commanding centre-halfs, quick-footed full backs, a stiff midfield, and fleet-footed strikers. Clubs like Bayern Munich and Barcelona attract the best players and pay the best wages; and while they score goals for fun, they're solid at the back. World-class defenders, just in case!

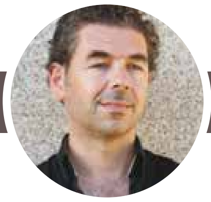
But more importantly they seek the best managers and coaches. There aren't that many about. US investor Jim O'Shaughnessy says outstanding investment managers don't grow on trees either. And he reckons they need seven traits to consistently win: They have a long-term perspective, ignore headlines and media noise; they have a consistent process, are patient and persistent with a strong mental attitude; and finally, they're highly disciplined and stick to objective probabilities.

Sounds good to me.

"THIS MANIA FOR PASSIVE FUNDS LOOKS INCREASINGLY LIKE A BUBBLE ACCORDING TO LEGENDARY US ANALYST NED DAVIS, A MAN WELL WORTH LISTENING TO."

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.



BY FILIPE R. COSTA

HOW TO INVEST LIKE...

JIM SLATER

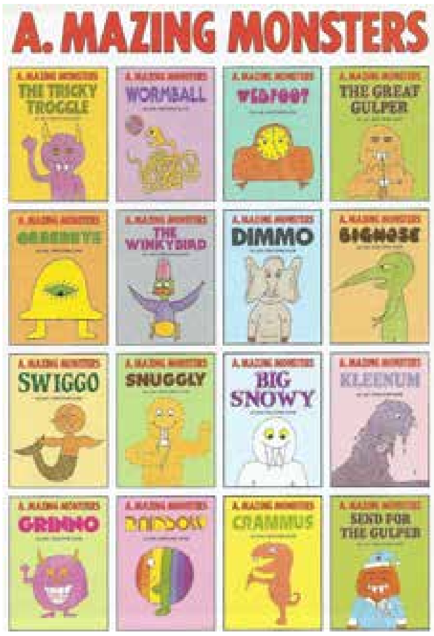
"It is no good trying to be master of the universe. It is better to specialise in a narrow area and become relatively expert in it".

— Jim Slater
"The Zulu Principle: Making Extraordinary Profits from Ordinary Shares", 1992

Finding a Magic Formula

Born in Heswall, Cheshire (now Merseyside), and qualified as a chartered accountant aged 24, James Derrick Slater (Jim Slater) changed his life when he was afraid of losing his job after a prolonged illness. The British accountant, investor and writer left an important legacy in terms of investment strategy. However, the core of his investment philosophy he learned through his wife: all we need do to beat the wider community is become experts in some particular niche, learning everything we can about it.

In the case of Jim Slater, the niche was growth stocks. But it could very well have been value stocks or any other sector. The point is it doesn't really matter. The most important part of a sound investment strategy is to find value were others won't look for it, and to avoid following the crowd. Slater spent his life seeking out growth at a reasonable price among the smaller stocks on the market, and in the meantime even had time to write the "A.Mazing Monsters", a series of children's books.



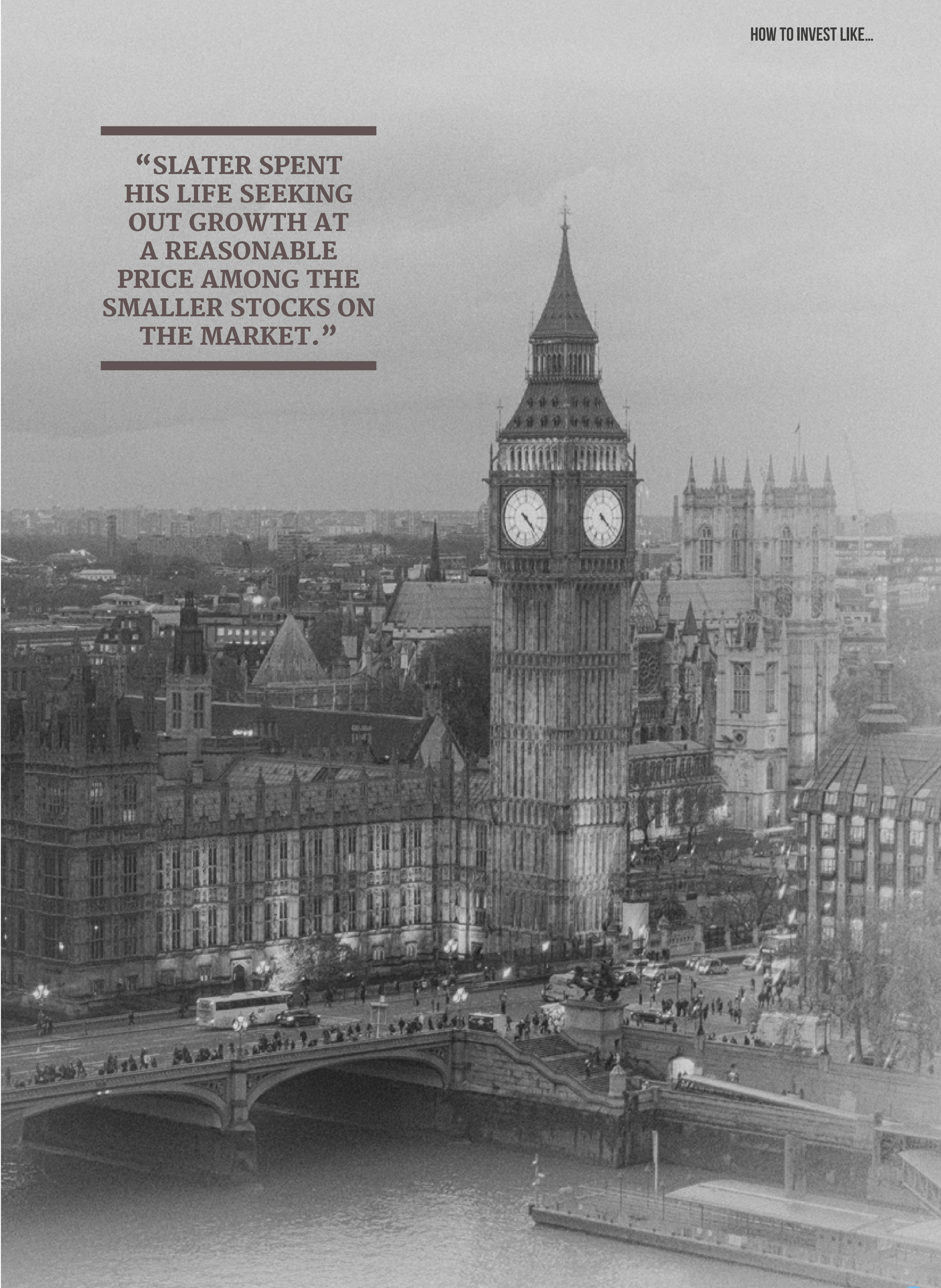
The "Zulu Principle"

When working as commercial director of AEC, Slater contracted a viral illness during a visit to Spain, which brought him some after-effects that lasted for several years. He became concerned that he couldn't keep his job for long and that he needed to find an alternative source of income. Investing in the stock market was the best answer because he could do it while keeping his current job. "The only problem was how to become relatively expert in the chosen specialist job". He needed to develop a profitable strategy.

One day he observed that, after reading a short magazine article about the Zulu people, his wife was well informed on the subject. He then thought that if his wife read all the books she could find on the topic and then eventually paid a visit to South Africa and met the Zulus, she could become an authority in the subject in a relatively short period of time. All one must do is find a very narrow topic that doesn't attract wide attention and interest and then research everything about it.

Slater acquired his initial expertise through an extensive reading of the two investment magazines that were then published in the UK: the "Stock Exchange Gazette" and the "Investors Chronicle". He purchased two years' back copies of the magazines and read through each page to find clues about how to develop a profitable strategy to invest. He was convinced that past

"SLATER SPENT HIS LIFE SEEKING OUT GROWTH AT A REASONABLE PRICE AMONG THE SMALLER STOCKS ON THE MARKET."

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winners shared some characteristics that make them more likely to be winners. What he needed to do was to identify those characteristics and develop a formula.

The realisation that stocks with a rising trend in earnings and a low price-to-earnings ratio usually outperform the market by a wide margin gave him a start. The confirmation that this is not always true gave him awareness for the need to develop a model that is based on more than a single criterion.

Slater developed his first stock-picking formula and put it into practice; giving advice to friends and his boss at AEC, creating an investment club, and writing a newspaper column. He contacted his friend Nigel Lawson, at that time City editor of the Sunday Telegraph, in order to convince him to publish a column about stock picking. Lawson found Slater's arguments very valuable and created an investment column where Slater, under the pseudonym "Capitalist", was able to explain his strategy and track the performance of a portfolio. Between 1963 and 1965 the "Capitalist Portfolio" rose 68.9%, which completely outperformed the wider market, which rose just 3.6% in the same period.

"BETWEEN 1963 AND 1965 THE 'CAPITALIST PORTFOLIO' ROSE 68.9%, WHICH COMPLETELY OUTPERFORMED THE WIDER MARKET, WHICH ROSE JUST 3.6% IN THE SAME PERIOD."

The strategy espoused by Slater in 1963 has been refined over the years, but the main concepts behind it are mostly valid today and are still the essence behind the full set of criteria Slater published in his main book, "The Zulu Principle: Making Extraordinary Profits from Ordinary Shares", first published in 1992 and then updated in 2008. In his first article, published in 1963, Slater presented a list consisting of nine criteria: "1) the dividend yield must be at least 4%; 2) equity earnings must have increased in at least four out of the last five years; 3) equity earnings must have at least doubled over the last five years; 4) the latest chairman's statement must be optimistic; 5) the company must be in a reasonably liquid position; 6) the company must not be vulnerable to exceptional factors; 7) the shares must have a reasonable asset value; 8) the company should not be family controlled; and 9) the shares should have votes".

Investment isn't just for the professionals

While individual investors have a clear disadvantage relative to professionals (as they don't have the expertise and resources to research the market as professionals can do), there are certain niches that may give an individual investor a competitive advantage. By focusing on smaller stocks, individuals are more likely to find a bargain since these firms have much less coverage than their larger counterparts. Investors may become more informed than professionals on these companies. At the same time, professional investors have very large amounts of money which makes them unwilling to purchase stocks with small capitalisations. If they did, prices would move erratically, and in the event of a sudden need to sell, they would again end up losing substantial amounts of money as they would drag the price down. Additionally, an individual investor may focus his attention on a smaller number of stocks, which isn't usually the case with professionals, who often run portfolios with hundreds of stocks. If, to some extent, adding stocks to a portfolio reduces idiosyncratic risk, it may also reduce its average expected

"IF INVESTORS CAN FIND A STOCK WITH A BELOW AVERAGE P/E RATIO AND ABOVE AVERAGE GROWTH RATE, THEY WOULD HAVE FOUND A 'JEWEL BEYOND PRICE'."

performance. This means that individual investors may hold portfolios that are on average better than those of the professionals.

During the 16 years that elapsed between the first and second editions of "The Zulu principle", Slater further refined his strategy, but always kept the focus on the small and micro-cap stocks, because he believed these to be the most under-researched stocks where investors can acquire an advantage over professionals. These stocks have outperformed the wider market by more than eight times during the last 50 years.

When looking for a new investment, Slater starts by searching for a tailwind, to avoid going against the market and to be able to concentrate his positions in a sector which has a very favourable outlook. To a certain extent, stocks are correlated with one another. Finding good businesses is crucial, but being in these businesses at the right time is even more important. The next step is to look for growth shares, usually found among smaller companies. As he put it, "elephants don't gallop", and therefore one can't expect the larger stocks to double in price in just one year – something that occurs often among smaller companies.

The main Zulu Principles as of today

Over the years, Slater had the opportunity to work on his strategy and refine it. In the second edition of "The Zulu Principle", Slater presented a strategy based on 11 main criteria to select good businesses at reasonable prices. A candidate for a purchase should exhibit the following:

1) A positive growth rate in EPS in four of the last five years;

In general investors should look for established businesses with a proven track record. EPS should have grown at an annual compound rate of at least 15% for the last five years. This is not to be used rigidly. As Slater states, "a shorter period suffices if there has been a recent sharp acceleration in earnings growth from an easily identifiable source". But growth should be steady to eliminate cyclical stocks. These stocks need a different selection process as they're well exposed to the business cycle, as opposed to growth stocks.

2) A low P/E ratio relative to the earnings growth rate;

The P/E ratio is the measure of how much an investor is paying for future growth. But earnings growth is the engine behind what will happen to this ratio. Slater analysed the FTSE market and found that in the period 1981 to 1991 the average compound growth rate in EPS for the index was about 10% while the average P/E ratio was around 11.7.

If investors can find a stock with a below average P/E ratio and above average growth rate, they would have found a "jewel beyond price". If the P/E ratio is above average but modest in relation to the EPS growth rate, they would still have found a "rare gem". Investors should look for growth companies that are trading cheaply, which is well summarised in the PEG (Price-Earnings/Growth) ratio. They should look for stocks trading at a PEG of "not more than 0.75 and preferably less than 0.66".

3) The last chairman's statement should be optimistic;

The reason for looking at the chairman's view is because the PEG ratio needs estimates of future growth which are no more than educated guesses about the future. Looking for other features helps reduce the risk to these estimates. The chairman's view and his enthusiasm in explaining it is

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of particular usefulness. Slater advises to go as far as interpreting the body language of the chairman when he is presenting a statement.

4) The company must possess a strong liquidity position with low borrowings and good cash flow;

Cash is, and always will be, king. Cash cannot be faked. Investors should stick to companies that are able to generate cash, as opposed to ones that eat cash. The main reason for this is to give some safety margin and to avoid Enron-like scenarios.

5) The company must possess some kind of competitive advantage;

Only companies with a competitive advantage, like a brand name, patents, copyrights or technology which enables it to dominate the market, or that have a strong position in a niche, are able to deliver high growth for many years. If the competitive advantage is insignificant, margins will deteriorate quickly and growth could stall very soon.

6) "Something new";

This factor includes not only the introduction of new products and technology but also a change in the management team, news events for the industry (including new legislation), and new acquisitions. "Something new" will frequently be the main reason behind accelerating earnings, a higher growth rate, a lower PEG and a higher relative strength of the shares in the market.

7) A small market capitalisation;

This is crucial because smaller companies attract much less attention than bigger ones and it is therefore easier for these to be overlooked by the professionals. At the same time, many of the small caps of today will be the large caps of the future. From the perspective of growth investing, the key goal is to buy these from the beginning and not when they're mature. Slater focuses on small dynamic growth companies, being those fast-growing companies with market capitalisations of between £5m and £100m. "Mammoth companies rarely double their market capitalisation in a year. In contrast, small companies often do this!" But, if other criteria are met, this figure can be relaxed a little, maybe to £200m or £300m.

8) Show a high relative strength compared with the market;

While this is not a mandatory requirement, it gives a sign about the future. The idea is that avoiding companies with price weakness reduces the risk of negative surprises. A value investor would certainly disagree with this, as companies showing weakness in price are the most hated ones which have a good chance of beating the market in the future when sentiment reverts. But in the context of growth investing, the goal of this criterion is to just filter out problem-cases.

9) A consistent dividend policy;

When he first defined his criteria in 1963, Slater was looking for companies with a dividend yield of at least 4%, but

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"FINDING GOOD BUSINESSES IS CRUCIAL, BUT BEING IN THESE BUSINESSES AT THE RIGHT TIME IS EVEN MORE IMPORTANT."

he later changed his view. The most important part about the dividend is its consistency. If a company has been raising its dividend and suddenly keeps it at the same level or suspends it, investors should be wary. But it is fine if a company has been paying lower dividends in order to finance growth, particularly when the return on its capital employed is high.

10) A reasonable asset position;

The value of assets is of key importance in value investing. The great value investors like Benjamin Graham and David Dreman were always looking for companies with a low price-to-book ratio in order to be sure they had some safety net in case things went wrong. But assets are less valuable in growth investing because these companies usually carry higher price/book ratios. That means that if the company were to be sold off piecemeal, investors would probably get back just a small fraction of what they invested. In the universe of growth investing, investors need to confirm that companies have sufficient working capital, aren't over-geared and have a relatively strong balance sheet. If that is the case, growth will take care of the rest.

11) Significant management shareholding

It is important to align management's interests with that of shareholders and avoid moral hazard issues. Top management should have a stake in the company that is large enough to matter to them, but not so large as to give them control of the company. As Slater puts it, "I like to see a good cross-section of the directors with reasonable shareholdings and I always worry if the finance director is not among them". Besides this requirement, there shouldn't be any significant selling from insiders. Some selling is normal, because management is paid in stock options and at times they sell the underlying shares, but when the amounts sold are high and shared by many insiders, the alarm bells should ring.

Mark Slater, Jim Slater's son, has been following his father's strategy with huge success. His fund MFM Slater Growth Fund returned an average compound rate of 12.8% between 2006 and 2016, which compares with 6.1% for the wider market.

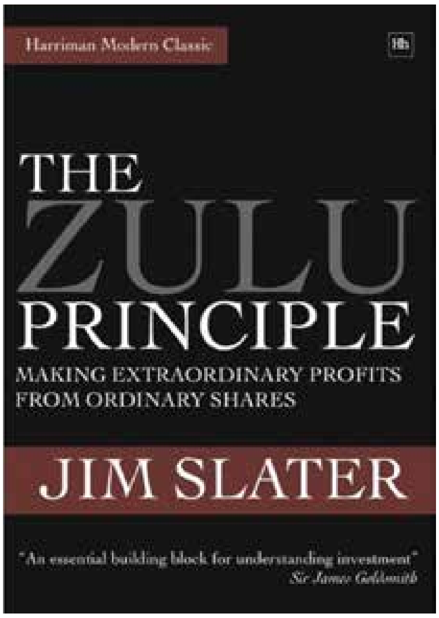
Jim Slater's Strategy Put in Practice By Mark Slater

Year	MFM Slater Growth Fund	Wider Market
2006	6.88	19.11
2007	7.11	-5.30
2008	8.31	3.73
2009	40.20	19.44
2010	8.06	14.08
2011	9.29	1.27
2012	47.10	19.53
2013	80.39	43.83
2014	-31.93	-34.22
2015	-11.35	-5.63
2016	14.81	11.32
Average Compounded Returns	**12.8**	**6.1**

Source: *Slater Investments Ltd.*

A few final words

Over the last few months the focus of this column has been on value investing. But buying unfavourable companies when the market is pessimistic to then wait for prices to converge to fundamentals isn't the only potentially successful strategy. Jim Slater spent his life focusing on stocks that could already be trading at higher price ratios than value investors would like to consider, but which still looked good value given the growth being exhibited. By redefining the notion of value – using the PEG ratio instead of the P/E ratio or the earnings yield – Slater put traditional valuation methods into perspective. But his main contribution comes from the essence behind his strategy, which confirms the view from other masters of his craft: investors should focus on some particular area that is neglected by the larger community, to then acquire expertise about it and become an authority on it. To that extent, Jim Slater is no different than Benjamin Graham (issue 13 – April 2016), Warren Buffet (issue 14 – May 2016), or Philip Carret (issue 23 – February 2017). The key focus is always to spend time researching to find value where others aren't looking for it. For those not willing to spend the necessary time, the market is a negative sum game, which would make John Bogle's (issue 18 – September 2016) advice on passive investment strategies much more worthwhile.



MARCH 2017

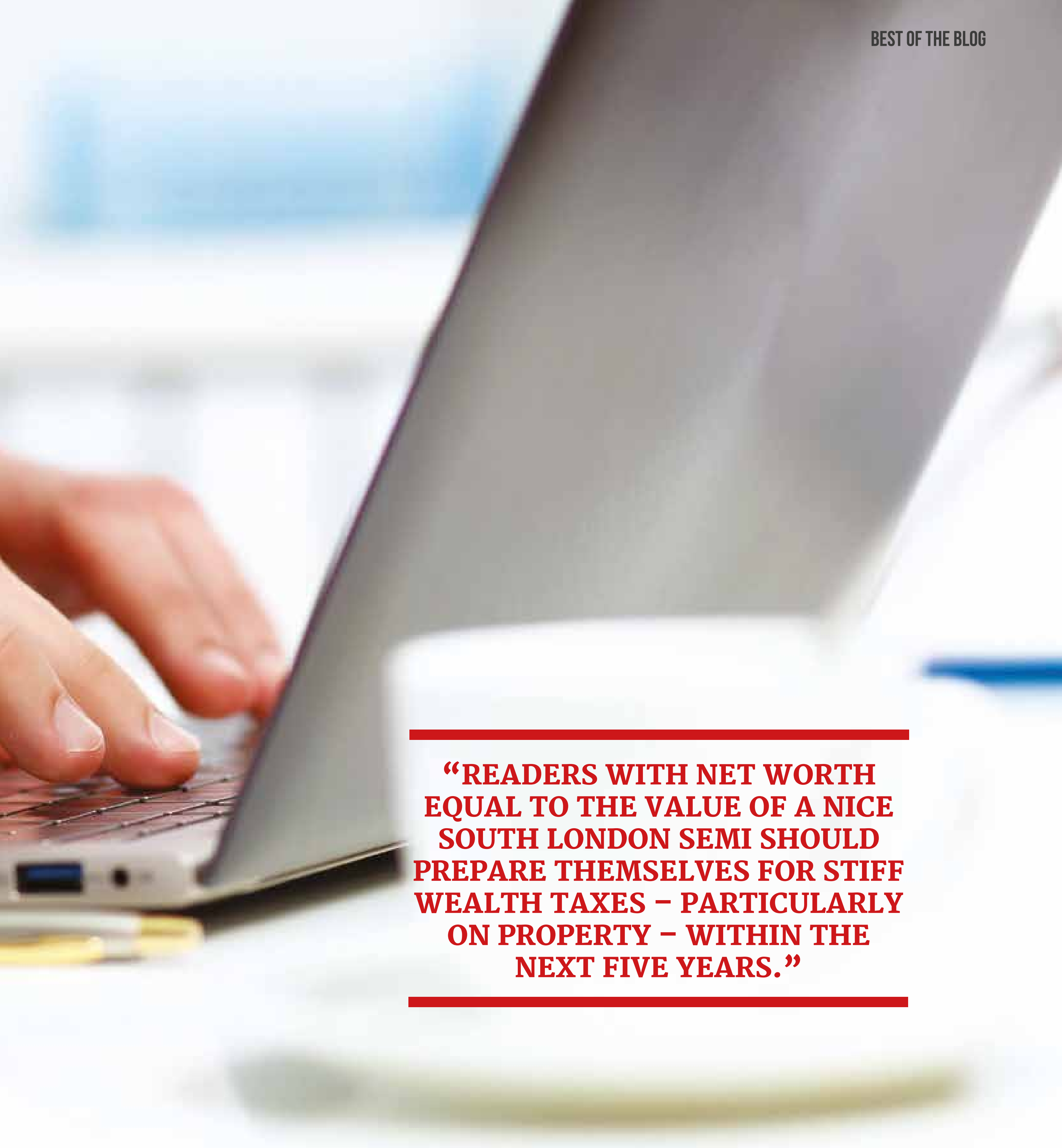
BEST OF THE BLOG

Prepare for wealth taxes in the UK

Governments in future will be obliged to move from taxing income to taxing assets, not least in the UK. Readers with net worth equal to the value of a nice South London semi should prepare themselves for stiff wealth taxes – particularly on property – within the next five years. Especially if the Tories regain power in 2020.

This is Budget week in the UK – still a preeminent parliamentary occasion at which the Chancellor of the Exchequer reviews the state of the economy and announces taxes for the year ahead.

In the good old days, Chancellors used to announce tax rates in the March budget to be implemented in the new fiscal year which in the UK, as we know, starts on 06 April. Under Gordon Brown's long tenure at Number 11 Downing Street, however, most tax rates and bands – and in particular those for income tax – were set more than a year



"READERS WITH NET WORTH EQUAL TO THE VALUE OF A NICE SOUTH LONDON SEMI SHOULD PREPARE THEMSELVES FOR STIFF WEALTH TAXES – PARTICULARLY ON PROPERTY – WITHIN THE NEXT FIVE YEARS."

in advance and the Budget announcement normally pertained to the following year – although even these can be amended in the Autumn Statement which normally takes place in late November.

So we already know the tax rates and bands for fiscal 2017-18 – unless Mr Hammond chooses to amend them, which would be unusual. What Mr Hammond will announce to the House of Commons on Wednesday will be the rates and bands for fiscal 2018-19. Moreover, this year Mr Hammond has signalled that the March budget will be as uneventful as possible because he intends to shift the main event to the autumn – by which time the Brexit negotiations will be at full tilt.

By Victor Hill

Click here to read the full article

16 must-watch movies for traders and investors

Not too long ago we reviewed what the hit film The Big Short can teach us about value investing. (See the original post **here**.) The blog post prompted us to take a look at what other finance and investment themed movies are out there. We at our FinTech start-up **CityFALCON** and **London Value Investing** are always looking to learn from every possible source.

With that said, here is a list of the top 15 movies, TV shows, and documentaries every trader and investor needs to watch.

1. Wall Street

Although Oliver Stone's epic film was released in 1987, the lessons of morality and doing what is good and right (not to mention legal) are timeless. Watch Charlie Sheen's character Bud Foxx cross the line between good and bad to satisfy the wants of billionaire investor Gordon Gekko (Michael Douglas).

2. The Big Short

Based on the book by the same name, the 2015 comedy-drama follows multiple storylines with one common theme: how to take advantage of the looming financial crisis while most of the world will suffer the deadly consequences.

3. Becoming Warren Buffett

For the first time ever you can follow billionaire investor Warren Buffett in this 2017 documentary. Fun fact: Buffett never spends more than $3.17 on breakfast despite his net worth which is north of $70 billion. We can all learn a thing or two about his humble lifestyle.

4. The Wolf of Wall Street

Leo DiCaprio's portrayal of Jordan Belfort tells the real life story of the criminal's rise from a shady stock broker to a criminal enterprise.

5. Boiler Room

Hard work and dedication towards a legitimate job doesn't appeal to Giovanni Ribisi's character. He learns the hard way that living of a life of scamming people out of their hard earned money has real consequences – both moral and legal.

By Ruzbeh Bacha

Click here to read the full article

5 UK personal finance podcasts every investor should download

Podcasts are now firmly in the mainstream, with more than a billion episodes downloaded globally and an estimated 75 million of us listening to podcasts every month.

Here in the UK, podcasting is quickly catching up with our friends across the

“ALTHOUGH OLIVER STONE’S EPIC FILM WAS RELEASED IN 1987, THE LESSONS OF MORALITY AND DOING WHAT IS GOOD AND RIGHT (NOT TO MENTION LEGAL) ARE TIMELESS.”

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pond in the US, where a thriving community of personal finance and investing podcasts has been created.

Whether you listen to podcast episodes whilst commuting, exercising or relaxing, here are the 5 UK personal finance podcasts every investor should download today.

Meaningful Money

My fellow Financial Planner Pete Matthew is passionate about financial education. After having an epiphany that there was more to life than making wealthy people wealthier, he created Meaningful Money as a YouTube channel, using his teaching skills to explain personal finance concepts. It evolved into a podcast and now boasts nearly 200 episodes.

www.meaningfulmoney.tv

The Financial Wellbeing Podcast

Chris Budd is author of The Financial Wellbeing Book and host of The Financial Wellbeing Podcast. This slickly produced podcast explores an often overlooked aspect of personal financial planning; how we can use money to achieve financial wellbeing and generally improve our lives. With 13 episodes published to date, Chris brings out the best from his guests and gets listeners thinking about what really matters.

www.financialwell-being.co.uk

By Informed Choice

Click here
to read the
full article

Why Barclays could become an unlikely income 'champion'

"A RAPIDLY RISING DIVIDEND AND LOW PAYOUT RATIO COULD MAKE BARCLAYS MORE POPULAR AS INFLATION TICKS HIGHER."

A recent poll suggested people in the UK are more worried about inflation than Brexit. That's understandable, in my view, since Brexit is an event which will not take place for at least two years. Inflation, on the other hand, is rising now. It is forecast to reach 2.7% this year, according to the Bank of England. Other forecasts have the figure at over 4%. In any case, it looks likely to move past wage growth of 2.6% and could even push past the FTSE 100's yield of 3.7%.

In such a scenario, I believe high-yield shares will become more popular. I think a lack of inflation-beating yields will cause more investors to turn to riskier, less obvious alternatives. One of those will be Barclays (LON:BARC), in my opinion. Before the financial crisis it was seen as a solid dividend play. While that status may not return, a rapidly rising dividend and low payout ratio could make it more popular as inflation ticks higher.

Just six months ago, inflation in the UK was only 0.6%. It hasn't been higher than 2% since November 2013, which has created benign conditions for income investors. Although low interest rates have meant cash balances and bonds have yielded relatively little, dividend shares have left income investors with returns in real terms of 3% or more in the last few years. Therefore, it has been a fairly straightforward existence for dividend investors in the last three or four years.

However, that situation is quickly changing. Inflation has picked up sharply since the referendum and has experienced negative correlation with sterling. This is to be expected, since a weaker pound is making imports more expensive. Although UK exporters have benefited from a depreciating pound, a range of goods and services are creeping up in price due to higher import costs.

By Robert Stephens

Click here
to read the
full article

BY RICHARD GILL, CFA

READ TO SUCCEED

REMINISCENCES OF A STOCK OPERATOR

BY EDWIN LEFÈVRE

Just a few weeks away from my ten year anniversary of working in the City of London, I have taken time to look through the vast library of investment, finance and economics books I have acquired over the past decade. From *The Bankers Who Sold the World*, a tale of aliens buying part of Earth to save it from financial crisis, to the 736 page insomnia cure that is *A History of Interest Rates*, I have certainly built up a varied and eclectic collection over the years.

However, only a small minority of books stand out to me as being real investment classics – ones that have stood the test of time and should be in the possession of every investor due to the knowledge and wisdom that they impart. One is *Popular Delusions and the Madness of Crowds*, a study of human psychology and greed which, despite first being published in 1841, is as relevant today as it was then. Another is *The Intelligent Investor*, Benjamin Graham's landmark work which is largely considered to be the value investor's bible.

One more classic, while perhaps being one of the worst investment books ever published in terms of its content, is the ridiculously titled: *Are You Missing the Real Estate Boom?: The Boom Will Not Bust and Why Property Values Will Continue to Climb Through the End of the Decade – And How to Profit From Them.* Published in 2005, just before the US housing bubble burst, the book is a masterpiece in its own special way. Read with hindsight, it exemplifies over-exuberance and reminds investors to be wary of listening to self-proclaimed "experts" with their own agendas – author and realtor David Lereah was declared by Time Magazine as one of its 25 people to blame for the financial crisis of 2008/09.

"BY THE TIME HE WAS 15 HE HAD ACCUMULATED HIS FIRST $1,000."

Back to the real classics...

Surprisingly, I had never before come across *Reminiscences of a Stock Operator*, an almost century old book about stock market trading and speculation which has just been republished by Harriman House under its Definitive Editions collection. Described by former Fed Chairman Alan Greenspan as being "a font of investing wisdom", Reminiscences was first published as a series of articles in US magazine The Saturday Evening Post in 1922/23, authored by journalist, investor and stock broker Edwin Lefèvre. He passed away in 1943, but providing some element of an update to the book, fund manager and financial commentator Tim Price gives a short foreword.

Reminiscences of a Stock Operator can be described as a lightly fictionalised account or thinly disguised biography of Jesse Livermore (characterised as Larry Livingston in the book), described by some as perhaps the most famous stock speculator and greatest trader of all time. Also known as "Boy Plunger", for his ability to make money from falling share prices, as well as "The Great Bear of Wall Street", Livermore was an investor and analyst, born in Massachusetts in 1877. Plying his trade in the

"LIVERMORE/LIVINGSTON MADE MONEY WHEN HE FOLLOWED HIS OWN ADVICE AND LOST IT WHEN HE FOLLOWED OTHERS'."

US during the late 19th and early 20th centuries, he was famous for making, as well as losing, several multi-million dollar fortunes during the stock market crashes of 1907 and 1929.

The book is a first person account of Larry Livingston's travails in the markets, beginning when he was fresh out of grammar school at 14 years old (in 1891) and working as a quotation board boy at a stock broker's office in New England. With a head for figures, he was able to track stock price movements in his mind, using the numbers to successfully predict future movements – but only on paper at first. After receiving a "hot tip" from a colleague he soon caught the stock speculation bug, deciding to put his theories into practice and, as it turns out, making a quick profit on his modest savings by trading with the local "bucket shops".

After that successful first trade there was no holding Livingston back and he soon quit his brokerage job to speculate full time. That was a good decision, as by the time he was 15 he had accumulated his first $1,000 – equivalent to about £21,000 today. Not bad for a teenager at the end of the 19th century.

Big money

While Livingston began his career trading his meagre wages he soon built himself up to being a major player. Following his first successful venture he goes on to have a run of winning trades, developing a reputation for "price scalping" – placing large trades to profit from only small changes in price. He becomes so adept at trading that he is even blacklisted from a number of the bucket shops he trades with.

"It took me five years to learn to play the game intelligently enough to make big money when I was right."

Larry Livingston

Keen for more action, Livingston then moves to New York and the glamour of Wall Street in order to further develop his trading abilities and make his real fortune. Unfortunately, he loses money just as quickly, and in the same huge amounts, as he makes it.

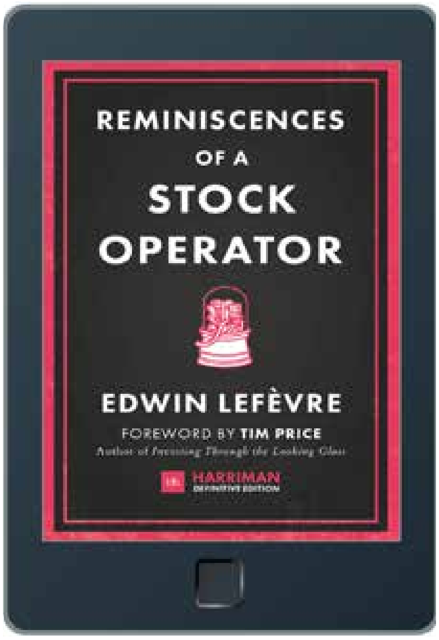
Some of his Wall Street trades paid off, such as selling shares in the Union Pacific railway just before the 1906 San Francisco earthquake. And he made his first real fortune by short selling the market during the Panic of 1907, building his worth up to an estimated $3 million. However, the majority of that was quickly lost on a disastrous cotton trade.

Throughout the book we are given top tips and advice on how anyone can go about trading successfully, derived from the fictional Livingston's market experiences. Even though it was written almost 100 years ago this advice is still just as relevant today: after all whatever happens in the stock market today has happened before and will happen again. My own particular favourite hint from Livingston is that he advises against following "hot tips" on particular stocks, often given by shady characters with dodgy information. He even suggests that trading contrary to tips can be a good way of making money from them – a strategy I know would have worked handsomely with several well-known tipsters of the present day!

However, the real life Jesse Livermore did not always follow his own advice. After the book was published he went on to grow his net worth to an estimated $100 million in 1929, again short selling the markets, this time in the famous Wall Street crash of that year. Unfortunately he saw it fall to $5 million at the time of his death in 1940. One of the lessons learned from the book is that Livermore/Livingston made money when he followed his own advice and lost it when he followed others'.

Worth speculating over

Reminiscences of a Stock Operator is a fascinating and perceptive work for many reasons. Not only does it provide an interesting historical insight into the US stock market as it was during one of the most exciting times of the early 20th century, it also gives readers a lesson on trading psychology and how to make (and lose) money. If you're a value based, long-term investor then Jesse Livermore/Larry Livingston is probably not your best role model. But this is a great read nonetheless for anyone interested in investment.



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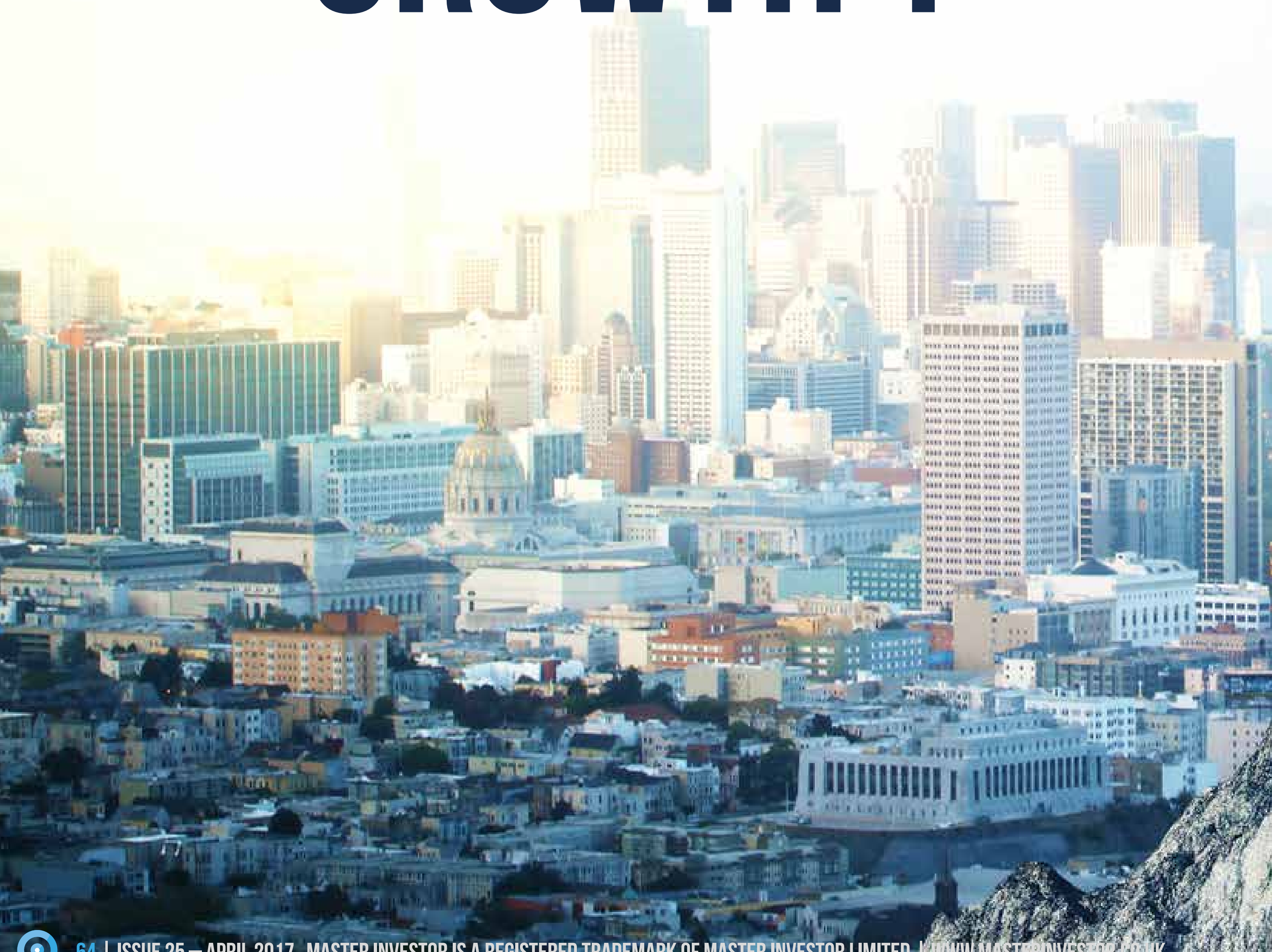
BY TIM PRICE

THE FINAL WORD

HAVE WE JUST SEEN 'PEAK GROWTH'?

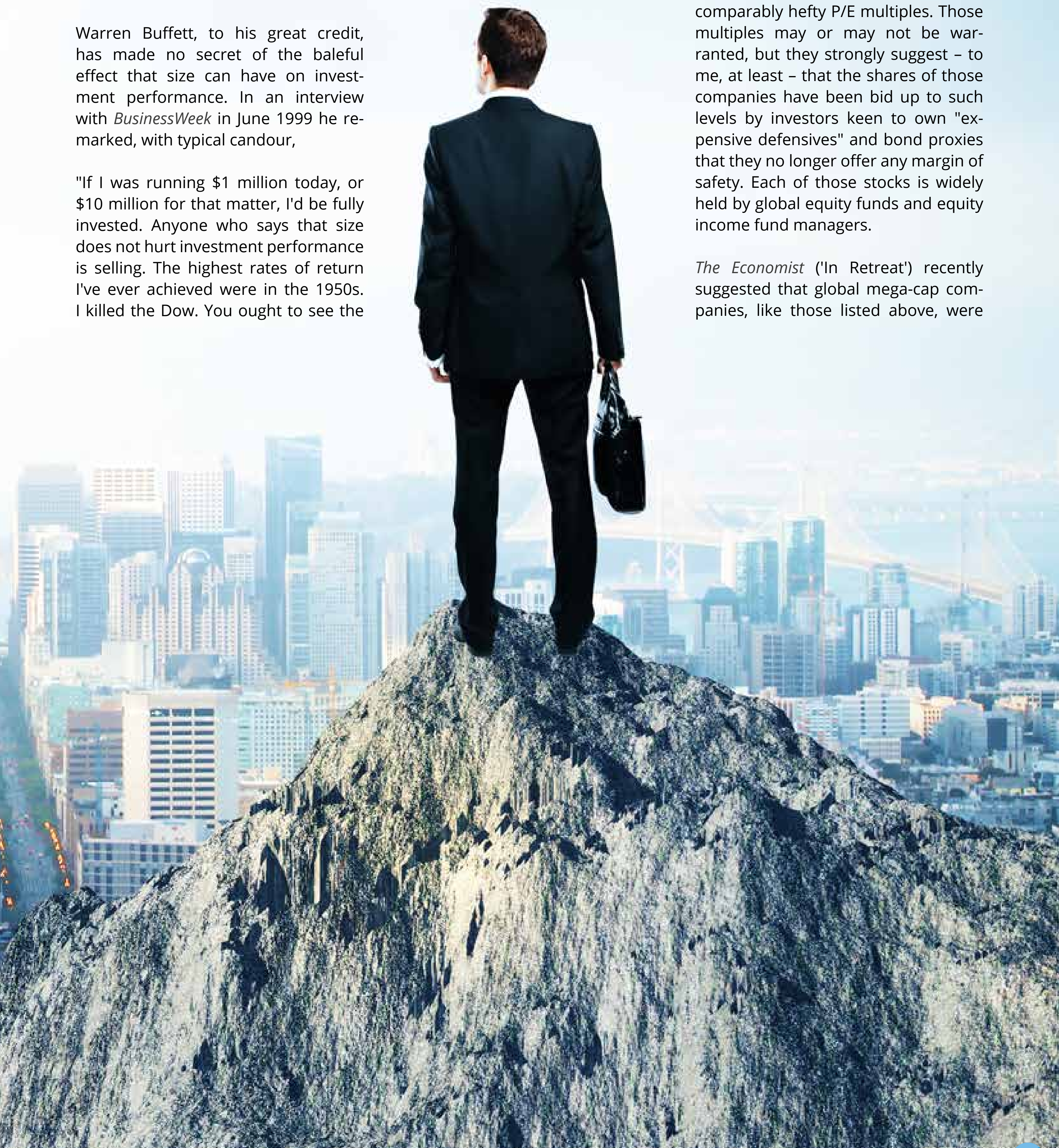


Two corporate events make me wonder whether the high water mark of equity 'growth' investing may already be behind us. One of them is the abortive bid for Unilever by Kraft Heinz (and Warren Buffett). The other is the nil-premium merger of Standard Life and Aberdeen Asset Management. Both incidents have a lot to say about the questionable health of developed markets.

Warren Buffett, to his great credit, has made no secret of the baleful effect that size can have on investment performance. In an interview with *BusinessWeek* in June 1999 he remarked, with typical candour,

"If I was running $1 million today, or $10 million for that matter, I'd be fully invested. Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on $1 million. No, I know I could. I guarantee that."

Size, then, is the enemy of performance.



Question: What do the following companies have in common? Altria (Philip Morris); Domino's Pizza; Roche; Glaxo; BAT; Unilever itself; Reckitt Benckiser; Coca-Cola; BAE Systems; Nestle.

By way of answer, check out the price/book and price/earnings ratios at which their respective shares trade. You'll find that each of them trades at hefty multiples of book value and on comparably hefty P/E multiples. Those multiples may or may not be warranted, but they strongly suggest – to me, at least – that the shares of those companies have been bid up to such levels by investors keen to own "expensive defensives" and bond proxies that they no longer offer any margin of safety. Each of those stocks is widely held by global equity funds and equity income fund managers.

The Economist ('In Retreat') recently suggested that global mega-cap companies, like those listed above, were struggling to grow their revenues and profits, even before the Brexit vote and the election of Donald Trump:

"In the past five years the profits of multinationals have dropped by 25%. Returns on capital have slipped to their lowest in two decades. About 40% of all multinationals make a return on equity of less than 10%, a yardstick for underperformance. In a majority of industries they are growing more slowly and are less profitable than local firms that stayed in their backyard."

So if you happen to be a bloated multinational, and your prospects for growing your top line are limited, that pretty much obligates you to address your bottom line instead, and to seek out cost cutting and operational efficiencies by shedding staff and divesting less promising brands and business divisions. Or merging with rivals, and doing the same thing. Enter Kraft Heinz, Warren Buffett, and the Brazilian billionaires behind 3G Capital.

The speed with which the Kraft Heinz bid for Unilever was announced, considered, and then roundly rebuffed, is indicative of a newly politicised climate for corporate M&A. We are living through a backlash against globalisation. It would not be going too far, I think, to suggest that we are living through a backlash against the free market itself, at least inasmuch as it operates across national borders, and affects workers in different jurisdictions. Global capital no longer feels as mobile as it once did.

And then there is Standard Life's effective takeover of Aberdeen Asset Management. Customers of the new business will find themselves investing in funds run by a £660 billion fund manager – the second-largest in Europe. Now ask yourself whether there is any evidence, anywhere in the world, at any time, of a fund group that became *better* at managing money after it took on hundreds of billions in new assets. (Admittedly, Vanguard Group has just passed an incredible milestone in reaching $4 trillion in assets for the first time – but this says nothing about their ability to manage money, only about their success in attracting it. Given that most of Vanguard's funds are essentially index-trackers, albeit with modest fees, *all* of those funds are predestined to perform less well than

the market. Not something their marketing department is likely to dwell on.)

"THE SPEED WITH WHICH THE KRAFT HEINZ BID FOR UNILEVER WAS ANNOUNCED, CONSIDERED, AND THEN ROUNDLY REBUFFED, IS INDICATIVE OF A NEWLY POLITICISED CLIMATE FOR CORPORATE M&A."

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It seems almost redundant to point out that major stock markets, after eight years of extraordinary monetary accommodation, near-zero interest rates and QE, are expensive. Nevertheless, North America's S&P 500 index currently sports a Shiller P/E ratio (taking account of the past ten years' history of earnings in order to smooth out the trend) of 29 times. If that sounds ominously high, it should. The last time the US stock market peaked at this level was on Black Tuesday, 1929. The market's long run average Shiller P/E stands at around 16 times. To put it another way, on the basis of the last 130 years of stock market history, the S&P 500 Index currently looks over 80% overvalued.

Whether or not the US stock market is expensive, it matters, because the US stock market also accounts for 60% of the MSCI World Index. Any fund manager with a global mandate is likely to be tracking the MSCI Index, either explicitly or implicitly. Where the US goes, the rest of the world is likely to follow.

Which leads me to draw a few key conclusions.

One of which is that index investing is for the birds. Professional fund managers may be obligated to track an index, but private investors are under no such pressure. Private investors are free to

> **"I'VE JUST SPENT A WEEK VISITING COMPANIES IN TOKYO AND OSAKA AND THE SENSE OF CORPORATE RESTRUCTURING AND (TYPICALLY CAUTIOUS) OPTIMISM IN THE AIR IS ALMOST PALPABLE."**

operate without any constraints as to portfolio composition, or frequency of portfolio reporting, or any of the other thousand things that the regulator obligates the professionals to do.

An example of the perhaps unintended consequences of indexation and benchmarking is the recent IPO of Snap, the parent of Snapchat. You may or may not use this particular app. Regardless, plenty of young people do, and its popularity allowed Snap to list on the US exchange with a market valuation of $35 billion despite never having made a penny in profits. Nor did the company offer shareholders any voting rights. As the saying goes, a fool and his money are lucky enough to get together in the first place. The problem being, any professional investor tracking US technology indices will be obligated to buy Snap stock whether he sees any value in it or not. Is this a healthy way to invest?

My second observation is more of a suspicion: the tide may be in the process of going out for so-called 'growth' investing. The recent market rally has been one of the longest on record. Valuations are getting stretched – along with the quality of new public offerings, as Snap's recent listing makes abundantly clear. The flood of money cascading into passive investment funds is completely indiscriminate – it just wants in, at whatever the price. And the new geopolitical climate is not, let us say, wholly conducive to the interests of huge multinational corporations.

This is not to say that investors should flee the stock market. Not at all. Both cash and bond yields are utterly derisory, and the bond market now offers the very real prospect of return-free risk.

But investors should, I think, be mindful of the risks to their capital that will come from simply owning "the market" – as opposed to discriminating between expensive stocks and all of the rest.

Over the past 25 years, the S&P 500 Index has risen by over 600%. Our own FTSE 100 Index has more than doubled, as has Europe's EuroStoxx 50. But there is one market that never got the invitation to the party.

Japan's Topix Index, amazingly, is lower now than it was back in 1990. At the same time, more than 40% of the Japanese stock market trades below book value – a state of affairs unrivalled by any other developed market. So there's a valuation argument to support Japan.

There's also a flow argument. The Bank of Japan, the Government Pension Investment Fund (the largest pension fund in the world), and Japanese corporates themselves are all either buying or buying back stock – each of them at a rate of at least ¥4 trillion a year. So cheap valuations are being accompanied by strong domestic buying for the first time in years. In addition, Japanese companies are now almost universally engaging in stock buybacks, or raising their dividends, or both. Incredibly, the average Japanese stock now yields more than the average US stock.

I've just spent a week visiting companies in Tokyo and Osaka and the sense of corporate restructuring and (typically cautious) optimism in the air is almost palpable. 15 years ago, a Japanese fund manager suggested to me that Japan – with its lost two decades – had been the dress rehearsal, and the rest of the world would be the main event. That suggestion seemed absurd back then, but no longer does today. So the question I ask you is this: is your equity portfolio exposed to growth, or to value? If it's the former, given current valuations in western markets and the mood music of contemporary politics, let alone corporate fundamentals, you may be in for some disappointment in the months and years to come.

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.

MARKETS IN FOCUS

MARCH 2017

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
IBEX 35	9.5	11.9	
CAC 40	5.4	5.4	
Euronext 100	4.6	5.6	
DAX Xetra	4.0	7.3	
S&P/ASX 200	2.7	3.5	
NASDAQ 100	2.0	11.8	
Russian Trading System	1.8	-2.8	
Hang Seng	1.6	9.6	
FTSE 100	0.8	2.5	
S&P 500	0.0	5.5	
Dow Jones	-0.7	4.6	
Nikkei 225	-1.1	-1.1	
Bovespa	-2.6	7.9	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Natural Gas	15.5	-14.7	
Cocoa	9.8	-3.2	
Palladium	3.7	17.5	
Gold	0.4	8.7	
Silver	-0.4	14.5	
Copper	-1.4	7.5	
Coffee	-2.3	2.8	
Crude oil (Brent)	-4.8	-5.7	
Crude oil (Light Sweet)	-5.7	-5.6	
Platinum	-6.8	5.2	
Iron Ore	-8.3	3.0	
Soybean	-10.0	-6.0	
Sugar (No. 11)	-12.6	-13.8	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
GBP/AUD	1.4	-4.1	
GBP/USD	1.3	1.6	
EUR/USD	0.9	1.4	
EUR/CHF	0.6	-0.1	
USD/CAD	0.1	-0.8	
AUD/USD	-0.2	5.9	
USD/CHF	-0.3	-1.5	
EUR/GBP	-0.4	-0.2	
EUR/JPY	-0.6	-3.4	
USD/JPY	-1.5	-4.8	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	May 11	Jun 15
ECB	0.00%	Apr 27	Jun 08
FED	1.00%	May 03	Jun 14
BOJ	-0.10%	Apr 27	Jun 16
SNB	-0.75%	Jun 15	Dec 14
BOC	0.50%	Apr 12	May 24
RBA	1.50%	Apr 04	May 02
RBNZ	1.75%	May 11	Jun 22
BOS	-0.50%	Apr 26	Jul 03
BON	0.50%	May 04	Jun 22

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Shawbrook Group PLC	32.6	24.8	
Softcat PLC	22.0	33.6	
Amec Foster Wheeler PLC	20.9	13.1	
Inmarsat PLC	19.5	13.2	
Marshalls PLC	18.5	20.6	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Allied Minds PLC	-20.9	-35.2	
Berendsen PLC	-19.9	-15.8	
Domino's Pizza PLC	-19.6	-14.4	
Aggreko PLC	-16.2	-3.8	
Acacia Mining PLC	-16.1	20.3	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Oil Equip, Serv & Dist	6.6	-1.8	
General Retailers	4.8	-2.9	
Mobile Telecomm	4.0	4.7	
Tobacco	3.7	13.1	
Electronic & Elect Equip	3.3	12.5	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Electricity	-4.5	-5.8	
Mining	-3.3	5.2	
Industrial Metals	-2.3	4.9	
Fixed Line Telecomm	-2.3	-12.3	
Food & Drug Retailers	-1.2	-3.1