ISSUE 26 — MAY 2017

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master investor MAGAZINE

RESEARCH • ANALYSE • INVEST

THE UK'S NO.1 FREE INVESTMENT PUBLICATION

LA BELLE FRANCE

IT'S TIME TO FEAST ON THE CRÈME DE LA CRÈME OF THE FRENCH STOCK MARKET

PLUS...

CAPITAL PUNISHMENT

COMMON INHERITANCE TAX PITFALLS AND HOW TO AVOID THEM

MOMENTUM INVESTING

IS THIS THE BEST-KEPT SECRET IN FINANCE?

SHAKY FOUNDATIONS

HAS BREXIT PUT COMMERCIAL PROPERTY FUNDS AT RISK?

BAG A BARGAIN

THREE SMALL CAPS TRADING AT BELOW BOOK VALUE

WELCOME

Dear Reader,

If, by now, you are suffering election fatigue, then you definitely aren't alone.

Following the extraordinary and intense campaigns leading up to the Brexit referendum and the US presidential elections, there is a growing sense that it's all getting rather too much. I've even got a number of friends who have now left their social media accounts, vowing to not get back to using them until June 9th.

Obviously, the French election, so pivotal to the future of the European Project, and UK general election have only added to many voters' and observers' sense of being overwhelmed.

Still, there is money to be made from political developments. That's why we continue to make it one of our focus areas to follow and dissect what's happening in politics.

Next up is the French election on Sunday. The nation of France has a great many problems, but as the old Chinese proverb says, every problem brings with it opportunities.

If we actually had a house-view (our contributors are free to express their own views), it would probably lean towards being fairly skeptical about the future prospects of France. That said, there is many an investment bargain to be had in "la Grande Nation". Victor Hill demonstrates as much on pages 10-18.

The actual election result from France will be two days away when this issue is launched. Le Pen does seem to have a small residual chance of winning, although it would now be surprising for Macron to lose.

Our cover story isn't geared towards any particular candidate. Rather, it is geared towards solid investment value eventually prevailing. Whatever the outcome on Sunday, we are showing you a number of opportunities to invest in undervalued French companies.

That other Chinese proverb, "May you live in interesting times", is certainly holding true right now. Your team at Master Investor will continue to observe and analyse these developments for you, to make sure you can maximise your investment gains and (equally important) protect your nest egg against nasty surprises.

Best regards,

Swen Lorenz
Editor, Master Investor Magazine

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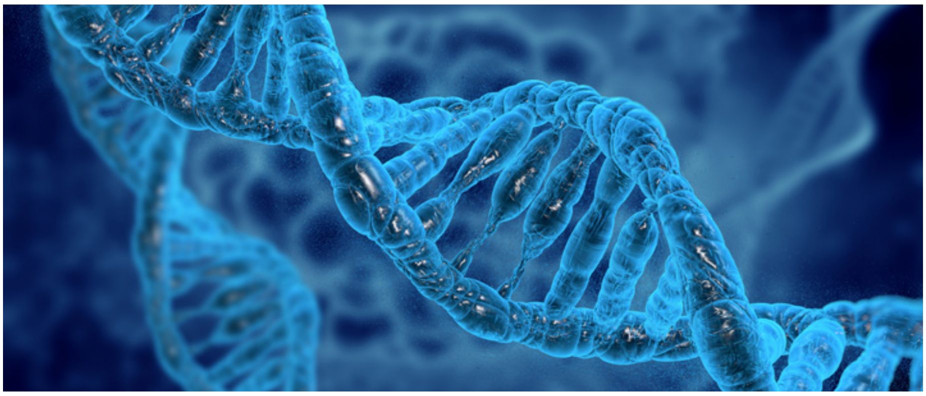

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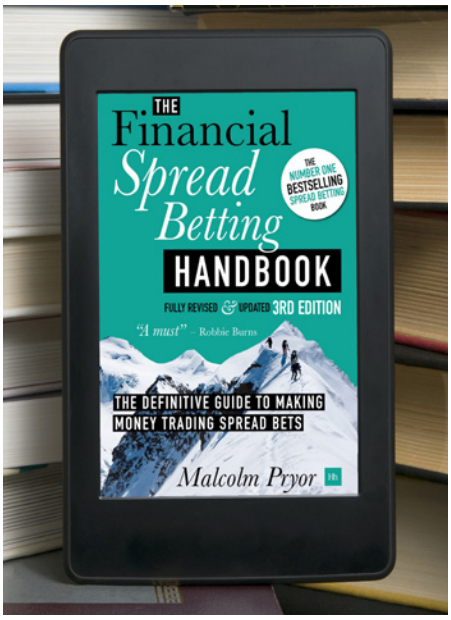

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BY JIM MELLON

MELLON ON THE MARKETS

JUVENESCENCE, BILL GATES AND THE MARKETS

It's been a month since the Master Investor Show, and it's been a busy one. Markets have basically gone nowhere, except for the post-Macron relief rally which, if you ask me, will soon peter out. I've been busy getting the *Juvenescence* book done, and I think I am now about 70% of the way there. It's a tough, but worthwhile, subject; and though it's behind schedule, we will all have so much more of it because of longevity. A month's delay is but a blink of the eye!

The book will showcase three portfolios for those interested in investing in the area of longevity, each tailored to different risk appetites. With nearly one fifth of US GDP devoted to healthcare, most of it spent in the last two years of people's lives, something has to be found to reduce the burden of disease in the elderly.

Two thirds of all deaths are the result of cardiovascular disease, neurodegenerative disease, diabetes and cancer; there is good news in abundance for three of these, and somewhat halting and disappointing progress in the area of dementia.

Nonetheless, it is really important that more money and scientific and public policy resources are devoted to the fundamental aspects of ageing if the world isn't going to be overburdened by huge numbers of old and illderly people.

The champions of ageing research – people like David Sinclair of Harvard, Aubrey de Grey of the SENS foundation, Nir Barzilai of Albert Einstein University, and Alex Zhakoronkov of Insilco – are really leading a new tidal wave of innovation. We have started to place our bets and I am super excited to be sharing the results of our studies with you in the next couple of months.

I was invited to a breakfast recently at which Bill Gates spoke. The man is a marvel, considering he has transitioned from one of the iconic entrepreneurs of the past century, to being part of a husband-and-wife team that has literally saved millions of lives.

He makes a very valid point that if we want to avoid an African-originated pandemic hitting the rich world, we must continue to sponsor the improvement of basic health in that continent. Gates puts particular emphasis on vaccination, maternal and infant health, and sanitation. He also says that a pandemic out of Africa would make bird flu look like a picnic, and that Western nations should do everything to help avert it.

"THE POPULATION PROJECTIONS FOR AFRICA ARE REALLY SCARY, SUGGESTING THAT BY 2050 AFRICA COULD HAVE 2 BILLION PEOPLE (DOUBLE TODAY'S NUMBER), AND POSSIBLY 4 BILLION BY 2100."

"GATES IS AN ADVOCATE OF TAXING ROBOTS AND MACHINES AS IF THEY WERE HUMAN LABOUR INPUTS – A NOTION THAT MAKES SENSE TO ME."

The population projections for Africa are really scary, suggesting that by 2050 Africa could have 2 billion people (double today's number), and possibly 4 billion by 2100. The only way, according to Gates, to get those figures down is to improve people's basic health so that they don't feel they have to have so many children.

I have written before about how the developmental models of say, Vietnam and China, reliant on the manufacture of low cost goods, don't apply to Africa and that it's tough to see what they can do to bootstrap themselves. Gates believes that services are the key to their economic future, but in all honesty, I think he is being too sanguine.

But his basic premise that developmental aid is worthwhile, notwithstanding the stories about waste and corruption, is a correct one. Helping people at source is a lot better than having millions of them becoming displaced migrants, swamping public services and humanitarian efforts.

Frederic Legrand – COMEO / Shutterstock.com

Gates was also interesting on the subject of automation. He thinks that 10 to 20 years is the window we have to get used to the replacement of manual and low pay jobs by machines. He is also convinced that jobs such as teaching, care giving, and public service will be the replacements for the jobs lost to machines.

Gates is an advocate of taxing robots and machines as if they were human labour inputs – a notion that makes sense to me, as money to pay for social welfare has to come from somewhere. He also makes a valid point that a universal basic wage is just a new term for taxation, and has no obvious merit.

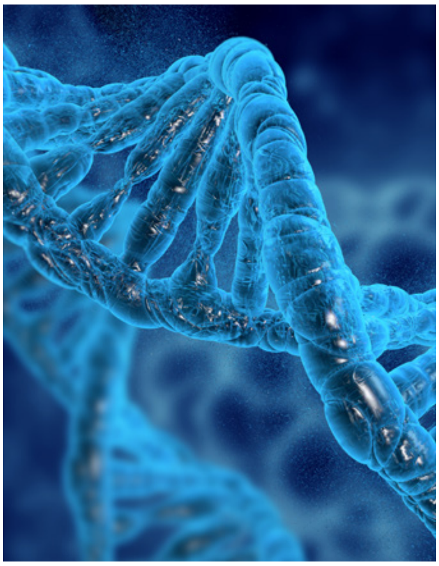
I managed to shake his hand, but not to tell him the story that, 30 years ago, as a young fund manager in San Francisco, I met him, and indeed sat behind him on a flight from Palm Springs to SFO. The unique feature of that particular flight was that he was sitting next to Steve Jobs. I wish I could have heard what they were saying, but the plane was noisy and I didn't have the cojones to introduce myself to them!

Another lost opportunity – the two leading protagonists of the technological age in a rare moment of harmony!

As far as markets are concerned, I think it's more of the same. Rotation, drift, lots of waffle and hard-to-make money times.

I have noticed that some of the big biotech companies have become very cheap, with low price to earnings ratios and good dividend yields in some cases. I think **GSK (LON:GSK)** in the UK falls into that category as it refreshes its portfolio. I like **Amgen (NASDAQ:AMGN)** in the US, as well as **Novartis (VTX:NOVN)** of Switzerland. And of course, **Gilead (NASDAQ:GILD)**, which doesn't have a yield but is dirt cheap. **Abbvie (NYSE:ABBV)** is super cheap as well, and Humira, its anti-TNF biologic, continues to be the world's bestselling drug.

Gold is a must for every portfolio as is silver. When there is a market-positive event, such as Macron's win in the first round of the French presidential election, it backs off, but it quickly recovers. I don't think monetary policy will turn tight any time soon, and excess liquidity and the push for higher wages in the gig economy will keep inflation bubbling. All good for the precious metals complex.



Meantime, I am off to the Isle of Man for a few days of hard writing. Then it's back to the US to attend and speak at the Milken Conference in LA, where I am joined by my colleague, Dr Greg Bailey.

Earlier this month I was fortunate enough to meet John Mauldin and Patrick Cox of Mauldin Economics and we discussed longevity in a hotel in Florida. They, ranking among the best global thinkers, are equally excited for the opportunities in the longevity science industry, and that's got to be a good thing.

Happy hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

THE FRENCH EXCEPTION

All eyes are on France right now ahead of the final round of the election on 7 May. Recent weeks have seen a gargantuan battle between globalisation and economic nationalism – between the Anywheres and the Somewheres. Whoever wins (it seems overwhelmingly probable that it will be M Macron) will have a mountain to climb. What should investors make of it all?

The trouble with France...

France is a wealthy country with more Fortune-500 companies than any other except for the USA, China and Japan. It has 29 top global companies as against 28 for Germany and 26 for the UK. It is a leader in nuclear technology, fast trains and aerospace. Its manufacturing sector is highly competitive. Most French still enjoy an extremely congenial lifestyle which many – not least the British – envy. Its healthcare system is amongst the best in the world and its welfare and pension systems are extraordinarily generous by Anglo-Saxon standards.

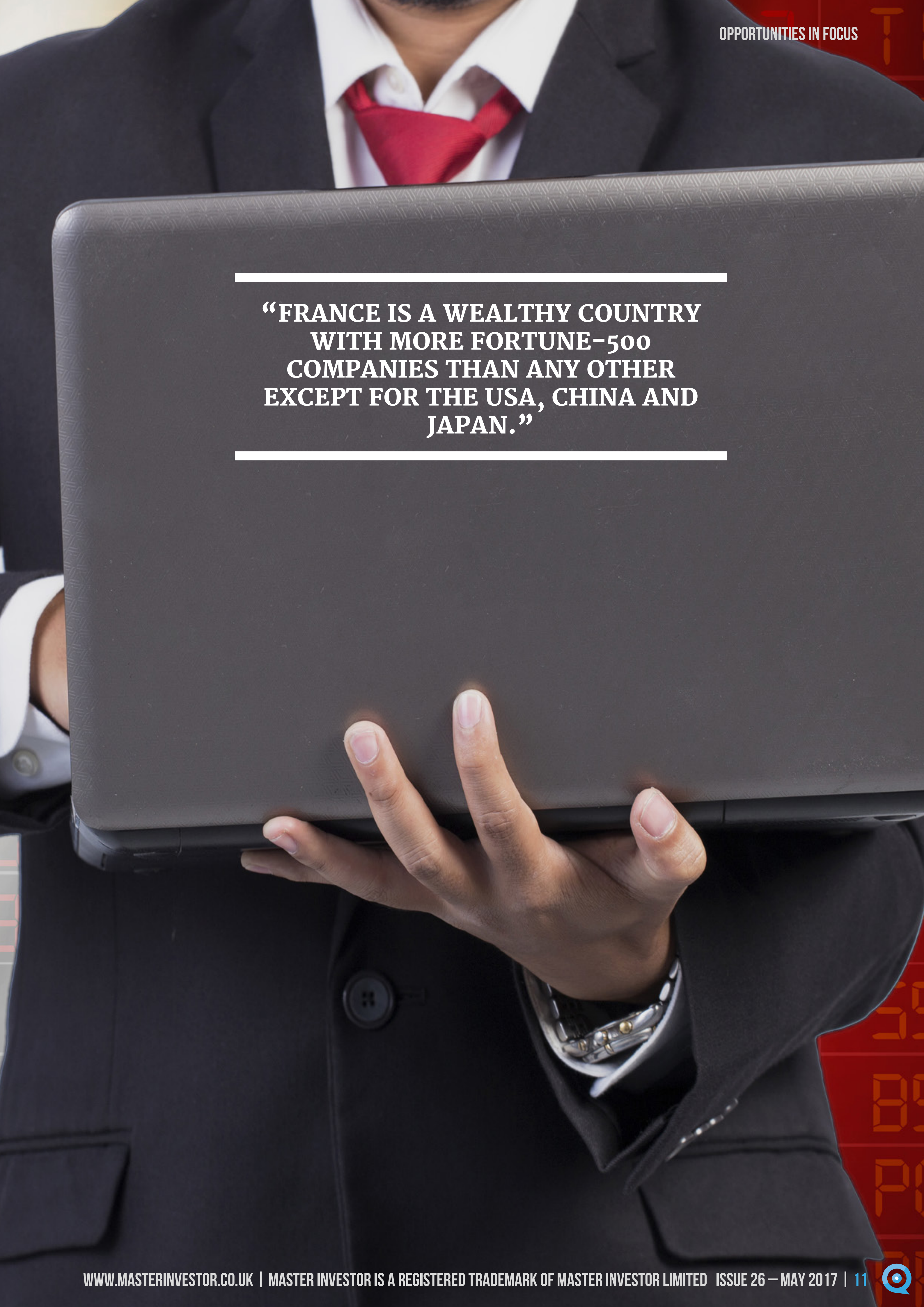
France has been, behind Germany, the engine of European integration: and in many ways exerts more influence over the machinery of the European Union in Brussels than the Germans.

But France suffers from high unemployment, inflexible labour markets, a crushing and deteriorating national debt, high taxation and pernicious bureaucracy. The labour market is amongst the most inflexible in the developed world – it is virtually impossible to fire people. Its trade unions are rampant and determined to oppose reform. It is not a good country in which to launch a start-up company, get credit or to invest. Small businessmen are in a constant state of war with the tax man. In the World Bank *Ease of Doing Business* rankings it comes out at number 29 as compared with 7 for the UK. Many of its most talented young people are voting with their feet and leaving – not least for London.

And increasingly France is suffering from a crisis of identity in a globalised world which has prompted large parts of the French electorate, after more than 70 years of centrist government, to turn to both the far right and the far left. But in that respect what is happening in France is familiar: a fear of job losses due to automation and deindustrialisation; resentment of immigration by the indigenous working class; an increasing distrust of the ruling elite reinforced by the echo chamber of social media.

For all that I'd like to show this month that France, whatever its many problems, benefits from a large stable of superb world-class companies. We should not underestimate French economic power.

The markets responded favourably to M Macron's result in the first round. Overall the CAC-40 index of France's leading shares has risen from around 3,000 in June 2012 to 5,260 as I write. That's about twice as large a gain as the FTSE-100 has recorded over the same period –



"FRANCE IS A WEALTHY COUNTRY WITH MORE FORTUNE-500 COMPANIES THAN ANY OTHER EXCEPT FOR THE USA, CHINA AND JAPAN."

and currently many French stock valuations look cheap. The French market may have a lot further to go, despite the country's ills.

The state of a nation

What struck me most about my last trip to France was how downbeat everyone was. The French even have a word for their national mood – *la morosité*. I got the impression that the French were sceptical that any of the presidential candidates could reanimate their country. Most French people seem to agree that France is a country that is in desperate need of reform; but few can agree on how to do it.

Unemployment in France is much higher than that of France's northern European neighbours. The unemployment rate on the eve of the Presidential election was above 10 percent as compared with 3.9 percent in Germany, 6.3 percent in the Netherlands and 4.7 percent in the UK[i]. Unemployment is even higher amongst the young (25 percent) and in certain regions it is chronic. In the pretty town of Cogolin in Provence the unemployment rate is 18 percent.

Many of the unemployed young have gone through France's elaborate educational system to the age of 24 and have gained excellent qualifications by any standards. But there are no suitable vacancies.

As for young members of France's 5-million strong Muslim community,

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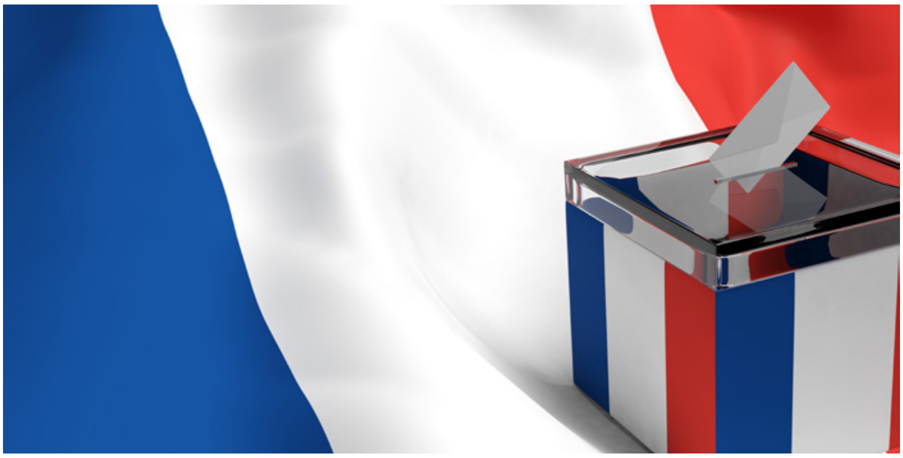

“HUGE PARTS OF THE FRENCH ECONOMY ARE SIMPLY CLOSED TO COMPETITION FROM LEGAL SERVICES TO INTER-CITY COACH SERVICES.”

overwhelmingly of North African heritage, unemployment has been endemic for some time. That is one reason why a small minority of them have drifted into Islamist fanaticism, lured by the hate preachers. I'm not going to try to explain away the insidious campaign of terrorist violence to which France has become victim in the last two years here. But the disaffection of Muslim youth has been something that mainstream French politicians have chosen to ignore for too long[ii]. France is a country that has been living under a State of Emergency since the Bataclan attacks of November 2015 - and yet the issue was hardly raised during the campaign (except by Mme Le Pen) until the final debate[iii].

The combination of inflexible labour markets and widespread tolerance of petty criminality by a police force loath to trigger unrest makes for a toxic cocktail. I was told by a French company boss last year that he was unable to fire an employee who was known as a notorious drug dealer for fear of being taken to court by the state – and being targeted by a criminal gang. As a result he just encouraged the said employee not to turn up for work!

And huge parts of the French economy are simply closed to competition from legal services to inter-city coach services. The Sunday trading laws are highly restrictive. A byzantine state pension scheme, consisting of 35 different public pension funds designated by profession, impedes people from re-training and changing career. You cannot buy aspirin in a French supermarket because the union of pharmacists would kick up a dust...

Even French culture seems to be in retreat. In the UK about 185,000 books were published last year; in France it was 42,000[iv]. The French deeply resent the rise of English as the world language, displacing French even in the Francophone world. They were appalled when the Democratic Republic of Congo changed its official language from French to English.

The French used to describe their colonial ambitions in the late 19th Century as *la mission civilisatrice*. Monsieur Macron describes French colonial history as a *war crime*. This is exactly the kind of historical guilt and self-doubt with which the British have grappled for years.

The other major weakness of the French Republic today is the parlous condition of its national finances.

Buddy, could you lend me a Euro?

The superstar French economist, Thomas Piketty, has written extensively on why in the modern world relatively poor countries have robust state finances whereas many rich countries have very poor state finances. France is a case in point.

The French state has not balanced its budget for more than 40 years. It spends a higher percentage of its GDP than any other advanced country – about 56 percent, higher even than social democratic Sweden at 51 percent. Neighbouring Switzerland, by contrast, spends 34 percent of its GDP. Under the 2017 budget (drawn up by the government of Prime Minister Valls in September 2016) the budget deficit is forecast to be 3.4 percent – still well above the European Stability & Growth Pact (1998) upper limit of 3 percent. But then, France has never believed that those silly rules apply to her.

France's debt-to-GDP ratio currently stands at 96 percent[v] – just shy of the psychologically troubling 100 percent level beyond which economists start to panic. In absolute terms the French Republic owes its creditors about €2.15 trillion Euros (£1.82 trillion at the current exchange rate).

So those wonderful fast trains, the gleaming museums of modern art, the alluring social spaces and generous pensions have all been financed on the never-never.

"THE FRENCH STATE HAS NOT BALANCED ITS BUDGET FOR MORE THAN 40 YEARS."

Governments incur systemic budget deficits, which turn over time into rapidly rising national debt, for two reasons. Firstly, they are committed to generous spending programmes in welfare, health, defence and so on. But that is only half of the equation. The other side is that the tax-take is insufficient either because taxes are unrealistically low (as in the USA) or because the country is growing too slowly. The deteriorating state of French national finances can largely be blamed on the fact that, further to a remarkable level of GDP growth achieved from 1945 to the early 90s, French GDP growth has been anaemic for the last two decades.

Currently, the French economy is growing at 1.1 percent – much better than the zero to negative rates recorded between 2009 and 2015. But this level of growth is far below France's long-term trend growth rate of 3.19 percent over 1950-2016. Consider that in the 1960s and 1970s French growth often hit double digits. In Q2 1969 it actually reached 12.5 percent. As a result, over these years, France caught up with the UK, having been far behind by the end of WWI, and then overtook its northern neighbour.

This extraordinarily dynamic growth was partly fuelled by mass rural depopulation. In 1950 France was still an agricultural nation in the sense that half the population lived in villages sustained by farming. Over the next three decades there was a mass movement of labour from the countryside to the towns and cities – something that had happened in Britain more than one hundred years earlier.

And rural depopulation is still an issue in France. As one who has hiked across several regions of France, I know how astonishing it is to enter an ancient village – only to find that there is almost nobody there. Until the English and the Dutch started buying up and renovating properties in rural France, many of these villages were falling into ruin.

So why has France lost its growth mojo in recent years? That's a complex question without a simple answer; but one reason is that France has not adapted to the digital economy as effectively as the English-speaking world. While it boasts superb, world-class companies, the small business sector is sluggish thanks to over-regulation.

As the differential in growth rates between France and Germany has widened so the Germans have pulled well ahead in their standard of living. In 2002 the two countries enjoyed approximately equal GDP per capita. Now, the Germans can boast 17 percent more purchasing power than their French neighbours.

Britain had a decade of economic reforms in the 1980s under Margaret Thatcher. Germany experienced major labour market reforms under Chancellor Gerhard Schröder from 1998-2005. France's labour market has only got more rigid. Why has it proven so difficult to introduce market reforms in France? The answer lies in the political culture.

L'exception française

The French are different. Or at least, they believe that they are different, which is what they mean when they talk about *l'exception française*. I'll just pinpoint three reasons why French political culture has made reform of the system so difficult to achieve.

Firstly, the French defer to "experts" who are overwhelmingly anti-capitalist (and usually anti-American). Relatively few French people read newspapers – and the broadcast media are pretty anaemic in political interrogation by comparison with their Anglo-Saxon counterparts. I was about to buy a hard copy of Le Figaro the other day – but gave up when I found out that this flimsy news sheet costs €5.50 at the counter. That's about half an hour's income on the minimum wage.

So ordinary French people tend to outsource political debate to an elite class of intellectual, often academic, opinion-formers with whose views they often do not feel themselves entitled to disagree.

Secondly, France, like President Putin's Russia, has a presidential system without a deep-rooted party system (i.e. with deep abiding allegiances to historic political parties). Much was made in the British media of the fact that the two candidates for the final round were "outsiders". But party allegiances are much less important in France than ideological allegiances.

The Republican Party, last in power under President Nicolas Sarkozy (2007-12) is not really an established political party as the British or Americans would understand it. It was a rehash of Jacques Chirac's movement, the *Rassemblement pour la République* (RPR) which became the UMP in 2002 and then had a new make-over in 2015.

"FRANCE IS STILL HOME TO MANY OF THE MOST ENVIABLE COMPANIES IN THE WORLD."

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There is no French equivalent of being a life-long Tory voter – the parties evolve too quickly. In most democracies politicians join political parties and work their way up the ranks in order to gain power. In France, individual politicians create political parties in order to secure wider support.

As a result, a brilliant ingénue like Monsieur Macron can launch a presidential campaign with a political party that was only cobbled together last year. But that means that politicians are not required to develop rigorous policy initiatives which are stress-tested by the political machine and by the party faithful. This affords the triumph of personality over policy.

Thirdly, France is the last communist country in Europe. By that I don't mean that the system of government is communist. Obviously it is a democracy with high levels of personal liberty, human rights and an effective judicial system. Yet the mind-set of its intellectual elite is overwhelmingly Marxist. The tentacles of Marxist ideology extend deep into the body of French life. It is not only acceptable for a university lecturer or a doctor to have Trotskyist leanings – it is expected. And all political parties – even on the far right – have deep-seated anti-market, pro-regulation instincts.

These three factors make it difficult for incoming presidents to drive through substantive reform. The last three personalities to have occupied the presidency – Jacques Chirac (1995-2007), Nicolas Sarkozy (2007-12) and François Hollande (2012-17 – he didn't even try to stand for a second term) all tried in their different ways to pull France in a more pro-market direction. All are now widely regarded as failures.

And yet – French multinationals dominate the world

And now for the good news. France is still home to many of the most enviable companies in the world. That is because, despite the politicians, over many decades the French state (i.e. a brilliant mandarinate of hyper sophisticated technocrats all trained in elite schools) has nurtured the conditions to grow strategic businesses. Most of the great French corporations, from

Two champion French retailers

Carrefour SA (EPA:CA) is one of the largest hypermarket chains in the world, operating nearly 12,000 stores under various banners in thirty countries right across the Middle East, central Asia, India, South America and North Africa, not to mention 231 hypermarkets in China. Since the opening of its first store in Annecy back in 1960 the company has drawn on American retail concepts to create popular and intelligent large space, massive volume retail outlets which yet retain a distinctly French flavour. Since 2011 Carrefour has been rolling out the *Carrefour Planet* concept in Western Europe. It has its own range of branded foodstuffs. Gross sales in 2016 amounted to €87.5 billion, generating EBITDA of €3.9 billion and net income of just over €1 billion. It has 360,000 employees worldwide serving an estimated 100 million households. Q1 2017 figures just released show sales up 6.2 percent to €21.3 billion. It currently has a market capitalisation of about €16.5 billion. The share price has lagged over the last year or so reflecting fears about downward pressure on margins. The outlook for 2017, however, is bright.

Casino Guichard Perrachon SA (EPA:CO). If Carrefour is the leader of the big surface retailers, Casino is the dominant French player in convenience stores. It operates through numerous brands. **Casino** and **Géant** are city-centre and rural supermarket chains. **Monoprix** is a city-centre chain selling both food and personal hygiene and beauty products. **Franprix** is a convenience store chain. **Leader Price** is a chain of out-of-town small supermarkets. Other brands operate in South America. The Group disposed of its operations in Thailand and Vietnam last year in order to reduce debt. High levels of debt prompted S&P to cut Casino's debt rating to junk status in March last year. Since then the company's fortunes seem to have improved and the share price is following an upward trend. The group now has about 12,000 stores of which about 9,500 are located in France. Q1 2017 total group sales announced on 18 April were up by 11.6%[vi]. The group had consolidated net sales last year of €36 billion with net income of just over €1 billion. It currently has a market capitalisation of about €6.2 billion.

Three world-beating French energy companies

Total SA (EPA:FP & NYSE:TOT) is the ninth largest oil company in the world by revenue with operations in about 25 countries, more than 100,000 employees and revenues of US$212 billion in 2015. It has adopted a diversification strategy and has an increasing focus on renewable energy via its New Energies division. It boasts that it is the world's second-ranked solar energy operator as a result of its acquisition of a 60 percent stake in **SunPower Corporation (NASDAQ:SPWR)** of the USA for US$1.38 billion in April 2011. Recently the French government announced its target to triple solar panel capacity in France by 2022. This could make France the leading solar power generator in Europe, overtaking Germany. Total is on course to become a green energy giant of the future.

EDF (EPA:EDF) is the largest nuclear power generator in the world. It operates 58 nuclear reactors in France across 20 locations with a total annual output of more than 120 gigawatts of electricity. The Hinkley Point power plant in Somerset, UK will be built by a consortium led by EDF. EDF is 84.5 percent owned by the French state. British Energy, which operated eight nuclear plants in the UK, was taken over by EDF in 2009, so EDF was already the leading player in the UK nuclear market even before the Hinkley Point C project. Furthermore, EDF is a major regional electricity company (distributor) in the UK. Despite EDF's clear technological advantages this is not a good time for nuclear power generators. In early March EDF's shares plunged nearly 10 percent as the utility began a €4 billion round of capital raising to support new projects, including the Hinkley Point and the acquisition of most of **Areva (EPA:AREVA)**. With a price earnings ratio of just over 8x the share price is looking cheap, especially given the decent dividend.

Engie SA (EPA:ENGI) (GDF-Suez before April 2015) is active in electricity generation and distribution, natural gas, nuclear and renewable energy. The company developed the first pressurised water reactor (PWR). The French state still holds about one third of its shares. The company holds a 35% stake in **Suez Environnement**, the water treatment and waste management firm. GDF Suez bought 70 percent of Britain's International Power PLC in August 2010, creating the world's largest independent utility company. The purchase of the remaining 30 percent followed in July 2012. On July 1, 2015, the company announced the acquisition of solar parks developer **Solairedirect**, which makes it the largest solar power electricity producer in France. "Everybody is talking about the energy transition but we are actually doing it" says Isabelle Kocher, CEO. Engie SA employs about 160,000 people worldwide and had revenues in 2016 of €66.6 billion. The group incurred a loss of €0.4 billion due to impairments. The current restructuring appears to be going well according to Seeking Alpha. The stock has lost a lot of value in recent years but may now have turned the corner.

An iconic French food giant

Danone SA (EPA:BN) is the world's number twelve food and beverage company by sales (roughly the same size as **Kraft-Heinz (NASDAQ:KHC)**). Danone is present in over 130 countries, more than half of those in emerging economies. Many of its brands will be familiar to English-speaking readers: Activia yoghurt; Cow & Gate baby foods; Evian, Badoit and Volvic mineral waters – and many more. Danone had sales of €22 billion in 2016 with €1.72 billion of net income. EPS was €3.10, yielding a current price-earnings ratio of 22.8. The market capitalisation of the company is now €41.75 billion.

EDF (energy) to Total (oil) to Peugeot SA (automotive) have been state owned and controlled at some time in their history.

"FRENCH MULTINATIONALS LIKE CARREFOUR SA THINK BIG AND THINK GLOBALLY."

And France has managed, in very subtle ways, to protect its greatest corporations from foreign encroachment and competition. Takeovers of French companies by foreign multinationals are almost never allowed by means of one ruse or another. The British may carp that France does not obey the EU rules – most of which were devised by French mandarins. In so doing they resemble the man who observes a school mate who enjoys a much more interesting love life than he does. One can question the ethics, but one cannot help but envy the success.

French corporate culture excels

French multinationals like Carrefour SA (see panel on previous page) think big and think globally. They have a highly strategic approach and show an ability to change strategy rapidly when required. The quality of management in French companies is generally excellent.

French offices are averse to the open plan models of their American rivals. (I have visited French companies where each manager works in their private office – the door resolutely closed). Although French management is not as target-oriented as the Americans and British, French corporate culture is highly competitive. Generally, French corporates are very open to foreign talent. At board level, French executives are highly mobile and will jump ship given an opportunity. Carlos Tavares, Portuguese by birth and now CEO of **Peugeot SA (EPA:PSA)**, was previously on the board of **Renault SA (EPA:RNO)**.

A world-class French pharmaceutical powerhouse

Sanofi SA (EPA:SAN & NYSE:SNY) is the world's number five pharmaceutical company but its subsidiary Sanofi-Pasteur is the world's leading manufacturer of vaccines - a branch of medicine which is growing in importance for both human and animal health. It is a leading producer of autoimmune, cardiovascular, metabolic and neurological treatments as well as antibiotics. It is a leader in the treatment of diabetes. 2016 net sales revenues were €33.8 billion with net income of €7.3 billion. EPS was up to €5.68. The pipeline of new products is impressive with a treatment for dermatitis about to be approved by the FDA. The dividend payout for 2016 will be €2.96 per share. The share price chart shows a pronounced upward trend over the last year.

Two brilliant French automotive players

Peugeot SA (EPA:PSA). PSA is now, further to its purchase of Opel AG from **General Motors (NYSE:GM)** in early March, the second biggest automotive manufacturer in Europe. Carlos Tavares CEO has turned PSA around, taking it from near bankruptcy four years ago to solid profitability today. His aim will be to do the same for Opel, though it will be difficult to achieve this by cost-cutting and lay-offs alone. PSA will certainly want to increase Opel's sales outside Europe, thus reducing the European dependency of the combined group. Peugeot SA's share price reacted favourably to the finalisation of the acquisition. Overall, the shares are up nearly 25 percent over twelve months.

Renault SA (EPA:RNO) was the tenth largest automobile manufacturer in the world last year by volume with over half its sales outside Europe. The Renault-Nissan Alliance is the number four vehicle producer in the world – the French and the Japanese companies have been strategic partners since 1999 but Renault is the senior partner having a 43.4 percent controlling stake in **Nissan (TYO:7201)**. Carlos Ghosn is the CEO of both companies. The group owns Automobile Dacia (Romania), Renault Samsung Motors (South Korea) and has an indirect stake in Avtovaz (Russia). Renault has one of the widest ranges of vehicle models of any manufacturer. In 2013, Renault became the number one manufacturer of electric vehicles in Europe by sales. Renault had €51.25 billion of sales in 2016 with net income of €3.5 billion. At the current share price the market capitalisation is less than book value and the price-earnings ratio at 6.6 looks modest. Another opportunity, perhaps?

France has managed to retain its envied engineering tradition with high standards of technical training. Finally, French design skills are admired the world over.

France's competitive advantage

France is the largest European nation by area after Russia and Ukraine. It enjoys very favourable climatic conditions and fertile soil. It has a highly educated workforce, possibly the best transport infrastructure in Europe and bountiful cheap nuclear energy.

The French are rightly known for their wonderful food and cooking. What is less well known is that food is a massive industry in France. In fact, France accounts for about half of the total food production of the entire EU. Because of its varied climatic conditions France can sustain a much wider range of crops than the UK from sugar beet in the far North to rice in the Camargue – and vines almost everywhere. Remember that the Common Agricultural Policy (CAP) was largely designed to sustain French farming.

Hadrian / Shutterstock.com

What now?

The French have certainly expressed grave doubts about *mondialisation* (globalisation). But the French describe also their country as a *carrefour* – a crossroads - across which trade and ideas will always pass. The *European ideal* runs deep in France in a way that it never did in Britain.

I would speculate that, even if Madame Le Pen were to come to power – if not this time then in 2022 - her proposed referendum on France's membership of the EU would most probably yield a vote to remain.

What will have to be addressed at some point, sooner or later, is the negative impact of the currency union on deficit nations – which includes France, and most of the South. Monsieur Mélenchon's proposal to devalue the Euro was by no means stupid. Macron is the European elite's

"NO DIVERSIFIED EUROPEAN EQUITY PORTFOLIO CAN IGNORE FRANCE, DESPITE ITS DEPRESSING INABILITY TO UNDERTAKE PRO-MARKET REFORMS."

Manchurian candidate. He has said nothing about the inherent structural weaknesses of the Euro, so we may assume that in Brussels it will be business as usual. In contrast to what the Daily Mail declared on 24 April, *the new French Revolution* has been postponed.

I doubt that Monsieur Macron would be able to drive through the reforms France needs. His makeshift party is highly unlikely to get a majority in the legislative elections due in June; and he will be increasingly dependent on the centre right Republican Party to get any legislation through parliament. This will incite the fury of the left. One thing that the Trotskyite candidate, M Mélenchon got right was that the constitutional machinery of the Fifth Republic is wearing thin. A political crisis under Macron is quite possible.

What is more, M Macron is not a friend of Britain and will back *Operation Punishment* against the UK. I anticipate a deterioration in Franco-British relations under his presidency.

Action

Buy undervalued French large-cap stocks. No diversified European equity portfolio can ignore France, despite its depressing inability to undertake pro-market reforms. Stocks like **EDF** and **Total** should be considered for their income value alone; although the opportunities for an upside capital gain are also considerable. I have mentioned some top French blue chip stocks, all of which have growth potential (see panels). But there are many funds which offer one-stop diversified exposure to French equities such as the [JP Morgan France Equity Fund] which is up by over 22 percent over the last twelve months.

A benchmark in global hospitality

Accor SA (EPA:AC) is by far the largest hotel chain operator in the world. We have all used their cleverly targeted products, depending on budget and purpose. It operates and franchises 3,900 hotels in 92 countries across five continents under five familiar brands. For economy hotels there is **Formule 1** (now styled F1), unmanned hotels where you can get a room for €25 a night. Then there is **IBIS Budget** and **IBIS** which has built up a formidable customer service proposition at an affordable price point. Midscale brands are **Mercure**, **Novotel** (414 hotels in 61 countries) and **Adagio**. Upscale brands include **Grand Mercure**, **Pullman** and **Swissôtel**. At the luxury end there is **Sofitel** (121 hotels in 41 countries) plus the **Thalassa** spa brand. Accor is still expanding furiously at rate of one new hotel every three days. 2016 revenues were €5.631 billion with operating profit before tax of €571 million and net income of €265 million. The share price has been on an upward trend over the last six months.

360b / Shutterstock.com

i All figures from The Economist, 15 April 2017, page 88.

ii If you seek a deeper understanding of the issue, I recommend *The French Intifada* by Andrew Hussey: https://www.amazon.co.uk/French-Intifada-Between-France-Arabs/dp/1847082599/ref=sr_1_1?s=books&ie=UTF8&qid=1492715112&sr=1-1&keywords=the+french+intifada

iii News of the killing of a policeman on the Champs Élysées came through as the candidates were debating on air on the evening of 20 April.

iv See: https://en.wikipedia.org/wiki/Books_published_per_country_per_year

v See: http://www.tradingeconomics.com/france/government-debt-to-gdp

vi See: https://www.groupe-casino.fr/en/communique/q1-2017-sales

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BY JOHN KINGHAM

DIVIDEND HUNTER

IS KCOM GROUP A YIELD TRAP?

Over the last two of month's I've outlined a series of ten questions which I use to help me avoid yield traps. This month I'm going to interrogate a company using those questions so that you can see them being used in a practical setting. The company in question is KCOM Group (LON:KCOM), a FTSE 250-listed telecoms and IT services provider. KCOM's yield is currently almost 7%, which puts it squarely in yield trap territory.

The company was created at the start of the 20th century as the council-run Hull Telephone Department, providing telephone services to the people of Hull and East Yorkshire. In more recent years (now as a publically listed company), KCOM has been trying hard to move away from its fixed-line business towards the world of internet services, but the results have been mixed. So are investors right to be wary?

A quick tour of the numbers

Before I dive into the yield trap questions, I want to run through KCOM's financial performance and share price valuation. This should explain why I think KCOM is a company worth looking at in some detail.

Starting with KCOM's dividend, its track record is not brilliant. The company only started regular dividend payments in 2005 and then announced a dividend cut just a few years later in the financial crisis. In terms of growth, KCOM's revenues declined over the last decade, but when earnings and dividends are taken into account it grew an average of 7% per year over the last ten years, which is well above the FTSE All-Share average. Growth consistency was mediocre, with revenues, earnings and dividends only increasing about 50% of the time over the last decade, which is below average. Profitability was good though, with return on capital employed (ROCE) increasing from mid-single digits to more than 20% in the last few years (the average company manages about 10%). Debts have recently fallen to almost zero, and while the company does have a fairly large defined benefit pension scheme which is in deficit, I don't think it's a serious risk.

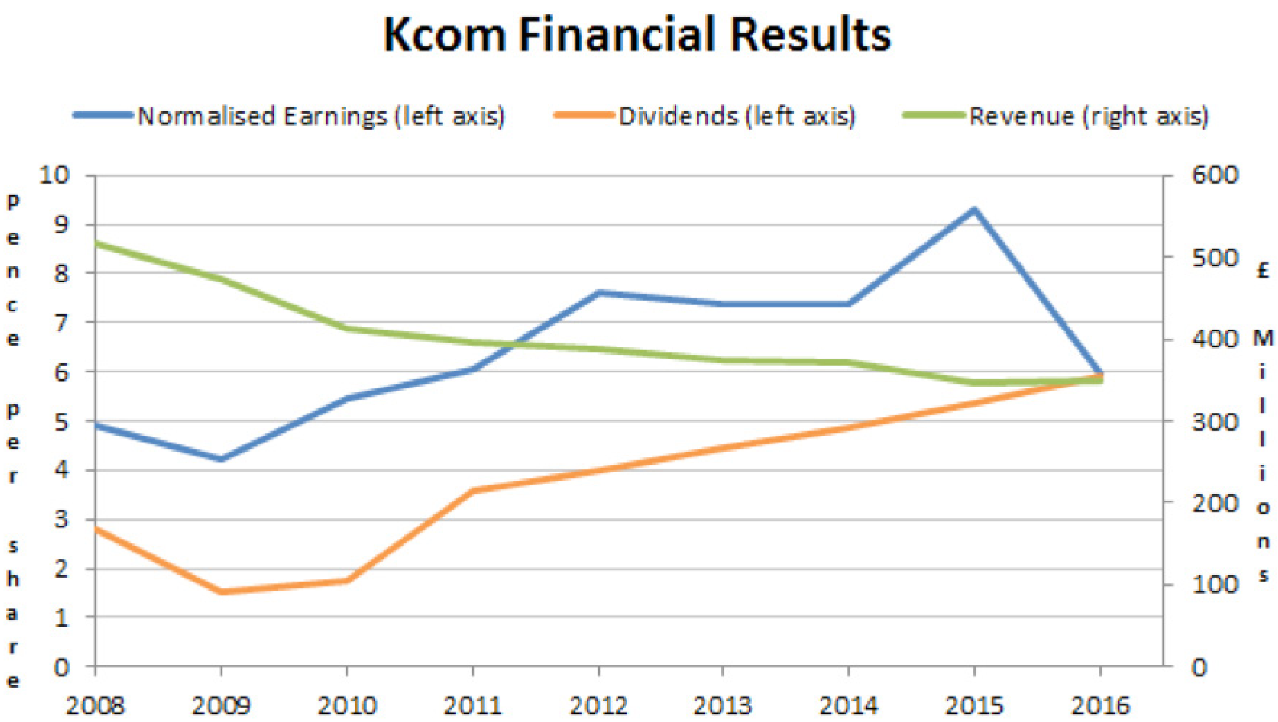
In terms of valuation, KCOM's share price of 88p gives the company a dividend yield of 6.7%, which is obviously very attractive. The share price is also attractive based on my preferred valuation metrics of PE10 and PD10 (price to ten-year average earnings and dividends respectively), with both those ratios currently well below average.

In summary then, KCOM is a company with a reasonably good track record of dividend payments and growth, combined with above average profitability and very low debts. Its valuation is below average, so at first glance it seems that KCOM could be the mythical above average company trading at a below average price. But is that true? Is it really a good company or is it a yield trap? Let's try to find out, using those ten yield trap questions.

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

NO. In the 20th century, KCOM's core business was to provide telecoms services to Hull and East Yorkshire. However, fixed-line telephone

"KCOM HAS BEEN TRYING HARD TO MOVE AWAY FROM ITS FIXED-LINE BUSINESS TOWARDS THE WORLD OF INTERNET SERVICES, BUT THE RESULTS HAVE BEEN MIXED."



services have long been a declining business, thanks to the now ubiquitous mobile phone. To avoid a long and slow death, KCOM has been developing alternative sources of revenues for many years, both internally and through acquisition.

"KCOM IS A COMPANY WITH A REASONABLY GOOD TRACK RECORD OF DIVIDEND PAYMENTS AND GROWTH, COMBINED WITH ABOVE AVERAGE PROFITABILITY AND VERY LOW DEBTS."

Today the company is split into three main businesses: Hull and East Yorkshire (providing fixed-line voice and broadband services), Enterprise (providing complex IT solutions for large organisations) and SMB National (providing simpler telephone and internet-related services for smaller businesses across the UK).

The fixed-line business is seen as a core but constrained by its limited geographic reach. The SMB business is seen as a non-core legacy business because the market is too commoditised to make further expansion worthwhile. That leaves the Enterprise business, which is seen as the company's best hope for a higher growth future.

Given this spread of different business, I would say that KCOM does not have an obvious and dominant core business. Perhaps in the future the enterprise business will grow to be the dominant core, but that is not true today.

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

YES. Given KCOM's two core businesses (fixed-line and enterprise) it has two sets of goals and two strategies, both of which have been fairly consistent over the years.

In the fixed-line business its goal is to grow revenues and profits for as long as possible in what is likely to be a market in long-term decline. To achieve this, the strategy is to stay one step ahead of ever faster wireless networks (5G is aiming at speeds of tens to hundreds of megabytes per second) by rolling out superfast fibre broadband to its customers. Fibre also has the added benefit of needing very little maintenance over its multi-decade lifetime, especially when compared to copper wires.

As for the enterprise business, in the somewhat jargon-filled words of the CEO (from a recent interview with Proactive Investor):

"Our vision is to create an asset-light, IP [Internet Protocol] cloud-based company that will be a new world disruptive challenger to the big IT and systems integration companies. And the market is just waking up to us as an organisation to watch."

In other words, the digital revolution is creating a lot of threats and opportunities for large organisations and many

of them are looking for a highly skilled and trusted partner to help them cope. KCOM's strategy is to go after larger, more complicated and longer-term "annuity" contracts, where revenues are recurring for long periods of time due to the need for a stable and deep relationship between consultant (KCOM) and client.

In summary then, KCOM's goal is to keep the fixed-line business breathing long enough so that the enterprise business can eventually take over as the main breadwinner.

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

NO. The fixed-line business is almost a monopoly, so it definitely has scale. However, KCOM's future is supposed to be its enterprise business, so for me that business is more important and here I think scale is lacking. Nowhere does KCOM describe its enterprise business as a market leader, and in fact the CEO describes the business as a "disruptive challenger to the big IT and systems integration companies", which suggests that the enterprise business is still a relative minnow.

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

YES. The fixed-line business has been in place for over a century, while the enterprise business only really got going with the acquisition of Omnetica in 2004 and Smart421 in 2007. However, that's still ten years ago, which is a reasonable period of time, and both acquired companies have histories going back to the start of the millennium or earlier.

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

YES. KCOM is in the middle of a transformational project to turn itself from an old-world fixed-line telephone company into a new-world internet consultancy. However, I don't consider that a bet-the-company project as it doesn't put the old fixed-line core business at risk. At the level of its two main businesses, there is nothing currently going on that I would class as a big, high risk project.

6. Are revenues generated from selling many small-ticket items rather than a few big-ticket items?

NO. The fixed-line business generates revenues from many thousands of individuals and businesses who make relatively small but regular payments for their phone and broadband services.

The enterprise business generates revenues from contracts, some of which are very large. Those contracts typically have a fixed life and will eventually come to an end. When a contract ends, KCOM will lose those revenues unless it can either renew the contract or find a new client (or clients) willing to sign a contract of similar scale. If KCOM fails to replace lapsed contracts then its revenues and profits will suffer. This is precisely what happened during the financial crisis when Lehman Brothers, KCOM's largest customer at the time, went bust.

Given that the enterprise business is the future I've given that business more weight, which is why I've answered this question with a no.

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

YES. Over the last decade KCOM has been largely acquisition-free. Before that it was highly acquisitive in an attempt to move away from its fixed-line business. For example, in 2004/5 KCOM spent over £100m buying Omnetica and over £25m buying Smart421 in 2007/8. Both were large acquisitions that were outside the company's core fixed-line business, so they were definitely risky, but also probably necessary. However, in general I consider acquisitions more than ten years old to be ancient history and not worth worrying about.

> **"KCOM'S GOAL IS TO KEEP THE FIXED-LINE BUSINESS BREATHING LONG ENOUGH SO THAT THE ENTERPRISE BUSINESS CAN EVENTUALLY TAKE OVER AS THE MAIN BREADWINNER."**

8. Does the company operate primarily in defensive markets?

NO. KCOM's fixed-line business is very defensive as it's based on phone and broadband subscriptions, which people and businesses will usually pay regardless of the economic environment. The enterprise business is definitely not defensive, as the financial crisis showed. Its enterprise customers are large public and private organisations, both of which are more than willing to cut their IT budgets if the economy takes a turn for the worse. As a result, additional IT consultancy work will be reduced and contracts with KCOM may not be renewed, or may be renewed on less profitable terms.

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

YES. Other than exposure to clients who may operate in the commodity sector, KCOM is largely unaffected by commodity prices.

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

YES. The voice side of the fixed-line business is in terminal decline thanks to the ubiquity of mobile phones. The broadband side of that business still has some legs though, thanks to its superfast fibre broadband rollout. That rollout is enough to keep fixed-line data speeds ahead of wireless, at least for now. Once fully deployed, the fibre network should allow additional services which can only be delivered through superfast broadband, which could be another source of revenue for KCOM. However, the pessimist in me thinks the fixed-line broadband market is also not a growth market.

For the enterprise business things are different. Computers and network technology are becoming ever more important for business, and for most businesses these are non-core skills. As the scale and complexity of these projects continues to grow for large businesses, so does the need for outside consultants who can design, build, deploy and maintain these systems. And that's where KCOM comes in. This is of course a much less dependable and stable market than the old fixed-line telecoms market, but at least it's likely to be a growth market.

Is KCOM a yield trap?

Having worked through all ten questions, the final score is six yeses and four noes. Remember that yeses are good and noes are bad, so while the good answers outnumber the bad, it's still a very mediocre score.

KCOM has several main problems: 1) Management's focus is split across two very different businesses (three if you include the legacy SMB business); 2) The enterprise business lacks scale; 3) The enterprise business depends on consistently winning large contracts; 4) The enterprise internet systems and services market is cyclical.

These are all negative factors, but they are not necessarily a reason to avoid KCOM. After all, there is no obvious crisis within the company, no obvious sign that its markets are about to suffer a downturn, and I think no obvious reason why the dividend should be cut anytime soon. But those negative factors are still there, so there is a realistic chance that the dividend could be cut if, for example, there is a downturn in the economy or if KCOM fails to replace several major contracts.

On balance though, I think I would invest in KCOM at its current price, should the opportunity arise. If the dividend is sustained then there is a good chance the share price could double, or better, although I would probably hedge my bets by keeping the investment to just a few percent of my portfolio.

"KCOM'S FIXED-LINE BUSINESS IS VERY DEFENSIVE AS IT'S BASED ON PHONE AND BROADBAND SUBSCRIPTIONS, WHICH PEOPLE AND BUSINESSES WILL USUALLY PAY REGARDLESS OF THE ECONOMIC ENVIRONMENT."

About John

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

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

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

BY NICK SUDBURY

FUNDS IN FOCUS

PROPERTY FUNDS ON SHAKY FOUNDATIONS

Theresa May's surprise decision to call a snap general election has highlighted the political challenges facing the country as it starts to negotiate the terms on which it will leave the EU. Brexit has created a huge amount of economic uncertainty with one of the sectors most at risk being the UK commercial property market.

The shock result of last June's EU referendum triggered a sharp fall in the value of commercial property during the third quarter, although the market began to stabilise towards the end of the year. The dramatic improvement in sentiment has continued into the first three months of 2017 with the MSCI/IPD All Property Index generating a gain of 1.3%, which is equivalent to half of the return produced in the whole of the previous 12 months.

Data compiled by the investment companies team at Winterflood Research shows that the 13 investment trusts in the Direct UK Property Sector have bounced back strongly in the last six months. During this period they experienced a 15% weighted average increase in their share prices that has moved them on to an average premium to net asset value (NAV) of 7.5%.

“INVESTMENT TRUSTS IN THE DIRECT UK PROPERTY SECTOR HAVE BOUNCED BACK STRONGLY IN THE LAST SIX MONTHS.”

"THE MAIN ATTRACTION OF PROPERTY INVESTMENT TRUSTS IS THAT THEY OFFER A DECENT YIELD WITH THE PROSPECT OF LONG-TERM CAPITAL AND INCOME GROWTH."

It is a very different story for the internally-managed large-cap Real-Estate Investment Trusts (REITs) such as **British Land (LON:BLND)** and **Land Securities (LON:LAND)**. Analysis by Numis Securities Research suggests that these are trading on an average discount of 16%, which in part they attribute to the limited interest from generalist equity investors that make up the majority of REIT shareholder registers.

When investing in illiquid assets such as commercial property – the actual bricks and mortar as opposed to property equities – it would be sensible to avoid any of the open-ended funds operating in this area. Many of these were forced to suspend dealing following a deluge of redemption requests after the Brexit vote last year as they were unable to raise the cash quick enough to satisfy the large number of investors who wanted to leave.

The Financial Conduct Authority is currently looking into this whole issue, but there are no such problems with investment trusts. The shares of these closed-ended funds are continuously quoted on the stock exchange with investors able to buy or sell them whenever they want without having any impact on the underlying portfolio.

Cautious outlook

The main attraction of property investment trusts is that they offer a decent yield with the prospect of long-term capital and income growth, although an economic slowdown could undermine both their rental income and the value of their underlying holdings.

Given the higher than usual level of economic uncertainty it is essential to consider the nature of the property portfolio before investing. It is then a case of weighing up the growth prospects, the prospective yield and the level of dividend cover. The gearing and cost of debt is also important as it adds to the potential risk and rewards with some of the funds having considerably more than the 15% average debt in the sector.

Numis cover 10 income-focused property investment trusts with a combined market value of £5.7bn. These vary in terms of their property and gearing strategies with the yields ranging from 3.9% to the 8% available from the **AEW UK REIT (LON:AEWU)**. Its shares are trading on a 7% premium despite the fact that only 90.5% of the most recent quarterly dividend was covered by the fund's revenue with the rest coming from its revenue reserves.

The analysts at Numis prefer funds with modest gearing, defensive property strategies and well-covered, attractive dividend yields. One such that they are recommending is the £382m **Custodian REIT (LON:CREI)** that was launched in March 2014.

CREI invests in good quality smaller properties that are valued at less than £10m and has put together a diversified portfolio that is exposed to retail premises, offices, industrial units and distribution facilities, with high profile tenants including Tesco, Royal Mail and RBS.

Numis believes that the portfolio has been well positioned for a slower growth environment by targeting investments with a high residual value where the majority of the value is in the bricks and mortar rather than the lease.

They think that CREI should be a solid performer, but with the shares trading on a hefty 12% premium they suggest that any dip in the price could be seen as a buying opportunity. The shares are yielding 5.7% with the dividend fully covered by the revenue.

Mainstream property recommendations

Numis is also recommending the £330m **Schroder Real Estate Investment Trust (LON:SREI)**, which is trading on a 2.6% premium and paying a well-covered dividend of 3.9%. They say that the portfolio has an attractive combination of core assets underpinning the current dividend target.

The management team has been positioning the portfolio towards high growth in areas where the local economy is growing at a faster rate than the UK as a whole. This future growth potential does not currently seem to be priced in, which suggests that the fund could offer attractive long-term total returns.

There are two property investment trusts in Winterflood's model portfolio for 2017 with the first of them being the £1.19bn **F&C Commercial Property Trust (LON:FCPT)**. Its shares are currently trading on a 12% premium and yielding 4% with monthly dividends.

FCPT's shares fell to a 24% discount in the immediate aftermath of the Brexit vote, but they have recovered strongly in the last few months. The fund has the highest quality portfolio of its peer group with a heavy weighting in London in the South East and minimal exposure to some of the most vulnerable areas such as offices in the City of London.

The analysts at Winterflood point out that the fund has a strong long-term performance record, with its portfolio having outperformed the UK property market in nine of the ten full years since it was launched in 2005. It also benefits from a low gearing rate of 29%, which gives it the scope to take advantage of new opportunities as they come along.

Their other recommendation is the £997m **TR Property Investment Trust (LON:TRY)**. This provides exposure to a diversified portfolio of property shares rather than the actual bricks and mortar. There are currently 76 different holdings with 37% of the assets invested in the UK and the rest spread around Continental Europe.

TRY is yielding a modest 2.8%, but Winterflood says that it benefits from an experienced and well-resourced specialist management team with a proven record of adding value and that the fund has a strong and consistent long-term performance record.

Investing in property equities allows the managers to achieve much greater diversification and to quickly reposition the portfolio to take advantage of those areas that offer the best value. The fund's shares are trading on a 7% discount to NAV and many of the underlying holdings are also at substantial discounts, which suggests that they offer a fair degree of value.

Alternative property funds

The sharp fall in the value of the pound in the wake of the Brexit vote has pushed up the cost of imports and the headline rate of inflation. It seems unlikely that earnings will be able to increase at the same pace, which would put pressure on consumer spending, especially if we get a hard Brexit.

In this sort of scenario there is every chance that many retail outlets would struggle and that office lets could run into problems as businesses cut back to cope with the faltering economy. One way to guard against this would be to diversify into alternative areas of the property market that are less dependent on the level of economic activity.

A prime example is student accommodation. Overseas students studying in the UK provide an important source of foreign currency for the country and the fall in the value of the pound has made it a lot more affordable for them.

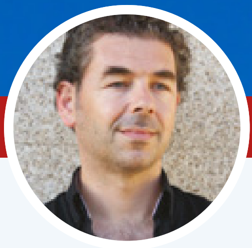
The two main options in this area are the £566m **Empiric Student Property (LON:ESP)** that is trading on a 5% premium and yielding 5.6%, and the £506m **GCP Student Living (LON:DIGS)**. This is trading on a 9.1% premium and paying 3.8%.

A more defensive alternative would be a healthcare property fund that invests in GP surgeries or other similar facilities. These benefit from government backed revenue streams that normally go up in line with inflation.

The £364m **MedicX Fund (LON:MXF)** provides exposure to a portfolio of 156 primary healthcare properties throughout the UK and Ireland. Its annualised rent roll is £38.9m with the shares yielding 6.8%, although they are trading on a massive 43% premium to NAV.

Another option would be the £291m **Target Healthcare REIT (LON:THRL)** that invests in care homes and other healthcare assets in the UK. It is yielding 5.4% and trading on a more reasonable premium of 16.3%.

There is also the **Impact Healthcare REIT (LON:IHR)** that floated on the stock exchange in March. This raised £160m at its IPO and will use the proceeds to acquire a seed portfolio of 58 residential care homes for £153m. It is targeting an initial yield of 6%.



BY FILIPE R. COSTA

THE MACRO INVESTOR

DO TRADE DEFICITS REALLY MATTER?

"Only those who see that the two sides of all phenomena, visible and invisible, are front and back or beginning and end of one reality can embrace any antagonistic situation, see its complementarity, and help others to do the same, thereby establishing peace and harmony."

– George Ohsawa

Two sides to the same coin

In the last few years concerns have arisen about the feasibility and sustainability of the huge and persistent current account deficits in the UK and in the US, and fingers have been pointed at countries like China, Japan and Germany for creating global trade imbalances due to their large current account surpluses. Recently, Donald Trump has directly criticised Germany, suggesting the country is a "currency manipulator", while at the same time urging Americans to buy "home-made" goods and blaming the outside world for the US's unfavourable current account position.

But, *is* such blame justifiable? Trump believes it is, even though Germany only has an indirect influence on currency values, as the ECB is clearly at odds with the Bundesbank's preferences. At the same time, does it really matter how much of a bilateral deficit/surplus a country carries in relation to another?

If Adam Smith and David Ricardo's observations are worth anything, then international trade improves the well-being of the regions involved, allowing an expansion of consumption, regardless of the direction of any bilateral trade. Each region should specialise in what it does best, with the free market forces taking care of the rest. But the gold standard remains a distant memory. Many blame it for the Great Depression. In a world where exchange rates were fixed, any current account imbalances were followed by painful adjustments in employment and output. Notwithstanding this, many years after the gold standard ended, and at a time when exchange rates are no longer fixed, current account deficits are still feared. But, such a view may be limited. Let me go back to the first paragraph of this article and rewrite it from a different perspective:

In the last few years concerns have arisen about the feasibility and sustainability of the huge and persistent capital account deficits in Japan and Germany, and the finger has been pointed at countries like the US and the UK for creating global capital imbalances due to their large capital account surpluses.

One of the most important balance of payments tautologies is that any current account deficit should be equal to a capital account surplus, and that those who run persistent deficits on their current account are the same who run persistent inflows of capital. If, on the one hand, someone in the US imports a tablet from China, which contributes to a deterioration of the US current account balance, the opposite side of the

"THE EUROZONE CURRENT ACCOUNT INCREASED TO A RECORD POSITIVE LEVEL OF €360.2 BILLION IN THE 12-MONTH PERIOD ENDING IN FEBRUARY OF THIS YEAR, WHICH CORRESPONDS TO 3.4% OF GDP."

coin is that someone in China may buy US Treasury Bills with the $200 received for the tablet, which increases the capital account balance. If China holds a very positive current account balance, the US holds a very positive capital account balance. China produces goods and services more efficiently than the US but the US is able to attract more investment. Which one is better? That's the million dollar question that no one is able to answer comprehensively.

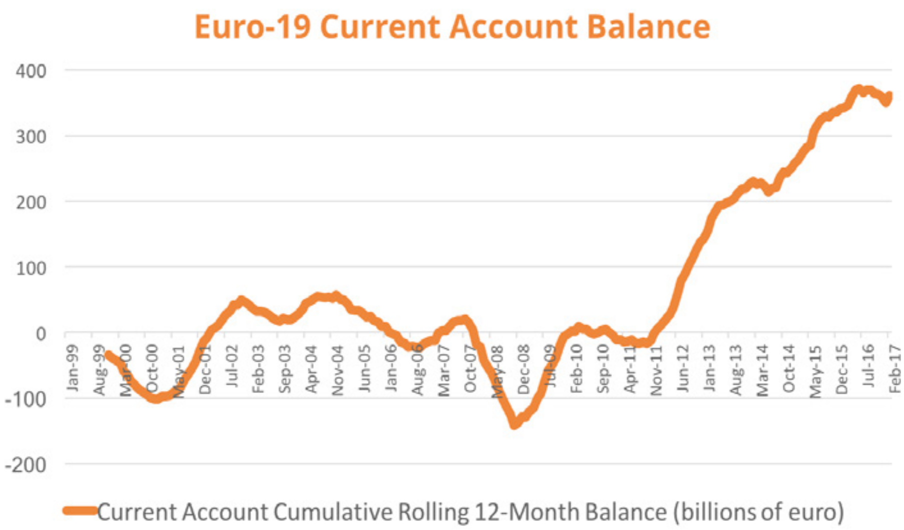
If a country is spending more on current goods and services sold by foreigners than foreigners spend on current goods and services from that country, then it necessarily means that foreigners must be investing comparatively more capital in that same country's assets. These are two sides of the same phenomena, which are the result of a free flow of goods and capital.

The eurozone's improving current account

Until 2008, the eurozone's current account went through periods of small deficits (1999-2001 and 2007-2008) and surpluses (2002-2006), but never really deviated significantly from being balanced. In 2008, with the advent of the financial crisis in the US and the subsequent sovereign debt crisis in Europe, the balance of the current account started rising. With interest rates battered down, the ECB providing massive liquidity to European banks, and governments imposing austerity policies that hit consumption levels, imports suffered a steep decline, while exports benefited from internal devaluations that led to a decline in real wages.

At the same time, the euro lost its shine and adjusted lower against other major currencies. The euro was worth nearly 1.40 US dollars in 2011 and traded as low as 1.04 in 2015. The eurozone current account increased to a record positive level of €360.2 billion in the 12-month period ending in February of this year, which corresponds to 3.4% of GDP. In February alone, the current account recorded a positive balance of €37.9 billion, with the largest part of it coming from the goods and services account (€29.5 billion from goods and €9.5 billion from services). The depressed euro is boosting the area's exports at the expense of companies' located in countries like the US, Trump claims. Germany alone holds a current account surplus of €270 billion, one of the largest in the world, mainly as a consequence of an undervalued currency. Trump, meanwhile, insists that Germany is a *currency manipulator*.

While it is true that the euro may be undervalued in the case of Germany, one can't blame the German state for this. Bearing in mind the recent inability of Wolfgang Schauble and Jens Weidmann to convince the ECB to conduct a more contractionary monetary policy, the only criticism that can be made of Germany is its membership of the eurozone. Apart from that, Germany suffers from the same problem as other eurozone countries: namely the consequences of monetary policy



being conducted towards the average, which may well not fit any of the member countries. If the euro is undervalued for Germany, it is overvalued for Greece, for example. The same reasoning applies in the US. What fits Texas, may not fit Nevada. Not all regions are in the same phase of the business cycle at all times.

But, while the current account surplus of the Eurozone has been heavily discussed, everyone seems to forget its counterpart – the capital account – which has been recording ever higher deficits. The eurozone is experiencing an outflow of money, as foreigners are investing less in the area's assets than eurozone nationals are investing outside. If the large current account reflects a competitive advantage in terms of trade, the huge capital account deficit reflects a disadvantage in terms of the eurozone's capacity to attract outside investment.

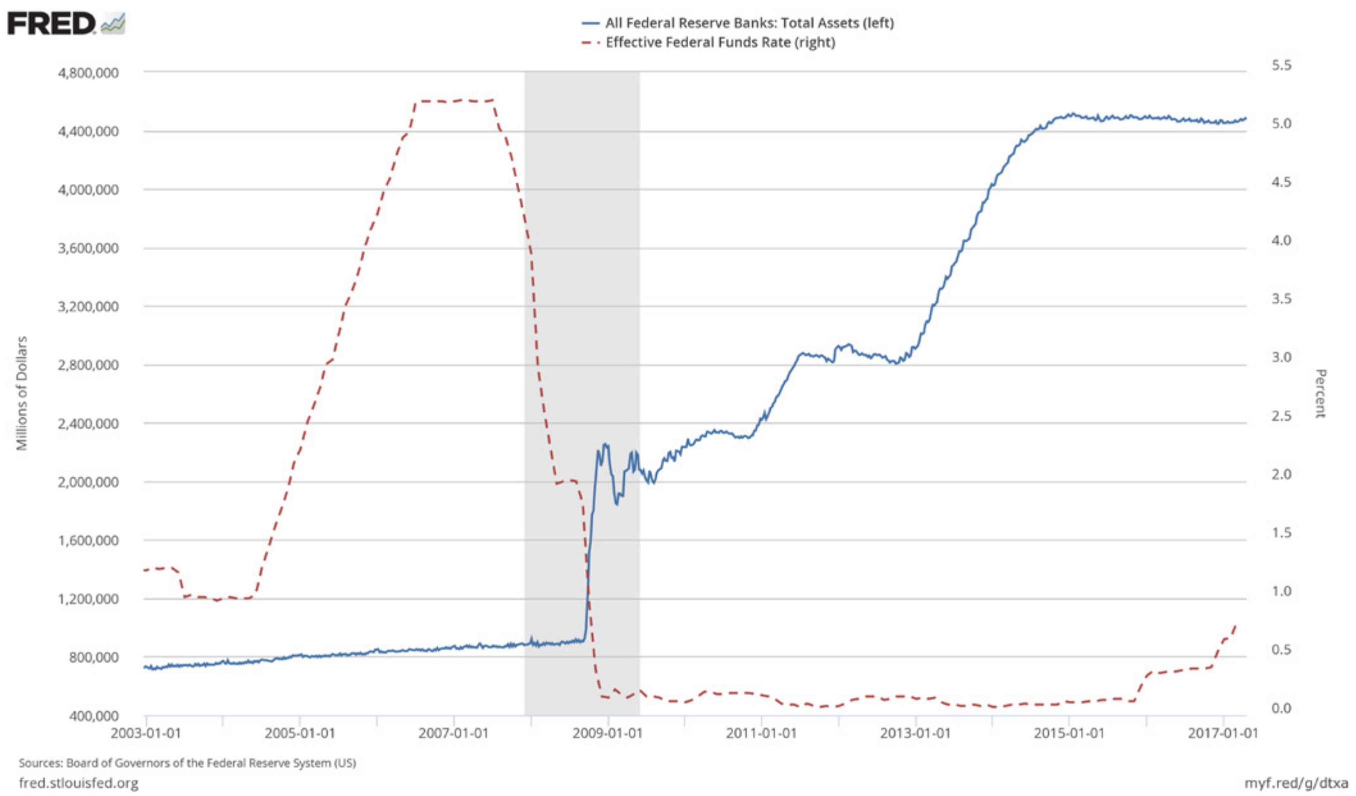
Central banks do have a huge impact on equilibrium values. The asset purchase programme put in place by the ECB in 2015 certainly puts some extra pressure on the euro vis-à-vis other major currencies. But to blame the ECB for a depressed euro is to ignore the fact that the FED, the BoE, the BoJ, and many other central banks have been conducting exactly the same policies as the ECB over the years. The ECB expanded its balance sheet from €1.52 trillion at the end of September 2008 to the current €4.14 trillion, a 172% increase. But the FED expanded its balance sheet even more, from $0.93 trillion to $4.47 trillion in a similar period, a 381% increase. Even though the FED is now normalising its policy, its balance sheet still seems more expansionary then the ECB's.

“THE RISING EUROZONE CURRENT ACCOUNT SURPLUS AND CAPITAL ACCOUNT DEFICIT ARE BETTER EXPLAINED AS A CONSEQUENCE OF POLITICAL AND ECONOMIC INSTABILITY.”

At a time when central banks are providing significant liquidity to markets, all at the same time, the rising eurozone current account surplus and capital account deficit are better explained as a consequence of political and economic instability. Since the sovereign debt crisis erupted, markets started pricing in the possibility of a member state failing to repay its debt, the possibility of a member country exiting the eurozone and, finally, the possibility of the euro collapsing at some point. Such fears have been exacerbated since the Brexit result last year, with populism on the rise across Europe.

Saving and investing

One of the most important relationships in an economy is that between investment and saving. When investment activities are greater than national savings, an economy needs to get additional funding from foreign savings. When an economy is in possession of more savings than investment opportunities, it allocates the excess savings to foreign investment opportunities. In the first case, the capital account is positive and the current account is negative. In the second case, the reverse occurs. Investment opportunities in the US have long since been substantial when compared with those offered by other countries. With the dollar having the status of the reserve currency, there are always plenty of investors willing to purchase US assets, either in the form of direct investment or in the form of currency, treasuries, or stocks. For some time now, this has enabled the country to invest more than it



saves and to run a negative current account balance. Due to its chronic nature, many ask how sustainable such a situation may be and often end up forecasting its end. But, as long as the dollar keeps its reserve currency status, the current account will continue to show a deficit. At times, the dollar may decline in value, but in general its status allows the FED to keep interest rates below what would be possible if the dollar wasn't a reserve currency. Therefore, investors shouldn't expect a currency crisis or any significant depreciation of the dollar just because the current account shows a chronic deficit.

By a similar token, the euro is not a reserve currency. With all the uncertainty hanging over the euro of late, for outside savings to be attracted into the eurozone interest rates and yields would need to be higher than before. But because the ECB fears the negative effects higher interest rates may have on consumption, it has not allowed them to increase. The ultra-loose policy pursued by the ECB has contributed to a decline in yields, a bad allocation of resources between consumption and investment goods, and an exodus of domestic savings in the direction of foreign opportunities. As a result, the current account shows a huge surplus and the capital account the opposite. More than anything, these balances reflect the eurozone's weakness and the consequences of deleterious monetary policy choices.

Why are imbalances perceived to be dangerous?

Economists tend to label any chronic trade or current account deficits as dangerous, on concerns over the adjustments that may follow in a kind of mean reversion process. As current account deficits are financed with inflows of foreign capital, investors would quickly repatriate their money if they lost confidence in the investee country, leading to an erosion of central bank reserves and potentially sparking a currency crisis. That was the case during the Asian currency crisis in 1997, for example. But such a scenario is unlikely in the UK, Europe or the US today. The pound re-adjusted its value last year after the Brexit result, but has stabilised since then. Small countries are more exposed to currency crises than trading blocs like the US or the eurozone.

Another reason why current account imbalances are seen as dangerous is the painful internal devaluations that sometimes follow. The reasoning is rooted in the observation of what happened during the gold standard. Back then, if a country experienced a huge current account deficit, gold would leave the country to pay for the net imports (as imports would outpace exports), reducing the domestic stock of gold. Because gold was trading on a fixed exchange rate against the currency, the money supply would also decline, which acted akin to a tighter monetary policy, leading to a contraction in jobs and output.

"I'M BULLISH ON THE EURO AGAINST THE DOLLAR, ON EUROPEAN EQUITIES, AND, IN PARTICULAR, ON EUROPEAN BANKS."

The gold standard imposed a very painful internal devaluation to restore a country's competitiveness, often leading to volatile swings in economic activity and employment levels. But central banks abandoned the gold standard long ago and most of them now operate under flexible exchange rate settings. Under such conditions, there is no risk of the aforementioned adjustments occurring because the exchange rate is the main buffer to restore the balance.

While member countries inside the eurozone may experience painful internal adjustments at times, as a whole the eurozone and the US aren't exposed to them as long as they allow currency values to oscillate freely in the market. There's no reason to be concerned with the current account deficit at that level.

Bringing everything together

For the balance of payments to be in equilibrium, there's no need for every sub-account to be in balance. In a world where both goods and money move freely, the specialisation recognised by Adam Smith and David Ricardo has been extended from labour to capital. A country may run trade account deficits forever, if it can attract substantial outside savings.

The capital account helps us to better explain what is currently happening in the eurozone and to understand the factors that are behind a potential change in the composition of the balance of payments. The euro, as a project, is in some serious trouble, as the market sees it as a reversible process. To invest in the eurozone, outside investors now require higher yields than they would require under similar conditions ten years ago. But, in trying to boost inflation (which to some extent is a necessary consequence of the internal devaluations), the ECB is just encouraging foreign savings to remain outside the eurozone while also boosting the amount of domestic savings that flow out of the eurozone.

Donald Trump's rhetoric is counter-productive. Through talking down the EU and the eurozone, he is merely helping to decrease confidence in the bloc and exacerbate political concerns, which further boosts the dollar against the euro and contributes to a larger US current account deficit. Trump would achieve better results if he turned more positive about the euro project.

With Theresa May having called an early election (from which she is widely expected to gain strength), Emmanuel Macron winning the first round in the French Presidential election (and likely to become the next French President), confidence is being restored in Europe. If Draghi also helps with some less dovish rhetoric, investment flows will change direction and the current account balance will revert to a more balanced state. More than anything, the record high current account surplus in the Eurozone is the reflection of low confidence in the European economy.

The euro is currently trading around 1.09 against the US dollar and I believe its true value is much closer to 1.20 than it is to parity, due to the effect the latest political developments will have on the capital account. If Macron can convert his lead into a victory on 7 May, a significant barrier will be overcome. I'm bullish on the Euro against the dollar, on European equities, and, in particular, on European banks.

BY RICHARD GILL, CFA

FROM ACORNS TO OAK TREES

DISCOUNT TO BOOK, WORTH ANOTHER LOOK

THREE SMALL CAPS TRADING AT BELOW NET ASSET VALUE

Valuing shares is a tricky business. That's why over the decades equity analysts have developed a range of different ways to estimate how much a company could be worth. Well established approaches such as discounted cash flow and earnings multiples have been popular for almost a century and remain commonly used methods for valuing businesses. More questionable measures also exist including the price to sales multiple, revenues per user figure and (as was the case for many analysts covering cash guzzling dotcom businesses) the ever popular "finger in the air" method.

One of the least complicated ways of valuing a company is to use the price to book value ratio (also known as the P/B ratio). This simple method compares the current market capitalisation of a business with the value of its net assets (or equity shareholders' funds) as at the last reported balance sheet date. For example, if X Company is valued at £50 million and has net assets of £25 million it would be trading on a price to book value ratio of 2 times. Investors can then use this information to ascertain if a business is under or over-valued, for example by comparing the figure to peers within the sector or to a company's own historic P/B ratio.

The Holy Grail of price to book value analysis is identifying a company which trades on a P/B ratio of below 1, or in other words, a company whose shares are trading at a discount to the value of its net assets. The thinking behind this approach is that (as with all methods of value investing) you are finding something you can buy for less than it is worth.

Say for example the situation above is switched around and X Company has a market cap of £25 million and net assets of £50 million. The P/B ratio here is 0.5 times so buying the shares could effectively be like buying a tenner for the price of a fiver. I say "could" because a company's asset value may be overstated on the balance sheet. Or the market might have a different opinion as to what the assets are *really* worth.

Of course, the P/B ratio should not be used in isolation.

A company's wider financial statements should be looked at to filter out any financially distressed businesses, many of which trade on low P/B ratios as a result of their troubled situation. To apply a further level of scrutiny, intangible assets can be stripped out of the P/B valuation to remove elements, such as goodwill, which can often have a questionable value. After doing this investors are left with net tangible assets. Find a company which is trading at a discount to *net tangible assets* and you could be on to a real winner.

While a price to book value analysis might flag up a few good investment ideas it is not always an appropriate

“FIND A COMPANY WHICH IS TRADING AT A DISCOUNT TO NET TANGIBLE ASSETS AND YOU COULD BE ON TO A REAL WINNER.”

way of valuing firms in certain sectors. It is most useful for valuing companies which hold a large amount of financial assets, such as banks, or "hard" assets like property. Different valuation methods are best applied to companies where earnings are driven by intangible factors such as intellectual property, technology or human knowledge as these are rarely reflected on the balance sheet and these companies' share prices have little correlation with book value.

At the bottom line, many academic studies have suggested that companies trading on low P/B ratios go on to outperform the market. So with that in mind, here follows three small cap companies which are currently trading at a discount to their last stated net asset value.

SUTTON HARBOUR

Plymouth is famous for many things – the Pilgrim Fathers, Plymouth Argyle Football Club and **Sutton Harbour Holdings plc (LON:SUH)**, the most westerly listed company trading on AIM. With a history going back to 1847, Sutton Harbour is today a well-known local property development and marina/waterfront regeneration specialist.

In its core Marine division the firm's flagship asset is the Sutton Harbour Marina, a fully serviced facility located in the historic heart of Plymouth which has been awarded 5 Gold Anchor status by industry monitor the Yacht Harbour Association. Secure berthing is provided for 523 vessels, with the company deriving a stable revenue stream in the form of berth dues, fees and ancillary income.

Sutton Harbour marina

Also in the Marine division, a mile or so down the coast is the King Point Marina, which was developed by the company and opened in September 2013, currently providing berthing for 171 boats. Lastly, the division runs Plymouth Fisheries, a fish landing and auction venue which sells more than 6,000 tonnes of fish every year.

Elsewhere, Sutton Harbour owns various real estate assets around the marinas and within Plymouth consisting of offices, retail units, food & drink venues and industrial units which are let to tenants ranging from small independents to major national companies. Supplementing these activities are various income generating car park facilities in Plymouth.

Finally, the Regeneration division provides a number of interesting long-term opportunities. These include *Sugar House*, a waterside development which will provide up to 22,000 sq ft of leisure retail space with waterside frontage, along with *The Boardwalk*, a 7,807 sq ft a pier-like structure arranged as two large restaurant units and a small pavilion. Then we come to the airport.

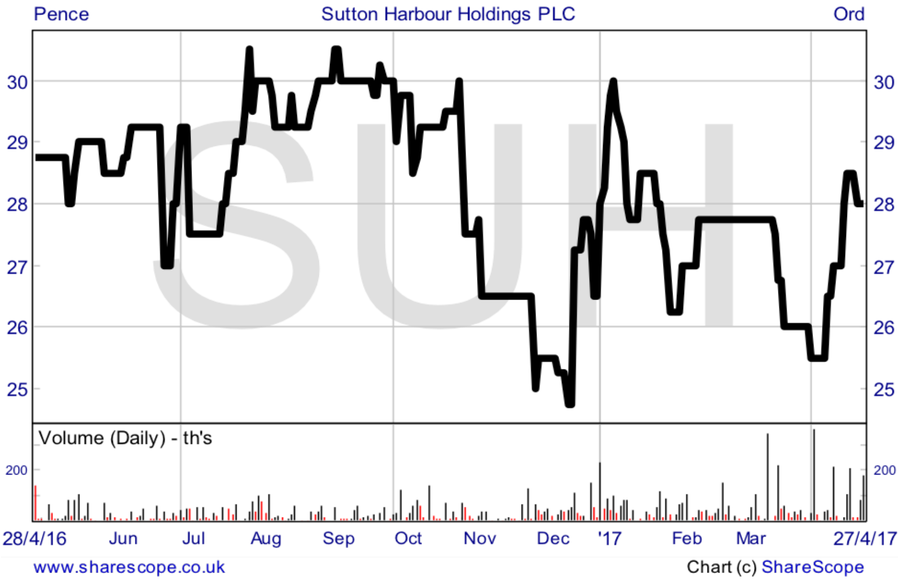
Air rage

Up until November 2010 Sutton Harbour owned a small regional airline, Air South West, which flew to a few select locations around the UK and Europe from its base at Plymouth City Airport – the company gained a 150 year lease on the site (at a peppercorn rent) from the local council in 2004. But following a period of sustained losses the airline was sold to Eastern International Airlines. A few months later the decision was made by the company to shut Plymouth Airport, with Sutton Harbour retaining the lease following its closure.

Since then a number of reports have been commissioned by various parties and vivacious local interest groups which are looking to re-open the airport. However, at the end of last year a review by the Department for Transport concluded that, *"a lack of demand and a short runway mean commercially viable passenger services could not be run out of the former Plymouth Airport site as it would remain financially vulnerable in a high risk environment."*

Sutton Harbour's own vision for the 113 acre site is for it to be turned into a new garden suburb named Plym Vale. Expected to cost £200 million to develop, Plym Vale will be a new walkable city quarter with c. 1,500 homes, village green, playing fields, shops, and multi-sports arena linked to the nearby University of St Mark & St John. The plans will be submitted to Plymouth City Council as part of an ongoing consultation which is due to be considered by a government inspector in the autumn.

"WHAT INVESTORS REALLY NEED HERE IS A CATALYST FOR THE MARKETS TO REVALUE THE COMPANY CLOSER TO PARITY WITH BOOK VALUE. IF THAT HAPPENS WE ARE LOOKING AT UPSIDE OF 49%."



Fish for a bargain?

Sutton Harbour's last stated net assets per share (as at 30th September 2016) stood at 41.6p. With the shares currently changing hands for 28p each that puts the company on a P/B ratio of just 0.67 times, or a discount to NAV of 33%. There are no intangibles on the balance sheet, with the assets mostly being the income generating properties and development assets, offset by net debt of £22.74 million.

Over the past five years the average price to book ratio has been just over 0.7 times, so that provides some short-term upside assuming reversion to the mean. But what investors really need here is a catalyst for the markets to revalue the company closer to parity with book value. If that happens we are looking at upside of 49%.

I see two such potential catalysts within the next year or so.

The first is the outcome of the consultation into the new use for the airport site, which could turn out to be a valuable long-term asset for the company. Secondly, almost exactly a year to the day as I write, in April 2016 Sutton Harbour appointed advisors Rothschild with a view to carrying out a review of its strategic options, including a potential sale. As confirmed in an April trading statement, this review is ongoing but no further details have been given. Any sale would of course have to be priced at least at net asset value.

For patient investors, Sutton Harbour is a buy and hold.

STANLEY GIBBONS

For many years stamp and collectables seller **Stanley Gibbons (LON:SGI)** was considered to be one of the success stories of AIM, a stock market darling which had delivered multi-bagging returns for investors. Listing on the junior market in September 2000, Stanley Gibbons shares went from 22.5p to a peak of 383.5p by March 2014. But a series of negative events has since sent them down to all time lows, with the company now trading at a substantial discount to its net assets.

Founded in 1856, Stanley Gibbons is one of the world's most well known rare stamp and collectibles merchants, with offices in the UK, US, Hong Kong and the Channel Islands. Famous for its shop and HQ on the Strand in London, the Royal Warrant holder sells a range of items including rare Penny Blacks, collectable coins, medals, furniture, rare books and even signed photographs of Marilyn Monroe.

Collecting profit warnings

Despite its success in the early years of being a public company, Stanley Gibbons had been no stranger to a couple of relatively small profit warnings. But things started to go really wrong in April 2015 after the company warned on profits again after several high value sales were not completed in time for the year end. This was followed up by another warning in October, the company blaming a slump in trading in Asia for further woes. Combined with an increase in debt taken on to finance acquisitions, the funding situation started to be stretched so a rescue equity financing of £13 million had to be completed in early 2016. This was at a price of just 10p per share, 97% lower than the shares were trading at just two years earlier. Adding to the perfect storm of events the company's auditors quit as they deemed the business to be too risky and the dividend was scrapped.

In a bid to turn around its fortunes Stanley Gibbons has undergone a number of changes, including a complete change of senior management

Est 1856 STANLEY GIBBONS

The Home of Stamp Collecting

and the implementation of a restructuring plan. Under the plan £10 million of annual cost reductions have been identified and debt is now starting to fall – down by £3.9 million over the six months to September 2016.The new management team believes that the company is finally approaching a turning point, with operating cost savings now visibly feeding through to day-to-day trading. The most recent statement to the market provided investors with a little cheer, the company announcing the sale of a strip of four Indian 10 rupee stamps featuring Ghandi for a record £500,000.

Stamp of approval

The markets are now valuing Stanley Gibbons shares at just 9.125p, only slightly higher than all time lows of 8.375p seen at the beginning of April. That capitalises the business at £16.33 million.

Looking at the most up to date balance sheet, net assets stood at £44.99 million as at 30th September 2016. Notable components of this were £59.38 million of stock and inventories, along with net debt of £16.5 million. Intangible assets were also significant at £19.46 million. **Stripping these out of the valuation then Stanley Gibbons has net tangible assets of £25.53 million – that's 56% higher than the current market cap.**

The majority of inventories (£40.1 million) comprise stamp stock. While the market for premium material is said to be strong, lower quality stock is slower to sell and usually retails at reduced prices. Nevertheless, gross margins standing at around 46% should give investors reasonable confidence that the inventories as a whole (at very least) will be able to be realised at the price they are valued at.

On balance, with things now seemingly settling down at Stanley Gibbons, the low valuation looks to provide an attractive entry point.

GRESHAM HOUSE STRATEGIC

Finally, we end with quasi-small cap fund **Gresham House Strategic (LON:GHS)**. The company as it is today came into being in October 2015 after AIM listed Spark Ventures changed its name following an earlier £14.4 million injection of new capital. This was completed alongside a change in investment strategy in partnership with specialist asset management group Gresham House – subsidiary Gresham House Asset Management is GSH's investment manager.

The new mandate focusses on what the company calls a Strategic Public Equity (SPE) strategy – in other words, applying private equity style techniques and due diligence to identity public companies which it thinks can deliver above market returns over the long-term. Not only that, GHS is an active investor, helping company management with developing and growing their businesses. GHS invests primarily in UK and European smaller public companies and is looking to put together a portfolio comprised of between 10-15 individual holdings.

Gresham House Strategic plc

Current portfolio

As at 30th September 2016 GHS had six main holdings within its investment portfolio. By far the largest was a £15 million stake in AIM listed mobile technology provider **IMImobile (LON:IMO)**. This represented 37.6%

"GHS IS AN ACTIVE INVESTOR, HELPING COMPANY MANAGEMENT WITH DEVELOPING AND GROWING THEIR BUSINESSES."

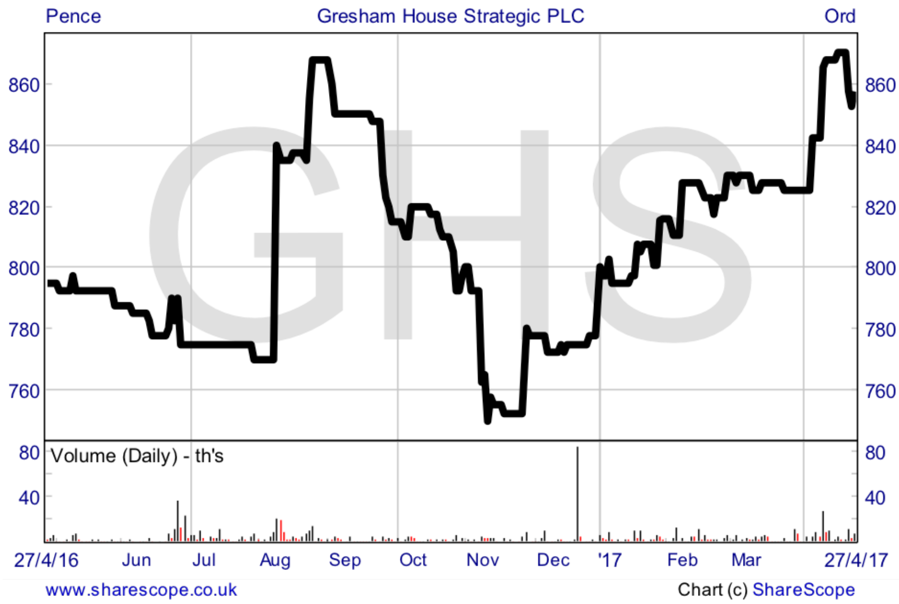
of GHS's total net assets and a 13.5% holding in the business. Other investee companies include the book publisher and distributer **Quarto Group (LON:QRT)**, specialist industrial equipment business **Northbridge Industrial Services (LON:NBI)**, fund manager **Miton Group (LON:MGR)** and digital marketing group **Be Heard (LON:BHRD)**. The smallest holding was in the advertising space seller **SpaceandPeople (LON:SPA)** and amounted to just £0.5 million.

Reflecting its focus on growth companies, Gresham calculated that its holdings (as at 30th Sept) had an attractive average forecast EBITDA growth rate of 22% for 2017 and an average free cashflow yield of 10.5%.

Since the period end GHS has invested in two additional companies – £1 million was committed to a convertible loan note in private company, **MJ Hudson**, an adviser and service provider to the alternative asset management industry; and £0.8 million was invested in **Warpaint London (LON:W7L)**, the global cosmetics brand which listed on AIM at the end of November 2016.

Hidden discounts galore

At the current share price of 857.5p investors have the opportunity to buy into Gresham House Strategic at a 21% discount to NAV per share of 1,082.05p as at 30th September 2016. But having analysed the figures in a bit more detail I believe that the underlying discount is actually a lot wider.



Firstly, GSH has a lot of cash on the balance sheet, with the investment manager having been cautious to invest it due to, paraphrasing its own words, uncertainty over Brexit and high valuations in the equity markets. If we strip net cash out of both sides of the P/B equation (reasonable to do so given cash's high liquidity) then we are left with an ex-cash market cap (or enterprise value) of £17.28 million and ex-cash net assets of £25.2 million. The "ex-cash" P/B ratio is thus 0.69, or a 31% discount to ex-cash NAV.

Secondly, investee companies on the whole have performed well since the last reported balance sheet date, which should have pushed up NAV even further. IMImobile is up 17.3% since 30th Sept, Northbridge 14.2%, Miton 23.8% and SpaceandPeople 3.3%, with shares

in Warpaint up from the IPO placing price of 97p to a current 203.5p. These gains have offset modest losses of 2.7% from Be Heard and 6.2% from Quarto.

Investors looking for modest income will also be happy with GHS, the company looking to distribute 50% of net profits on realisations at the end of its financial year. For 2017 a first dividend of 15p per share has been confirmed along with a share buyback programme, which together will total £864,573.

Overall, GHS provides an attractive opportunity to buy into a portfolio of risky growth stocks on the cheap.

Company	Value (£m)	% of NAV	% of company
IMImobile	£15.00	37.60%	13.50%
Be Heard Group	£2.70	6.80%	10.60%
Quarto Group	£2.50	6.30%	4.40%
Northbridge Industrial Services	£2.40	6.10%	10.90%
Miton Group	£2.10	5.20%	4.10%
SpaceandPeople	£0.50	1.10%	10.60%
Cash and other net assets	£14.70	36.90%	N/A
Net Asset Value	£39.90		

Gresham House Strategic net asset make up as at 30th September 2016

BY SAMUEL RAE

FORENSIC FOREX

THE FRENCH ELECTION AND THE EURO

As I write this, Marine Le Pen has just passed through to a run-off against the centrist candidate Emmanuel Macron in the French Presidential election. She's done so with 21.5% of the first round votes, falling short of Macron's 23.8%, but well clear of the 19.9% picked up by François Fillon and the 19.6% of Jean-Luc Mélenchon.

Common sense, in line with the seemingly prevailing opinion of mainstream news media, dictates that Macron should take the top spot come the second round vote on May 7. The argument that supports this suggestion is rooted in the likely rallying of the majority of those that voted for the candidates who came third and fourth, the aforementioned Fillon and Mélenchon respectively, behind Macron.

He's Euro-centric, pushing for what's being portrayed as a progressive agenda, rooted in climate change, commercial expansion, social acceptance – all that good stuff – and he's a natural second choice for many of the voters whose first place horse is no longer on the ticket.

In contrast, Le Pen is a nationalist, and if elected, has promised to start a sequence of events that could lead to France leaving the EU, or at very least rejecting the Euro as its national currency, and maintaining some of the national policies that many see as contributory factors towards the country's relative inability to compete commercially on a global scale – the 35-hour work week, mandatory retirement at age 60, and more. She'll also slash immigration, and strengthen the social safety net on which a large portion of the French working class relies heavily.

As mentioned, commentary suggests it's Macron's race to lose. If this is the case, there's no immediate concern for the Eurozone, and in turn, its flagship single currency.

But then, we've been here before a couple of times over the last twelve months, and both times, the mainstream commentary, on which many rely as informative to their economic decisions, has proven hopelessly inaccurate.

The facts that the UK is now well on its way to EU secession and that Donald Trump is at his desk in the Oval Office are illustrative of this inaccuracy.

The question I'm asking myself now, then, as regards how I should conduct my operations in the currency markets over the coming weeks and months, is this: What happens if Le Pen wins?

Sure, it's not easy to see a situation in which she might. There's credence to the suggestion that some of the less hard line voters in France will line up behind Macron – if not for the fact that they support his


NAPOLÉON BONAPARTE 1er CONSUL

policy, but simply because they don't want to see a National Front led government. It's also tough to imagine any of Macron's supporters shifting to Le Pen's camp.

That said, however, the assumption that Sanders supporters would shift to support Clinton in last year's US election was, while likely accurate on the whole, not enough to get Clinton past the post. There are also likely to be many hidden nationalist voters – just as there were in the US, despite mainstream media's insistence late in the election process that their numbers had been overstated. Sure, we're looking at voter numbers in France, as opposed to polls, but the potential still exists.

So, if we do see a President Le Pen, it's going to be catastrophic for the Euro.

That the UK has left the EU is potentially indicative of the union's weakening; but the UK never adopted the Euro, so much of this perceived weakness failed to filter through to global perceptions of the currency itself. If France threatens to leave – and that's a very plausible scenario if Le Pen gets into power – the Euro will not enjoy this relative insulation.

There's also the potential for the situation escalating via similar outcomes in other European nations. If the UK has left, and France leaves, how many Spaniards, or Italians, are going to start thinking that it might be in their own interests, and those of their respective nations, to follow suit? This potential amplifies if the UK gets a good deal out of the Brexit negotiations.

Frederic Legrand – COMEO / Shutterstock.com

Frederic Legrand – COMEO / Shutterstock.com

All said, things aren't looking good for the Euro right now, and haven't looked good for some time, but if Le Pen get's the presidency, things are going to get a whole lot worse, and quickly.

So getting back to the question – how does this impact my operations in the markets? Well, those familiar with my strategy will know I'm a technical trader – I let price signal my entries, and I manage my risk with predefined exits on either side of the trade. At the same time, however, I allow fundamentals to dictate my aggression – how much I'm willing to take on risk-wise, and for what level of reward.

Near term, and in line with this second aspect of my strategy (and how the current situation in France plays into it), then, I'm going to be far more aggressive on the bear side of a Euro trade than I am on the bullish one.

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BY DAVID JONES

CHART NAVIGATOR

USING SIMPLE CHARTING TO MANAGE RISK

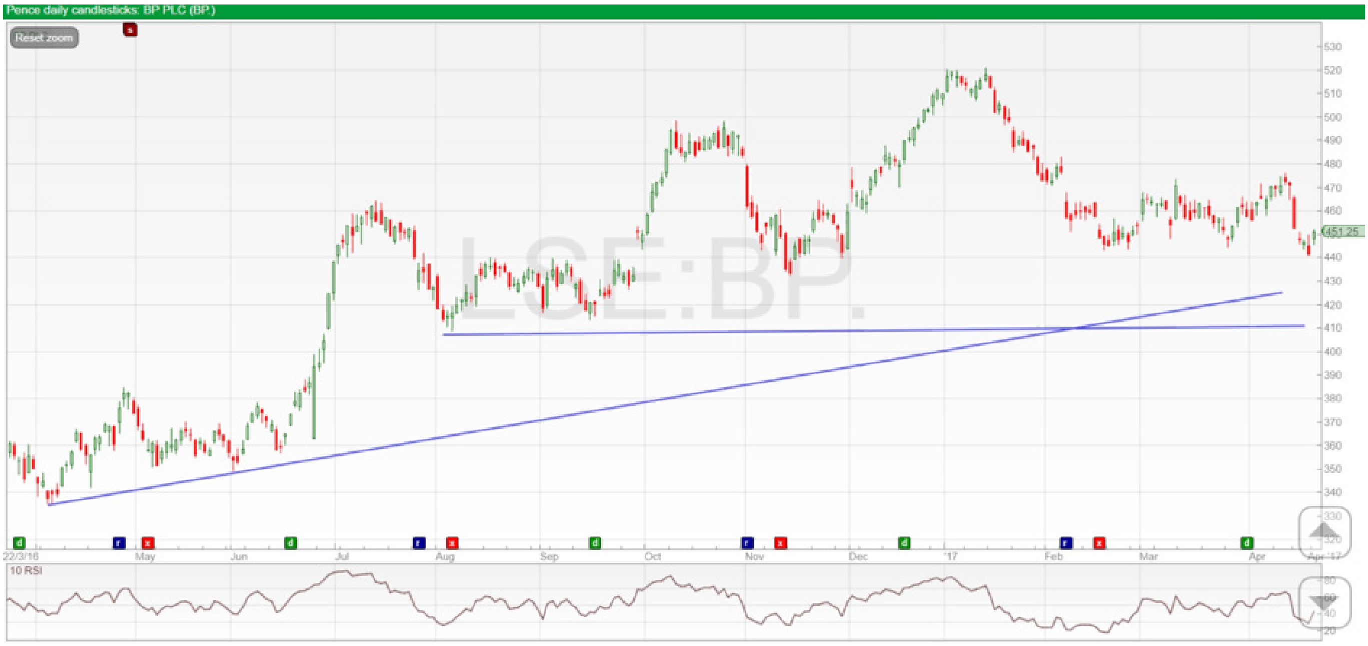
For this month I thought we would carry on with the theme of a practical, everyday use for charting - an approach that applies whether you are a medium to long term investor, or a shorter-term trader. Whilst technical analysis and charting can be an interesting intellectual or academic diversion for some, with discussion back and forth about what works or doesn't, I have always preferred to use it to try to figure out ways to make money - or, even more usefully, how to get out with a small manageable loss when things do not pan out quite as expected.

Using it this way does not have to be complex and can help reduce one of the major problems that investors and traders encounter - when to cut losses, throw in the towel and look for other opportunities. How many times have you looked at your portfolio of shares and thought "if only I had got rid of a couple of the underperforming dogs quicker, my return would have been so much better"? This is even more of a problem in the world of short-term trading - whether on indices, foreign exchange, commodities or something else. It's a well-known fact that more than 70% of retail traders lose money - and a big part of this can be the "head in the sand" approach to not facing up to losing trades quick enough. A simple charting approach to risk can definitely help with this.

> **"HOW MANY TIMES HAVE YOU LOOKED AT YOUR PORTFOLIO OF SHARES AND THOUGHT 'IF ONLY I HAD GOT RID OF A COUPLE OF THE UNDERPERFORMING DOGS QUICKER, MY RETURN WOULD HAVE BEEN SO MUCH BETTER'?"**

It's all about watching "price action" which is a term that gets bandied around quite a bit and can sound quite a fancy approach to trading and investing, but it is actually simplicity itself. It's all about the market giving you clues as to where it is probably going to head to next - and when an idea you have had may have gone wrong. For example, if a market hits a low then rallies, you may decide that this is the base of a major decline and it is time to buy in before it recovers. Perhaps you end up calling this right, and the market rallies - well done you! But let's say it turns out differently - after a small blip higher the market turns back down and slips below that old low, setting even lower prices. You

"IN THE SAME WAY THAT BREAKS BELOW PREVIOUS LOWS CAN BE A WARNING OF FURTHER WEAKNESS TO COME, BREAKS THROUGH PREVIOUS MAJOR HIGHS - REFERRED TO IN THE JARGON AS 'RESISTANCE' - CAN ALSO SUGGEST A SHIFT IN SENTIMENT AND POINT TO THE START OF MORE GAINS."



may still want to hang on in there but clearly your timing is out - perhaps it is time to take a manageable loss?

To illustrate this principle I thought I would use an example of a share I have recently bought - the oil giant BP. Here's the chart:

There were a couple of reasons I thought this was worthy of my hard-earned cash. First of all the yield is attractive, and I also feel that the price of oil could well recover further ground this year. But the main reasons are based off the chart and what the price has been doing. For the past 12 months or so the price has been trending higher - and we all know the chartist mantra is "the trend is your friend". I viewed the sell-off from the beginning of the year as an opportunity to jump on board this trend. But also, look where any share price weakness has stopped since August. Whenever BP has slid back to the 410/430p area, market sentiment has changed. The share price has been viewed as too cheap at these levels and offering value down here to investors. For those familiar with the jargon this is known as an area of "support" - an area below the current market price where sentiment changed.

So I have a definite price band to use as a reference when it comes to thinking about a stop loss. If I am buying around the 450p mark because I feel the price has been undervalued, then it really should not go sailing through this 410/430p zone. If it does then it starts to look like something has changed, my timing is off and the better decision may be to take a loss of around 10% or so and move onto fresh opportunities.

You see these sort of turning zones on all sorts of charts of course - short, medium and long term. For the trading fans out there, let's take a look at a short-term chart from the third week of April for the US S&P500 index - a very popular market with day traders.

What we are looking at here are hourly candlesticks - each of the colour can-

dles represents an hour's worth of trading for the S&P500. The coloured zones on the chart denote separate days, starting with Monday's trade at the far left of the chart. We can see the market rallied on Monday and then the next day had a small pullback, trading as low as 2334 around 5pm UK time before turning around and finding some strength into the last half of the session.

But the next day is the interesting one and where our short-term entry point occurred. After starting strong the market lost some ground - markets of course don't move in a straight line. But where does the weakness stop? The circle on the chart highlights the low for Wednesday which was within a point or so of Tuesday's low. A zone where sentiment had changed the day before proved to be an important area yet again the next day.

There's no witchcraft in this of course. Markets are made up of buyers and sellers and plenty of people will be aware of where the major turning points have been over all sorts of time frames. But for the shorter term trader, if the trader was a buyer of the S&P based on this chart, this level was a logical place to set any stop-losses beyond. If our trader was betting that the upward trend was going to continue, a move below that previous day's low may have questioned that outlook.

I should stress that this is not the "well-chosen example", found by scouring tens of markets over the past few years. It's from one of the world's most popular traded markets and it was from the current week at the time of writing. It's not an approach that works all the time - these levels do break of course, otherwise markets would just trade in endless sideways ranges, and you will get stopped out of investments or trades only to see the market go the way you always thought it would. But when it comes to choosing where to set stop-losses and taking those manageable losses, I think this idea of major turning points is hard to beat.

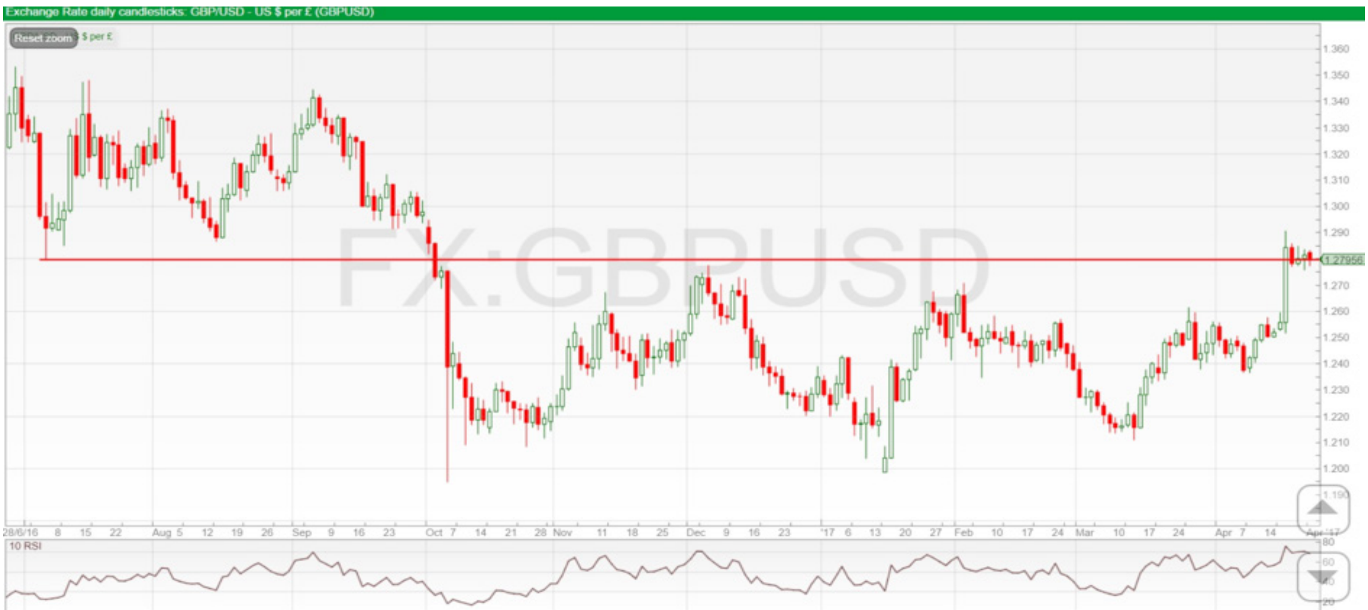
Of course, I still have to see how things will turn out for my BP investment. At the moment it is trading around where I bought it, so one to watch for me in the months ahead. But another interesting market for all of us - and one that broke a major level last week is the pound/US Dollar exchange rate (GBP/USD). As has often been the case for our home currency, the moves over the past 12 months have been dictated more by political mutterings and events rather than any economic influences. The shock announcement from Prime Minister Theresa May really put a rocket under the value of sterling - here's the chart.

The horizontal red line on the chart is at the 1.2800 level for GBPUSD. It had been something of an important base post the EU Referendum vote - but then it broke. Since then it had been a barrier - a line in the sand where rallies for the pound would run out of steam. But all this changed on the announcement of a June General Election.

"WHEN IT COMES TO CHOOSING WHERE TO SET STOP-LOSSES AND TAKING THOSE MANAGEABLE LOSSES, I THINK THIS IDEA OF MAJOR TURNING POINTS IS HARD TO BEAT."

GBPUSD broke though this level hitting a six month-plus high. In the same way that breaks below previous lows can be a warning of further weakness to come, breaks through previous major highs - referred to in the jargon as "resistance" - can also suggest a shift in sentiment and point to the start of more gains. The jury is still out - it is early days for this break after all - but it is an interesting one to watch to see if the pound can recover more of the ground lost since last June.

Hopefully all of these different examples - various markets over all sorts of time frames - demonstrate a few things. Even for the most sceptical, charts can add some input whether as an investor or a shorter term trader. It's not an approach that works all the time, but looking at major levels on the chart can help keep our egos in check when it comes to admitting that maybe a decision was a wrong one. We can get out with the manageable loss, and live to trade or invest another day.



BY ALAN STEEL

DEATH & TAXES

CAPITAL PUNISHMENT

Last month I mentioned Professor Parkinson's take on our tax system... "It's designed to tax income when you're living and capital when you die". This time round let's look at what happens when we exit this mortal coil. On what has been called "Capital Punishment".... taxing wealth you managed to accrue despite the best efforts of HMRC over the years.

A couple of quotes I came across again reminded me of what happened when, as an IFA (since January 1973), folks would come along looking for advice on their finances. Most of them just wanted to consider the short term. "How do I get better returns now? How do I beat inflation (which hit 26% year on year in 1975/76)? How do I pay less tax?" Always short term. The long term was, well, far too far away to bother about and frankly was for another day.

Urgent or important?

So what's Urgent and what's Important? Is there a difference? Former US President Dwight D. Eisenhower wasn't in any doubt. He said: "I have two kinds of problems: the urgent and the important. The urgent though are not important, and the important are never urgent". American author Rick Warren agreed, adding "The number one problem in our society today is short-term thinking". And that's the problem for wealth builders today, no matter their age. Investors still focus on what appears to be urgent or short term. They get sucked into must-have investment opportunities, or react to revolving headline worries, instead of focusing on what's important. For the avoidance of doubt, that's long-term goals and protecting themselves and their families against dying too soon or living too long – proactivity as opposed to knee-jerk reactivity.

There's plenty written about what happens when you live too long and haven't focussed on the important. Both here and in the US there's hardly a week that goes by without one report or other discovering that far too many of us have hardly a bean to rub together when we reach retirement.

A study in the Wall Street Journal recently surveyed would-be baby boomer retirees asking what kept them awake at night. As you'd imagine for this age cohort (and I can confirm), sadly it's not what it used to be. Approaching retirement their sleepless nights were down to either money worries (48%) or health concerns (42%). However, while Jim Mellon so eloquently reminds us that science continues to make progress with rapid advances in healthcare leading to increased longevity, it's difficult, if not impossible, to make improvements to your wealth when you've already long missed the boat.

All this suggests that unless we start thinking soon about what's really important, most of us will fall well short of a decent retirement income. So if I were you I'd have a good think about that today if it hasn't yet occurred to you. Chasing the next small-cap ten-bagger or panicking at each headline "worry" should be filed away under "looks urgent but not really important".

"ACCORDING TO JEAN-BAPTISTE COLBERT (1619 TO 1683), LOUIS XIV'S PRECOCIOUS FINANCE MINISTER, THE ART OF TAXATION 'CONSISTS OF PLUCKING THE GOOSE SO AS TO OBTAIN THE MOST FEATHERS WITH THE LEAST HISSING'."

The "art" of taxation

According to Jean-Baptiste Colbert (1619 to 1683), Louis XIV's precocious finance minister, the art of taxation "consists of plucking the goose so as to obtain the most feathers with the least hissing". Let's also remember what US founding father Benjamin Franklin said over 200 years ago: "Nothing is more certain than death and taxes". It's still the case today. And as we live much longer on average these days, it's even more important to consider taxation as it's far more complex than in Franklin's day. Never mind Brexit – what about your own exit?

The UK Tax code today is 17 times the length of War and Peace and equally impenetrable. At 10 million words it's 66 times the length of Hong Kong's tax code, according to bean counters at Artemis. And a significant proportion of that complexity is to scoop up even more tax from us when we exit this mortal coil.

> **"IF YOU DIE WITHOUT A WILL YOU'RE LEAVING ONE HELL OF A MESS FOR YOUR FAMILY."**

Tax on death has been around formally in the UK since 1894. Prior to 1975 it was called Estate Duty, more popularly known as Death Duties (though not popular with families short-changed by it no doubt). It was a nasty tax because it taxed the deaths of both husband and wife. That stopped fortunately when it was replaced by Capital Transfer Tax, but the top rate of that tax was 75%. So the next time you moan about Inheritance Tax (IHT) (which appeared in 1986) be thankful it's a flat 40%.

Because we don't pay attention to what's important, because we've "plenty of time to think about" our exit, and because IHT triggers on the second death of spouses and civil partners, and penalises heterosexual couples plus those not bothering with a will, IHT tax receipts are exploding. Last year HMRC pocketed £4.9 billion, up 150% from only 15 years ago.

Where there's a will there's a way

So first up, get a will written. It's astonishing how many intelligent and wealthy folk still don't have a will. Or if they do they haven't bothered to update it for years. And as mentioned above, heterosexual couples with a few bob are especially vulnerable to IHT thanks to far fewer reliefs and rights.

Even billionaires have been known to assume it's not important to get a suitable will drawn up. Twenty seven years ago Australia's richest man Robert Holmes died of a heart attack aged 53. He'd allegedly carried around in his briefcase for a year a draft will which he never got round to signing. He died intestate leaving tax authorities, advisers, his wife and four kids to fight over the spoils. His profession? He was a lawyer!

My tax colleagues tell me surveys still show that between a third and forty per cent of folk die intestate. Lawyers are among the worst, I'm told. That's something up here in Scotland we call "Cobbler's Bairns". Some years ago at an Investment Trust dinner I shared a table with Scotland's great and good. From a table of ten only one admitted to having a will. (It was a fairly boring occasion so the discussion on death sprung up as some light relief.)

Regardless of whether it's Scots or English law, if you die without a will you're leaving one hell of a mess for your family – long delays, unwelcome complications and most probably a tax bill that would have you turning in your grave. Dying intestate and without any sensibly thought-out plan is like running through a dynamite factory with a burning match.

So do yourself a favour. Go get advice. Get that will put in place now. And make bloody sure there are no horrible surprises for those left behind. Make sure there's access to funds for those left behind carrying the can. If you don't like the idea of much of your hard earned wealth being grabbed by HMRC: do something about it. Simple and cheap life assurance in trust is

uniquely effective at providing liquidity and avoiding IHT.

Any idea what it's like to be left behind with an estate locked up for a year or more? It gets even worse if HMRC reckon there's an IHT bill to pay. And if the next government brings in the stiff increased charges for probate there's another bill to pay. This is all important and urgent stuff to address. Stop kidding yourself, start today.

Got extra to give away now?

In the good old days (before 2006) if you wanted to give away to the next generations while keeping control it was customary to use trusts. This was not the typical discussion subject at dinner, but trusts were pretty effective at reducing tax. Alas, not any more thanks to Gordon Brown and George Osborne.

Those who specialised in setting trusts up and looking after their compliance requirements may not like it, but with top rates of income and capital taxes applying these days, setting up new trusts to give assets away to the following generations is back to running through the dynamite factory with a lit match. Not a good idea.

As Brexit approaches, however, it may make sense to learn a tax efficient lesson from our European cousins (who have no trust legislation) in how they've coped with transferring wealth to the next generations with some control.

As hinted above, in the UK such transfers have worked in the past through legal structures such as "Accumulation and Maintenance Trusts". Not any more – unless you're happy to watch HMRC pocketing even bigger slices of the kitty.

Who wants to see children or grandchildren get unlimited access to your money when they're young? In the old days even having access at age 25 for some was too early, dangerous even. But changes to trust laws mean that to avoid extra taxes they would have full access at age 18. Sound like the dynamite factory again? So does Europe offer escape?

Brexit and tax planning

Inheritance planning is big business in Germany, Spain and Italy in particular, where wealthy investors are just as keen to pass wealth on to future generations to avoid capital taxes on death. Not hidebound by the inflexibility, tax inefficiency and high costs associated with UK trusts, it's no surprise their alternative solution is attractive. What may come as a surprise to UK residents is that these flexible and efficient plans (based on mainstream insurance regulations) have been available to them under EU cross-border rules. And there's every chance they will continue to be attractive long after Brexit.

What are these little known plans? One we have used for a few years now very successfully is "The Accumulation and Maintenance" plan marketed by Luxembourg based wealth management group Lombard International Assurance, who are subject to the strongest investor protection regime in Europe. It has almost £78 billion under management and is probably the leading product innovator in European inheritance planning.

Avoiding the constraints now imposed on UK trusts, it uses life assurance law instead to provide a simple tax-efficient solution to anyone in the EU who plans to gift wealth to the next generations. The gift is still a Potentially Exempt Transfer, and it lets you, the donor, choose the age that the inheritance passes to them with no age or time limit. So control is maintained. Income rights can be passed on too.

So, for example, funds can be gifted using the plan to provide a "legacy" pension for them at, say, 55 or later to assist their retirement income. Or a number can be set up in sequence with an aim to cover house deposits, marriage, retirement and so on.

Such plans make clever use of insurance law. Which brings us back to Brexit. In the UK a contract's taxation follows its legal status. This means if a single investment life policy of a UK resident client of Lombard is legally regarded by the UK Government, no distinction is made between EU or non-EU insurers. So the taxation of the policy (and benefits) will not be adversely affected in future even if it originated in the EU, as in the case of the Lombard solution.

Thanks to the Luxembourg base the plan rolls up free of Capital Gains Tax, so the underlying investments – a wide range of collective funds – can by managed without UK trust CGT constraints, and there's only internal withholding taxes on reinvested income, not top rate UK income tax.

It is regarded that this simple tax & IHT effective gift alternative using straightforward insurance contract laws will continue to be valid long after Brexit comes along, whenever that is, now we have another election on the way.

"I Love EU" sang the Super Furry Animals (I'm assured by a younger friend). Even the most fervent Brexiteer will surely love the simplicity of this EU inheritance planning tool both pre and post Brexit!

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.

This is the personal view of Alan and is not advice. Readers should take personalised independent advice on such matters.

BY FILIPE R. COSTA

HOW TO INVEST LIKE...

WALTER SCHLOSS

I'm not very good on timing. In fact, I've stayed away from it. I think it makes life easier – people come to me and say, "Well, what do you think the market's going to do?" And I always say, "I've got no idea; your guess is as good as mine"

— Walter Schloss
"The Right Stuff", Barron's, 1985

Small is bigger

Over the last 100 years, some investors became legendary because of their consistent record of beating the market. A few of them are well known, not only because of their performance but also because of the coverage the media gave them. But there are quite a few others that are less well known, either because the media didn't pick them up or just because they tried hard to keep a low profile during their investment life. But many of them are legendary as well, in the sense that they proved it is possible to consistently beat the market and left an important legacy for investors.

The success of Warren Buffett (issue 14 – May 2016), Peter Lynch (issue 15 – June 2016), and Ben Graham (issue 13 – April 2016) is certainly undisputed. Through accumulating astounding profits during their careers, these investors proved how wrong business schools were about the rationality paradigm. But there are other investors that shined as well, but who remained relatively sidelined. That was the case of Walter Schloss, a direct disciple of Ben Graham, who consistently beat the market for more than 40 years, delivering huge profits to investors, but always hiding from the media.

"FOR SCHLOSS, INVESTMENT WAS ALWAYS A SOLITARY ACTIVITY, WHERE A PASSIVE STRATEGY OF DIGGING THROUGH THE NUMBERS WAS THE CORE FOUNDATION, AND REMAINING RELATIVELY UNKNOWN WAS A MATERIAL BENEFIT."

While many fund managers today adopt a very active attitude towards investment – meeting with management at the companies they invest in, sending timed letters to partners and holding press conferences to discuss their most recent trades – for Schloss, investment was always a solitary activity, where a passive strategy of digging through the numbers was the core foundation, and remaining relatively unknown was a material benefit.

"AMONG THOSE WHO KNEW HIM, WALTER SCHLOSS GAINED A REPUTATION AS ONE OF THE BEST VALUE INVESTORS IN THE BUSINESS."

Targeted learning

> **"WHILE IN TODAY'S WORLD A COLLEGE DEGREE SEEMS INDISPENSABLE FOR ALMOST EVERYTHING, NOT HOLDING ONE MAY HAVE SAVED SCHLOSS, AS BUFFETT ONCE EXPLAINED."**

Among those who knew him, Walter Schloss gained a reputation as one of the best value-investors in the business. Warren Buffett met Schloss early in his life and was his friend for more than 60 years. Upon Schloss' death, Buffett said that Schloss *"had an extraordinary investment record, but even more important, he set an example for integrity in investment management. Walter never made a dime off of his investors unless they themselves made significant money. He charged no fixed fee at all and merely shared in their profits. His fiduciary sense was every bit the equal of his investment skills."*

Unlike many other investors, Schloss never went to college. He also didn't start his career at the best of times. At the age of 18, in 1934, he went to Wall Street looking for a job. With the Great Depression still a recent memory, his mother was heavily criticised for allowing his son to start a career on something that would soon cease to exist, people believed. But, as is always the case, talk of the stock market's demise was greatly exaggerated, and Schloss made his way through the ranks and managed to learn investment from the best of the best.

In 1934, Schloss got a job as a runner at Carl M. Loeb & Co. (now defunct as part of Lehman Brothers), delivering securities by hand to the various brokers on Wall Street. He was soon promoted to the cashiers department and one year after that tried his luck in the securities department. By then, still a young boy with no college education, he was denied a job by Armand Erpf, a partner at Loeb & Co. But Erpf recommended Schloss read "*Security Analysis*", a book written by Ben Graham and David Dodd, which he believed contained everything needed for someone to become a good investor. The now legendary book was a novelty at the time, establishing the key principles behind value investing. Schloss followed Erpf's recommendation and additionally attended two investment courses on the New York Stock Exchange Institute, paid for by his company. These courses proved more valuable than any college degree, as they were taught by the father of value investing, Ben Graham.

Schloss spent four years of his life fighting in World War II, from which he escaped alive by pure chance. But a life-changing event was waiting for him. After coming back, he was contacted by Graham who invited him to work at the Graham-Newton partnership. Schloss accepted the offer and remained at the partnership between 1946 and 1955, learning everything Graham knew about value investing in a very rigorous way. For Graham, before anything, investment was about not losing money.

Graham's strategy is rooted in buying value with a margin of safety to protect against downside risk. This margin of safety has always been his brand name, mainly as a result of the rough time he had during the Great Depression. Schloss learned this lesson in full, and was a follower of Graham in the purest sense.

In 1955, Graham was bored (as Schloss puts it) and retired. Packed with the knowledge accumulated along the years, Schloss opened his own shop, which he kept open until 2003. The partnership was launched with just $100,000 from 20 associates (equivalent to around $890,000 today, which is still a very tiny sum by industry standards). In 1973, his son joined and the partnership became known as Walter and Edwin Schloss Associates. Unlike many funds today which impose a 2-20 fee schedule on investors, Schloss had no fee on assets and was earning 25% from realised profits.

Beating the market consistently

While in today's world a college degree seems indispensable for almost everything, not holding one may

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have saved Schloss, as Buffett once explained. Many years ago students started being taught about the rationality of market participants and how that notion supports the efficient market hypothesis. Under the EMH, Investors are supposed to digest all available material information and take the best possible rational action at all times, which by definition is never influenced by emotions. Everything is priced in at all times and there is no way of consistently beating the market. Any above-average performance would be the result of pure chance. Such a paradigm is still present in today's world and is often prevalent at business schools. But Graham, Buffett and Schloss constitute invaluable evidence against it, such is the consistency of their long performance records.

Over the period between 1956 and the first quarter of 1984 (just over 28 years), for which there is a detailed track record, Schloss' performance hit an astounding annual compound rate of 21.3%, which compares with the 8.4% achieved by the broad S&P market. It is rather unlikely that chance alone could drive such outperformance.

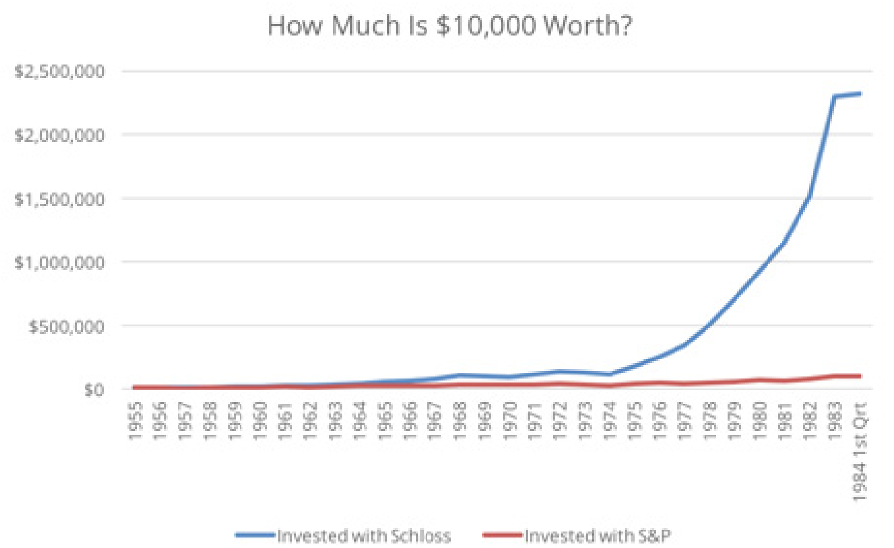
Walter Schloss Partnership Vs S&P (Annual Return Percentage)

Year	Walter Schloss	S&P
1956	6.8	7.5
1957	-4.7	-10.5
1958	54.6	42.1
1959	23.3	12.7
1960	9.3	-1.6
1961	28.8	26.4
1962	11.1	-10.2
1963	20.1	23.3
1964	22.8	16.5
1965	35.7	13.1
1966	0.7	-10.4
1967	34.4	26.8
1968	35.5	10.6
1969	-9.0	-7.5
1970	-8.2	2.4
1971	28.3	14.9
1972	15.5	19.8
1973	-8.0	-14.8
1974	-6.2	-26.6
1975	52.2	36.9
1976	39.2	22.4
1977	34.4	-8.6
1978	48.8	7.0
1979	39.7	17.6
1980	31.1	32.1
1981	24.5	-6.7
1982	32.1	20.2
1983	51.2	22.8
1984 1st Qrt	1.1	-2.3
Average Compounded Returns	**21.3**	**8.4**

Source: *"The Superinvestors of Graham-and-Doddsville"*

emin.kuliyev / Shutterstock.com

> **"THE AVERAGE ANNUAL COMPOUND RETURN SCHLOSS ACHIEVED BETWEEN 1955 AND 2000 WAS 15.7%, WHICH OUTPACES THE 11.2% FOR THE S&P 500."**



Over the period, Schloss' annual performance was 2.54 times greater than the overall market performance. Due to the *magical* effects of compounding, this number turns into an accumulated amount 23.66 times bigger over 28 years. Someone investing $10,000 with the S&P 500 at the beginning of 1956 would have $98,120 at the end of the first quarter of 1984. The same amount invested with Schloss would have been turned into $2,321,078.

While there is no detailed performance record for the whole investment period, the average annual compound return Schloss achieved between 1955 and 2000 was 15.7%, which outpaces the 11.2% for the S&P 500.

Disassembling the strategy

Schloss' strategy is strongly rooted in Graham's, centred on the goal of finding good value while taking almost no risk. Unlike Buffett, for example, who likes to hold a more targeted portfolio, Schloss always kept a very well diversified portfolio of at least 100 stocks. He was terrified of the possibility of losing partners' money and took his risk minimisation to the extreme. Interestingly, and unlike many other investors (including Buffett), the game was always played from inside his office. To remain as unbiased as possible, Schloss never paid visits to corporate managers, because he believed everything was in the numbers. Not that he thought management unimportant; in fact, Schloss always tried to purchase stakes in companies where management had a good reputation and where management was involved by owning substantial stock. But when figuring out intrinsic value, the most important factor was always the numbers crunched into the financial statements.

Schloss always avoided buying anything based on earnings because of the difficulty in properly guessing such a volatile figure and because, even if he could do it, the market was always changing its views on earnings multiples. Buying companies with real assets and with virtually no debt was Schloss' main game, as these companies tended to be unloved by the market and provided a margin of safety in case of liquidation.

Once, in an interview, Schloss tried to summarise the main points behind his strategy in 16 rules he believed investors should follow. These rules are described below:

1) It's all about price

Price is always the most important factor, as it is against this that intrinsic value is compared. Value comes from the difference between price and intrinsic value.

2) Try to establish the value of the company

A share of stock represents a part of a business rather than being just a piece of paper. Investors should try to establish the value of that business.

3) Start with book value

Value investors should protect themselves against unfavourable declines in price. In focusing on book value, investors are looking at how much a company would be worth in case of liquida-

Songquan Deng / Shutterstock.com

tion. Investors need to determine how much is left to equity after debt is paid.

4) Have patience

As David Dreman used to say, "*patience is a crucial but rare investment commodity*". A value investor usually opposes the market, in the sense that the market sometimes acts irrationally with regard to prices. It then needs time for prices to converge to their rational levels.

5) Don't buy on tips and don't sell on bad news

Value investing is about hard work to find value. Tips just represent market views and lead to the classic herds that don't drive consistent profits over time. Bad news is just a good time to buy undervalued businesses and not a time for panic selling.

6) Don't be afraid to be a loner

Value investing often assumes the form of contrarian investing, in the sense that it opposes the herd and tends to lead to the purchase of unloved companies. In that sense, it rarely finds a broad consensus in the market. But the main point is not to imitate what others do but to concentrate on making educated judgements.

7) Follow your convictions

After making a decision that comes from a thorough analysis, investors should stick to the main conviction, unless something material changes.

8) Follow an investment philosophy and stick to it

While finding value is always crucial, there are several ways of investing. Buffett and Schloss are both Graham's disciples, but they differ in the adopted strategies.

9) Don't hurry to sell

What should command the decision to sell is the re-evaluation of the position of price relative to intrinsic value and not the percentage by which a security rose in the meantime.

10) Buy near the low of the past few years

This rule comes from Schloss' loss aversion (which is rooted in Graham's). While appearing somewhat restrictive, it acts as another layer of protection. We could also justify this with what we know from behavioural finance today. Let's say two equally undervalued stocks trade at $50, but one of them is at a five-year low while the other has traded at $20 two years ago. While rationally, they should be equal, humans suffer from an anchoring bias, often relying too heavily on some explicit piece of information. In a bear market, it would appear that the stock that traded at $20 recently had more scope to decline. Avoiding this gives extra downside protection.

11) Buy assets at a discount, not earnings

The focus of Schloss and Graham was never on earnings but rather on assets. Schloss believes that earnings can change dramatically from period to period, while assets change slowly. Much more info is needed to estimate future earnings than assets.

12) While you may listen to suggestions from people you respect, the decision always comes from you

There is nothing wrong with collecting respected opinions, but investors should keep in mind that if money is lost it is theirs. The final decision should be taken by investors themselves, after considering every bit of information.

13) Avoid emotions, in particular fear and greed

Investors should disconnect themselves from the market to take the most rational decisions.

14) Remember the rule of 72

This rule represents the time needed to double the money invested. When dividing 72 by the annual percentage return, investors get a rough approximation of the number of years needed to double their money.

15) Prefer stocks over bonds

Bonds will limit the gains and inflation will reduce the purchasing power of money. David Dreman explains this very well in his book "*Contrarian Investment Strategies*".

16) Be careful of leverage

Leverage is a double-edge sword. It boosts losses as well as gains.

A superinvestor of Graham-and-Doddsville

While less well known that many of the best investors, Schloss, who died in 2012 at the age of 95, deserves a special place in the value investing framework because of the performance he achieved and, in particular because he has been one of the most faithful disciples of Ben Graham. As Buffett exclaimed at the time of the 50th anniversary of the book "Security Analysis", Schloss is a "*superinvestor of Graham-and-Doddsville*" with a great sense of fiduciary duty and investment skills. Schloss' investment life serves as another piece of evidence that markets are not fully rational and that it is possible to achieve consistent market-beating returns by following a tight strategy of picking unloved, undervalued stocks. At the same time, he proved that it is possible to deploy a sound investment strategy by just following the numbers without any need to network or contact management.

APRIL 2017

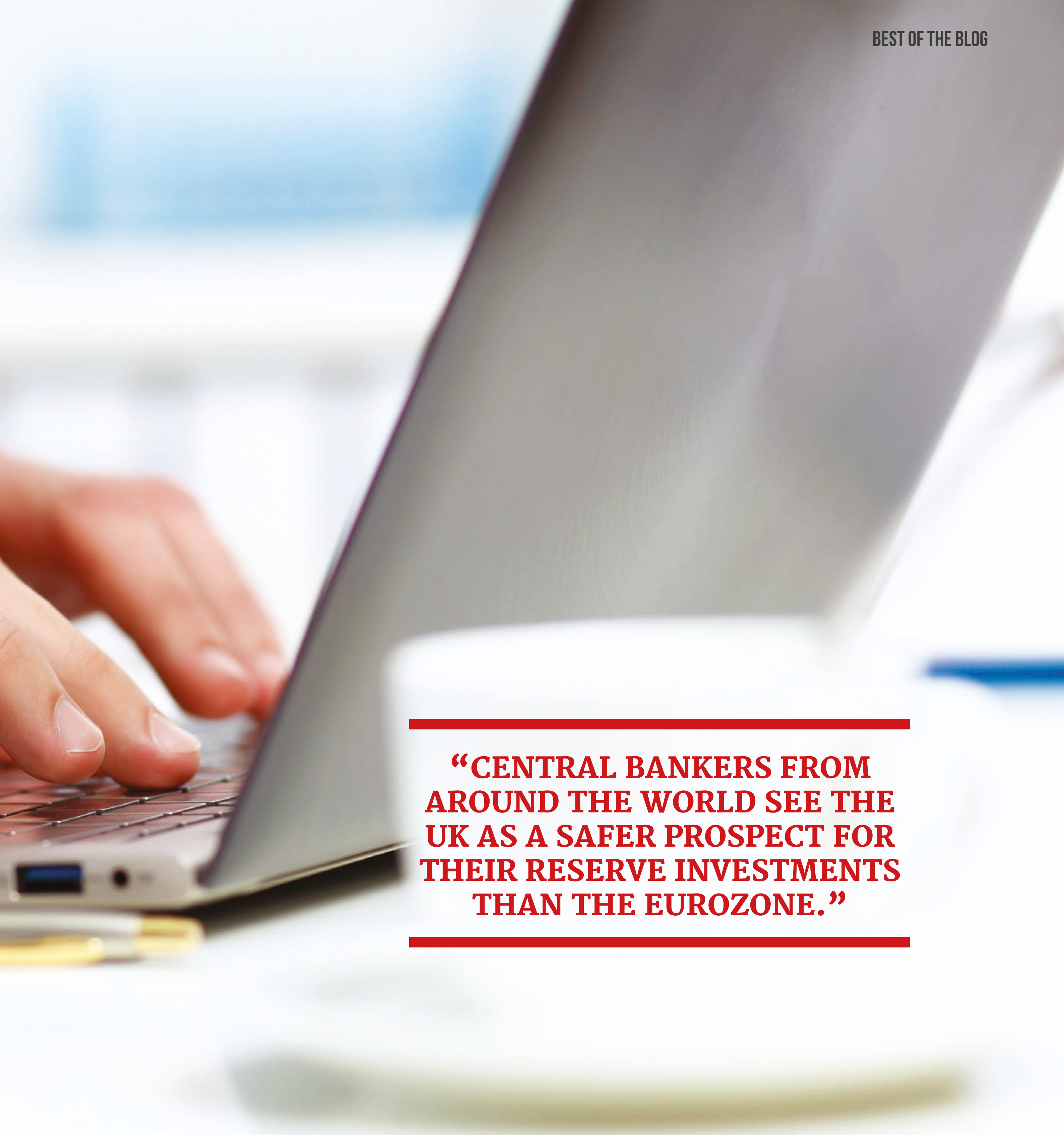
BEST OF THE BLOG

Where will sterling go from here?

At the Master Investor Show in London on 25 March, which many of my readers will have attended, one question came up again and again to the various luminaries gathered to dispense their insights and knowledge. *Where do you foresee Sterling going?* Overall, most of the assembled experts, including my friend Evil Knievel, were Sterling bulls.

I think they are right. Basically, all of the bad news and uncertainty around Brexit and the two years of tedious negotiations ahead of us have already been priced into the current value of Sterling (US$1.25 and €1.18 as I write); while a steady flow of positive economic data offers good potential on the upside. I am going to stick my neck out here and predict that Sterling will trend towards US$1.30 and €1.25 by the end of this year. (I am assuming that the US$-Euro rate will remain substantially stable). Here's why.

On 02 April the *Financial Times* reported that 80 of the world's central banks are dumping Eu-



> **"CENTRAL BANKERS FROM AROUND THE WORLD SEE THE UK AS A SAFER PROSPECT FOR THEIR RESERVE INVESTMENTS THAN THE EUROZONE."**

ros amid concerns over political instability, the rise of "populist" political parties, weak growth and the European Central Bank's negative interest rate policy. And they are buying Sterling as a long-term, stable alternative.

Despite the Brexit furore formally set in motion by Prime Minister Theresa May on 29 March, central bankers from around the world see the UK as a safer prospect for their reserve investments than the Eurozone. This was according to a survey of reserve managers at 80 central banks, who together are responsible for investments worth almost €6 trillion. The results, compiled by trade publication *Central Banking Publications* and HSBC show that many central banks have cut their cash and investment exposures to the Euro substantially....

By Victor Hill

Click here to read the full article

How management change has made Tesco a star buy

Less than three years ago, Tesco (LON:TSCO) was in dire straits. It had recently announced a possible overstatement of profits, its sales growth was negative and its outlook was downbeat. Fast forward to today and the company's potential for rising profitability as well as an increasing share price is high.

The catalyst for this revolution is the company's CEO, Dave Lewis, and the rest of its management team. Although a relative unknown when he took the job in September 2014, he has had a huge influence on the company's fortunes. He and his team have made the business smaller, simpler and provided a clear sense of identity for a company which was becoming lost in its pursuit of conglomerate-like status.

The speed of change at Tesco has probably surprised most investors. However, it shows the difference which can be made by having the right management team in place. In my view, a company's reputation, balance sheet strength and economic moat count for little unless the right team is in place to manage it.

"THE SPEED OF CHANGE AT TESCO HAS PROBABLY SURPRISED MOST INVESTORS."

Prior to the arrival of Dave Lewis as CEO, Tesco had become a jack-of-all-trades and, arguably, a master of none. It had diversified into a number of frivolous sectors which ultimately sapped management time and investment capital away from the majority of its business. For example, it sought to become a major player in the USA grocery industry via its Fresh & Easy brand. While it was at times able to post strong LFL sales growth, high profitability proved elusive despite significant investment....

By Robert Stephens, CFA

Click here to read the full article

Is there any upside in oil?

Far from memory is the time when Saudi Arabia and OPEC were in control of global oil prices, as are oil prices above $100. A nascent fracking industry in the US, deteriorating social conditions in some oil producing countries and a desire in Saudi Arabia to retain market acted like an explosive mix that changed the fundamentals of the market. If OPEC still has the ability to put a floor on prices, the US fracking industry has the ability to put a ceiling on them.

Every time prices go down significantly, OPEC cuts production. But, at the other extreme, every time oil prices start rising, the fracking industry starts adding output and thus limits upside price potential. With the fracking industry having been able to decrease breakeven prices, the upside limit on oil prices will be ever lower. For this reason, I'm not bullish long term on oil. The fundamentals behind the supply side are concerning and demand has also been struggling to grow. Part of that demand may be permanently lost to alternative energies. But in the short term, things may be a little different.

The last 8-10 years have been interesting in terms of price action in oil markets. In July 2009, oil hit a record high of $146. Back then everyone was bullish on the commodity, with supply seen as being unable to meet demand. But the financial turmoil quickly proved that what goes up must go down, and just a few months later oil was trading as low as at $36. With OPEC unable to react to the heavy reduction in global demand incurred through financial collapse, prices adjusted rather quickly. But later, after some output adjustments, oil prices started to recover, hitting the $100 level again by January 2011, and then moving sideways until October 2014. But if losses taken during the financial crisis were easily reverted, that

was not the case during the 2014 crash that smashed oil prices down to $28 per barrel. In January 2016, oil was still trading in one of its worst bear markets on record....

By Filipe R. Costa

Click here to read the full article

The even slower death of the stockbroker's analyst

Following [Tim Price's article on the slow death of the stockbroker, written from the perspective of a fund manager](), here is that of an analyst insider whose City career spanned pre-big bang, when the species hardly existed, to today – when Mifid could be about to hammer a final nail into their coffin. Or maybe not.

Tim asks 'Are analysts necessary'? Well – they certainly weren't before the early '70's, when stockbrokers made their cosy equity commissions on 'tips from the horse's mouth' circulating on the Stock Exchange floor (alongside the best jokes from the prisons) at a time when the steady, profitable business in gilts still fed thick reliable gravy to the brokers.

I was perhaps unusual (not to mention naive) when I entered the City in 1972 into one of the largest firms. I arrived – after a spell in industry and management consulting – with the ridiculous notion that an analyst could help direct the nation's savings into the most efficient use of their capital in the most efficient companies. And from an engineering background where calculations, plans, and estimates had to be 100% correct if whatever we were constructing wasn't to collapse, sink, go slower than planned, cost more than desired, or to fail to meet all the criteria we were working to for decades into the future, I was disconcerted to discover that most brokers' memories of their opinions and recommendations spanned no more than a few days.

"I WAS DISCONCERTED TO DISCOVER THAT MOST BROKERS' MEMORIES OF THEIR OPINIONS AND RECOMMENDATIONS SPANNED NO MORE THAN A FEW DAYS."

That first broker, basking in gilts commissions up to a short time before, had decided to gain at least some expertise in the equities that pension funds were starting to invest in alongside gilts. But imagine the dislocation to my theory when the first analyst 'Nellie' whom I sat next to told me that his forecasting method was to assume a 5% (or whatever) rise in earnings, and work back from there to the profits breakdown he would publish. (In that era it was easy for a company to manipulate its accounts to show whatever result – within reason – it – and the market – wanted.)

By John Cornford

Click here to read the full article

BY RICHARD GILL, CFA

READ TO SUCCEED

THE FINANCIAL SPREAD BETTING HANDBOOK

THE DEFINITIVE GUIDE TO MAKING MONEY TRADING SPREAD BETS

BY MALCOLM PRYOR

Financial spread betting is a funny business. If you went to your bank and asked them if you could borrow money in order to speculate on the stock market they would probably (politely) tell you where to go. But spread betting effectively allows you to do exactly that, with investors able to "leverage" their initial deposits higher by trading on margin. That benefit, along with the major attraction of profits being tax free, has led to the industry booming over the past decade or so, with the FCA estimating that around 125,000 people in the UK now have an active spread betting account.

For those investors not familiar with spread betting here is a quick primer. Starting with the basics, financial spread betting is essentially a wager on the movement of an underlying asset, such as a share, commodity or an index like the FTSE 100. While traditional investing is centred on "pounds invested", spread betting is all about "pounds per point". For example, a traditional investment could see an investor buy £1,000 worth of Vodafone shares. If the share price goes up by 10%, then they have made a profit of £100.

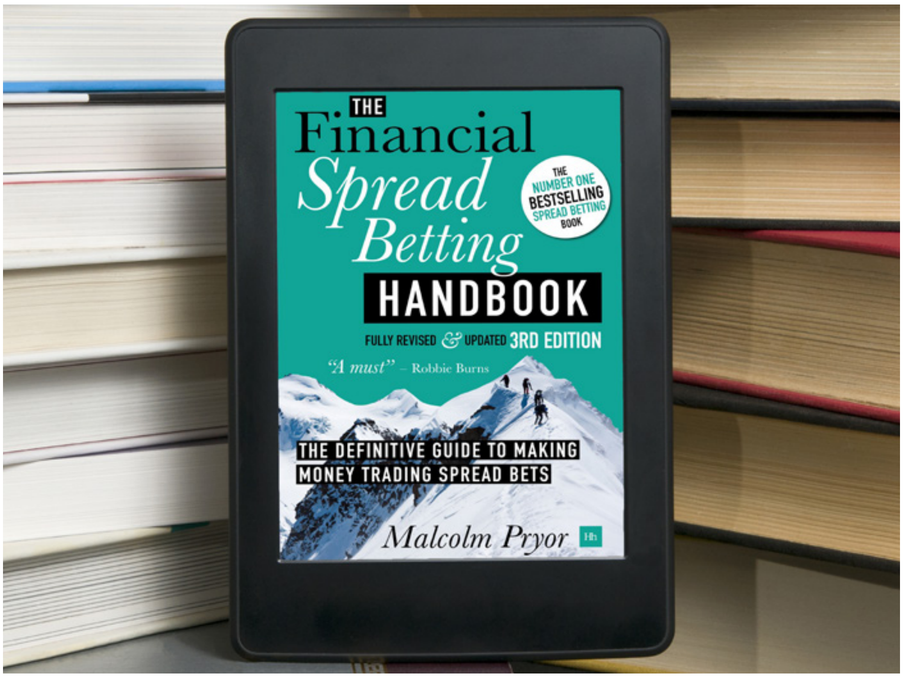
But in spread betting you bet an amount per "point price move" of the stock. To give a simplified example, say that Vodafone is being quoted by a spread betting provider at a price of 200p to buy. You like the look of the company so place a spread bet of £10 per point (or penny), betting that the shares will rise in value – you could bet that they will fall in value too. If Vodafone shares then rise to 220p you will be standing on a £200 profit (20 x £10 = £200). The more right you are (and the higher your stake) the more profits you will make. But if you're wrong you could lose your shirt.

If that has sparked your interest then you need to buy *The Financial Spread Betting Handbook* by Malcolm Pryor, this being the 3rd edition of the popular guide to be published since 2007. The author is well regarded as an authority on the subject having published several other trading books as well as being a Certified Financial Technician and a member of the Society of Technical Analysts. Through three parts and 27 chapters the book teaches investors how not be one of the estimated 82% of people who lose money from spread betting.

Three Peaks

The three chapters of the book compare the journey of a successful spread bettor to that of a mountaineer planning their expedition to the summit of a challenging peak. Before you start off you have to set up your base camp, or in other words get together the re-

"EVEN EXPERTS IN THE FIELD SHOULD HAVE A COPY ON THEIR INVESTMENT SHELF."



sources needed to climb the spread betting mountain. Of course you will need an account to trade with so Pryor suggests a six step checklist to find one relevant for your needs. Once opened this should be complemented by quality hardware & trading software, along with knowledge of exactly which underlying assets you are going to be trading.

The second part of the book moves on to climbing the face of the mountain, with all the equipment gathered at base camp now being put to use in placing some successful spread bets. This section is mainly about finding a strategy that works for you and brings technical analysis into the equation, which Pryor believes is "excellent" for use in spread betting – fundamental analysis is not covered in the book as its focus on the long-term is considered to be beyond the timeframe for spread betting, where trades are typically held for just weeks, days or even minutes.

Finally, in part 3 we plan the route to the summit. After climbing Mt. Spread Bet for some time and making progress we can finally see the peak in the distance. In spread betting terms this is analogous to the difficult achievement of making consistent profits from your account. Having consideration for an individual's own attitudes, this section goes beyond the strategies described in part two and brings in concepts such as psychology, planning, record keeping and a number of additional risk management techniques. These are factors which in the long run can make the difference between a losing and a winning spread bettor.

Pryor discusses the typical approach of a successful spread bettor and concludes the chapter with a useful list of ten rules which capture the essence of winning at the game. While they are all important, my own particular favourite is, *"stay in control of your betting and yourself"*. Readers keen to further advance their trading skills are then provided with details of Pryor's top 25 books for continuing development, along with other useful resources.

This being the third edition of the book there have been a number of additions and revisions, so even if you have a previous version it will be worth buying. Amongst other things, Pryor updates details about the best available hardware and trading software, along with new products which have been developed as technology has progressed over the years.

Conclusion

Since the first edition, this book has changed its byline from "*a guide* to making money trading spread bets" to "*the definitive guide* to making money trading spread bets". I would not argue with that proclamation.

While this is not a book specifically pitched at beginners to the industry it contains enough information, delivered in the right manner, to enable anyone with a decent knowledge of finance to understand it. A useful appendix provides examples of basic spread betting trades, an extensive glossary of commonly used terms, further details of technical analysis and a few comments on spread betting via sports exchanges

It is perhaps most useful for those who have dabbled with spread betting in the past but have maybe lost money and now want to develop a clear and sound strategy for making tax free profits. Even experts in the field should have a copy on their investment shelf for the wisdom it imparts.

BY TIM PRICE

THE FINAL WORD

THE BEST-KEPT SECRET IN FINANCE?

Historians, in their quest to make sense of the past, refer to two types of source material. Primary sources are those artefacts, diaries or documents created more or less at the same time as the events they depict. Secondary sources, as their name implies, are somewhat second-hand; they refer to books or articles written subsequently, including those written by journalists after the fact. For historians, primary sources attract a degree of kudos and authenticity. Secondary sources, not so much. Primary sources are closer to the pure experience; secondary sources are tainted by at least some degree of reflection and inevitable bias.

The financial markets offer only one real source of objective, non-negotiable news, for want of a better word. The primary – and for that matter the only – source of 'truth' in financial markets is the price itself, the price of a security as agreed between a buying and a selling party in voluntary exchange. Everything else is, if you'll pardon the inadvertent pun, speculation.

At a time when the source and veracity of news itself is subject to heated debate, not least online, the limitations of, and the notorious blind alleys created by, the financial media have long been a topic of discussion for engaged investors. Thomas Schuster of the Institute for Communication and Media Studies at Leipzig University has written probably the most damning indictment of the failings of financial media:

"The media select, they interpret, they emotionalize and they create facts. The media not only reduce reality by lowering information density. They focus reality by accumulating information where "actually" none exists. A typical stock market report looks like this: Stock X increased because... Index Y crashed due to... Prices Z continue to rise after... Most of these explanations are post-hoc rationalizations. An artificial logic is created, based on a simplistic understanding of the markets, which implies that there are simple explanations for most price movements; that price movements follow rules which then lead to systematic patterns; and of course that the news disseminated by the media decisively contribute to the emergence of price movements."

> **"THE PRIMARY – AND FOR THAT MATTER THE ONLY – SOURCE OF 'TRUTH' IN FINANCIAL MARKETS IS THE PRICE ITSELF, THE PRICE OF A SECURITY AS AGREED BETWEEN A BUYING AND A SELLING PARTY IN VOLUNTARY EXCHANGE."**

One of the more dismal and now thoroughly discredited beliefs associated with the Efficient Market Hypothesis, still widely promoted within investment training courses despite the fact that it is nonsense, states that at any given time, securities prices reflect all available information. By way of example, Schuster cites the stock of a company called Entremed:

"Within a year, if all goes well, the first cancer patient will be injected with two new drugs that can eradi-

cate any type of cancer, with no obvious side effects and no drug resistance – in mice."

New drugs are said to lead to the complete eradication of tumours. The New York Times reports the story on the front page of its Sunday issue. The company holding the licence for the active substances is named: Entremed. Its stock price immediately surges by 600%.

As Schuster points out,

"The news is spectacular and exciting. But it is not new. The New York Times itself had reported about the new therapy of tumours in animals in an article half a year earlier. Financial economists are amazed by the stock price reaction to the non-event as well. According to the efficient market hypothesis, which says that all available information is always completely reflected in prices, the republication of the story should not have provoked any significant price reactions. But what happens in this case is exactly the opposite. The Entremed stock reacts twice: to the publication of the original news. And, much more violently, to the prominently placed re-run of the research report on the Times cover. (Other biotechnology stocks rally sharply too.) The stocks of a whole branch of industry rise, as it seems, because some newspaper journalists have repackaged already known research results a second time."

So much for efficient markets. As one of the world's most successful investors, Warren Buffett, has observed, if markets were truly efficient he would be a bum on a street corner holding a tin cup.

The reality, then, is that most of what the financial media report is not news, and it is certainly far removed from truth. It is simply gossip. Or as Marcus Aurelius put it,

"Everything we hear is an opinion, not a fact. Everything we see is a perspective, not the truth."

Worth remembering, the next time you read a market report.

I strongly believe that there are two, and only two, ways of sustainably achieving attractive returns from the financial markets. One is to pursue value investing: focus on well-run companies with disciplined, shareholder-friendly management who are adept at capital allocation, and then buy their stock when it trades – for whatever reason – at a meaningful discount to its inherent value.

The other is to exploit the opportunities presented by momentum in securities pricing. The historic price, as we have seen, is non-negotiable; it is a statement of fact. It is the closest thing that the market will ever generate that equates to objective truth.

Another thing we know is that human nature is fickle. The psychology of investors is such that we tend to herd. And we tend to oscillate between cycles of greed and fear. When markets and prices are rising, we tend to crowd onboard the bandwagon. When markets and prices are falling, we tend to flee, collectively, again, for safer pastures. These cycles of rising and falling prices ensure trends. And probably the most successful trading strategy of all, systematic trend-following, exploits those trends for longer term profit.

Systematic trend-following, as the name implies, is rules-based. A simple trading rule might be: if a given security, or entire market, trades at a new 52-week high in price, then buy it. If a given instrument trades at a new 52-week low in price, then sell it. (Human nature being what it is, we tend to be wary of buying new highs and selling or shorting new lows, but trend-following is an entirely unemotional strategy – which may explain some of its success.)

And it is successful. A friend of mine who runs a small trend-following fund has crunched the numbers on the best performing funds in history. To distil that universe down into manageable levels, he first insisted that funds for consideration had to have at least a 20-year audited track record. He then insisted that funds for further consideration had to have an investment track record equating to generating overall returns, over that minimum 20-year period, of at least 20% per annum.

The results are shown in the table below.

"AS ONE OF THE WORLD'S MOST SUCCESSFUL INVESTORS, WARREN BUFFETT, HAS OBSERVED, IF MARKETS WERE TRULY EFFICIENT HE WOULD BE A BUM ON A STREET CORNER HOLDING A TIN CUP."

The best funds in the world?

Fund	Class / Share / Programme	Manager	Inception	Compound Annual Growth Rate %
Eckhardt	**Standard Programme**	**William Eckhardt**	**Jan-87**	**23.81%**
EMC	**The Classic Programme**	**Liz Cheval**	**Jan-85**	**23.20%**
Hawksbill Capital Management	**Global Diversified**	**Jerry Parker**	**Nov-88**	**22.24%**
Blenheim GL Markets LP		William Kooyker	Dec-86	22.06%
Tudor Investment Corp	BVI Global Fund	Paul Tudor Jones	Oct-86	21.76%
MJ Walsh	**Standard Programme**	**Mark Walsh**	**Sep-85**	**21.33%**
JW Henry & Co	**Financials & Metals Programme**	**John Henry**	**Oct-84**	**21.10%**
Moore Capital	Global Inv Fund Ltd	Louis Bacon	Dec-89	20.64%
Abraham Trading Company	**Diversified Programme**	**Salem Abraham**	**Jan-88**	**20.33%**
Gamut Investments		Bruce Kovner	Jun-86	20.31%
Berkshire Hathaway	Per share book value	Warren Buffett	1965	20.30%

(Source: Lawrence Clarke Investment Management)

What is astonishing about this exercise is that of the eleven funds that made the final cut (and my friend was being generous, allowing Berkshire Hathaway stock onto the list), fully six of them were systematic trend-following funds. ***Over half of them.***

Within my wealth management practice we typically allocate 20% or so of client capital to systematic trend-following funds. We do so for two main reasons. One is that whatever such funds return, those returns are typically uncorrelated, or even slightly negatively correlated, to stock and bond markets. Within a diversified portfolio you want asset classes that don't move lock-step with each other. The second is that when market conditions deteriorate markedly, such funds offer the potential to generate meaningful positive returns. 2008, for example, saw some of the worst financial market conditions in living memory. Winton Futures, a large London-based trend-following fund, in 2008 generated returns, after fees, of over 20%. Mulvaney Capital, also a London-based trend-follower, in 2008 generated returns, after fees, of over 100%. Please form an orderly queue.

There are caveats, of course. Systematic trend-following funds are typically structured as hedge funds. Amongst other things this means that a) such funds may not be able to market themselves to private investors and b) such funds may have sufficiently high minimum investment thresholds that they are outside the reach of many private investors. They typically employ leverage and can reasonably be considered risky investments (but then these days, what isn't?) – but I'd argue that the best systematic trend-following managers are in fact some of the best risk managers, too. Trend-following funds typically track price trends across multiple markets – equity indices, interest rates, foreign exchange, hard and soft commodities – and unlike most traditional fund managers, they're perfectly happy to go short as well as long, which is where some of that lack of correlation comes from. Most managers, of course, have little choice but to track markets down when they fall. Trend-following managers, on the other hand, are perfectly relaxed about selling (or more realistically, shorting) into market weakness. Hence their risk and return profile. And trend-following funds don't work all the time – but, again, which strategies do?

If this article has piqued your interest in systematic trend-following as an investment strategy, I recommend a handful of books that will help you become familiar with the approach. First there is one of the best books on trading ever written, Edwin Lefèvre's excellent *Reminiscences of a Stock Operator*, a thinly disguised biography of the speculator Jesse Livermore. Publishers Harriman House have just published a definitive edition. Then there is Michael Covel's *Trend Following*, an excellent primer on the subject. No discussion on trading could possibly ignore Jack Schwager's two outstanding works, *Market Wizards* and *The New Market Wizards*, which contain interviews with some of the financial world's sharpest minds.

I'll leave the last word this month to Jack Schwager in his interview with the trend-following trader Michael Carr:

"Don't worry about what the markets are going to do, worry about what you are going to do in response to the markets."

Systematic trend-following, whether you practise it on a disciplined basis yourself, or hand over that responsibility to a gifted third party, will enable you to do precisely that.

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

APRIL 2017

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
CAC 40	2.8	8.3	
NASDAQ 100	2.7	15.8	
Euronext 100	2.5	8.3	
IBEX 35	2.4	14.6	
Hang Seng	2.1	11.9	
Nikkei 225	1.5	0.4	
Dow Jones	1.3	5.8	
DAX Xetra	1.0	8.3	
S&P/ASX 200	1.0	4.6	
S&P 500	0.9	6.7	
Russian Trading System	-0.1	-2.9	
Bovespa	-0.5	8.6	
FTSE 100	-1.6	0.9	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Palladium	3.5	19.8	
Natural Gas	2.4	-13.8	
Gold	1.4	9.2	
Soybean	1.1	-3.5	
Platinum	-0.6	3.2	
Copper	-3.2	6.9	
Crude oil (Light Sweet)	-3.3	-9.7	
Crude oil (Brent)	-3.4	-9.7	
Silver	-5.8	6.0	
Coffee	-7.0	0.4	
Sugar (No. 11)	-8.2	-17.0	
Cocoa	-10.9	-16.3	
Iron Ore	-17.0	-12.0	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
GBP/AUD	5.2	0.0	
GBP/USD	3.2	4.4	
USD/CAD	2.5	1.8	
EUR/JPY	2.3	-0.8	
EUR/USD	2.1	3.7	
EUR/CHF	1.2	1.4	
USD/JPY	0.1	-4.4	
USD/CHF	-0.9	-2.2	
EUR/GBP	-1.1	-0.8	
AUD/USD	-1.8	4.5	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	May 11	Jun 15
ECB	0.00%	Jun 08	Jul 20
FED	1.00%	May 03	Jun 14
BOJ	-0.10%	Jun 16	Jul 20
SNB	-0.75%	Jun 15	Dec 14
BOC	0.50%	May 24	Jul 12
RBA	1.50%	Jun 06	Jul 04
RBNZ	1.75%	May 11	Jun 22
BOS	-0.50%	Jul 03	Sep 06
BON	0.50%	May 04	Jun 22

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Atkins (W S) PLC	39.4	47.3	
Sophos Group PLC	24.6	29.3	
Homeserve PLC	18.4	7.9	
PageGroup PLC	16.8	28.0	
BTG PLC	16.0	15.3	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Allied Minds PLC	-48.6	-66.7	
Electra Private Equity PLC	-46.3	-44.3	
Vedanta Resources PLC	-14.6	-21.4	
Acacia Mining PLC	-12.0	5.8	
Petrofac Ltd	-11.4	-6.3	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Soft & Computer Serv	8.6	9.8	
Health Care Equip & Serv	7.4	8.7	
Electronic & Elect Equip	6.8	20.1	
Real Estate Invest & Serv	5.6	11.3	
Industrial Engineering	5.5	14.9	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Electricity	-5.4	-10.8	
Pharma & Biotech	-4.9	0.9	
Oil & Gas Producers	-4.5	-12.3	
Mobile Telecom	-4.3	0.2	
Mining	-4.3	0.6