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CYBER WARS

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PLUS...

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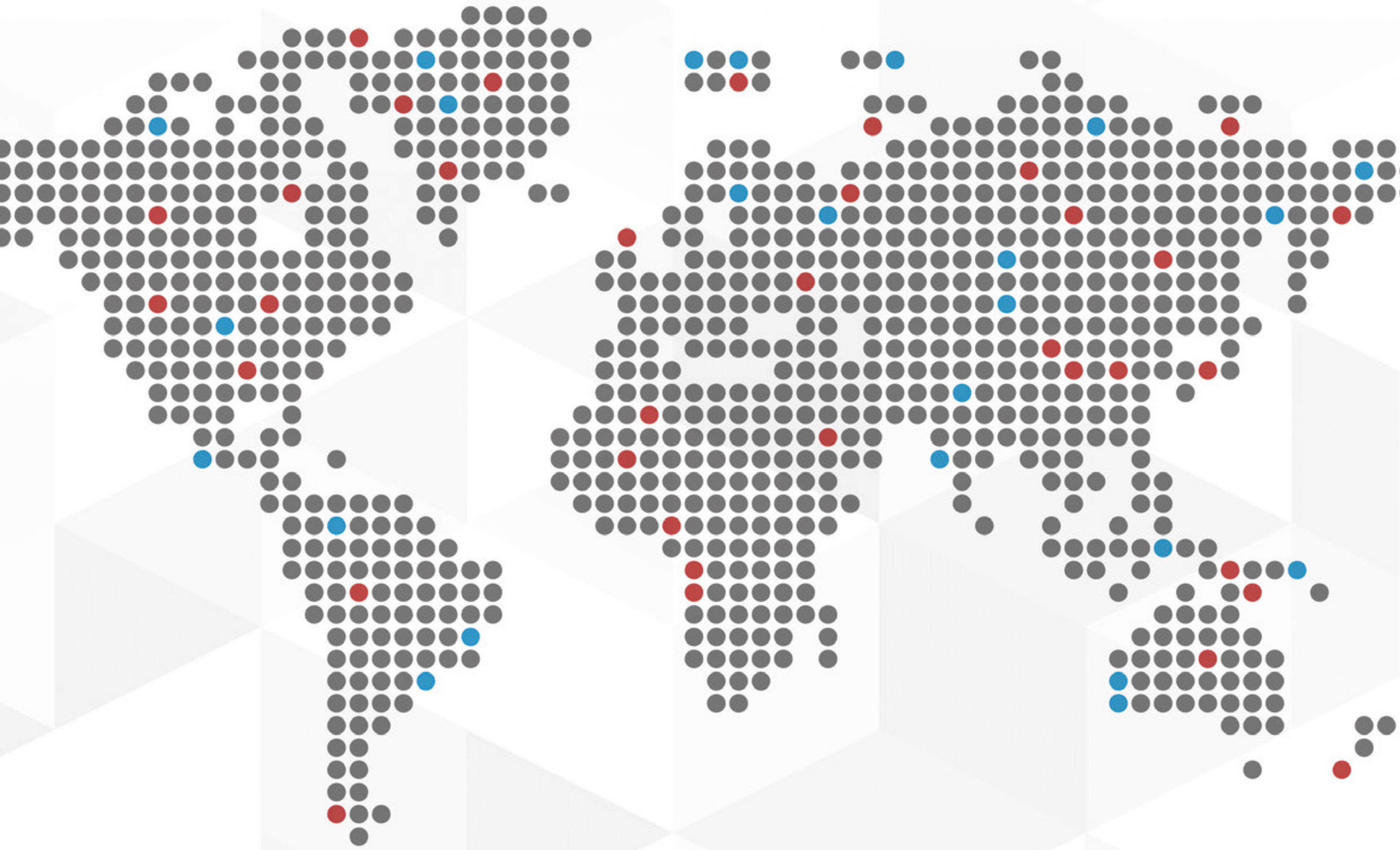

WELCOME

Dear Reader,

Master Investor is all about learning from the best! That's why I am delighted to announce the launch of a new series of Master Investor events.

The concept behind these small scale, intimate events is to create a platform for CEOs, Chairmen, Founders and Fund Managers to present their insights on exciting topics and industries in a panel discussion format to interested investors.

Presentations will not be boring corporate style pitches, but instead represent the best thought leadership you can find in the UK.

We have teamed up with Edison Group, one of the world's largest equity research firms, to launch our first event, ***"Investing into Health Care – learn from the masters!"***.

Panelists on June 20th include:

- Our very own Jim Mellon. He needs no introduction, but what is worth mentioning separately is his forthcoming book, Juvenescence, which is all about investing into the emerging field of human longevity. Due out later this summer!

- Sir Chris Evans, Europe's leading biotechnology entrepreneur by a significant margin, and Chairman of Arix Bioscience plc (AIM), which recently raised £100m and which has the backing of investors such as Neil Woodford.

We are organising these events to connect private investors to interesting investment opportunities. As always we have carefully chosen the timing for this event. The healthcare sector index was negative in 2016. Given earnings growth and return on equity, healthcare stocks typically trade at a premium, but currently look inexpensive versus the rest of the market.

The event is already booked out, but we will make a video of it available on our website, where you will get to watch the entire discussion and subsequent Q&A. If you have subscribed to our e-letter, you will get an automatic notification when the video appears.

Best regards,

Swen Lorenz
Editor, Master Investor Magazine

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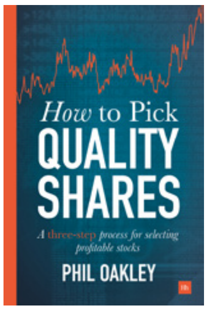

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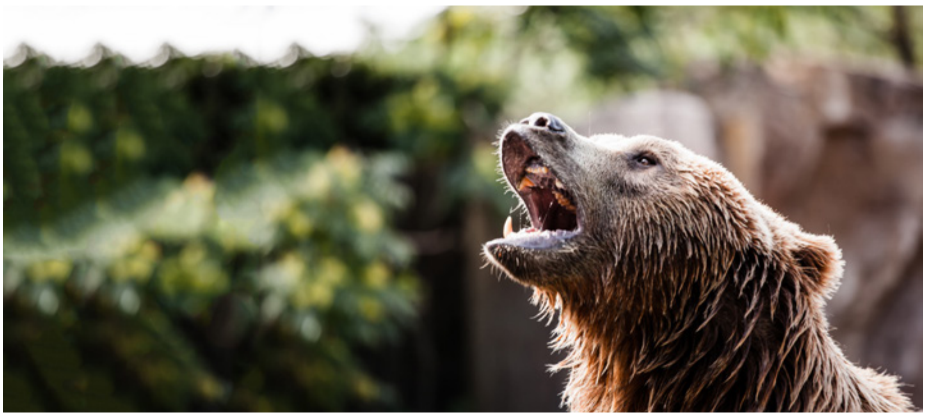

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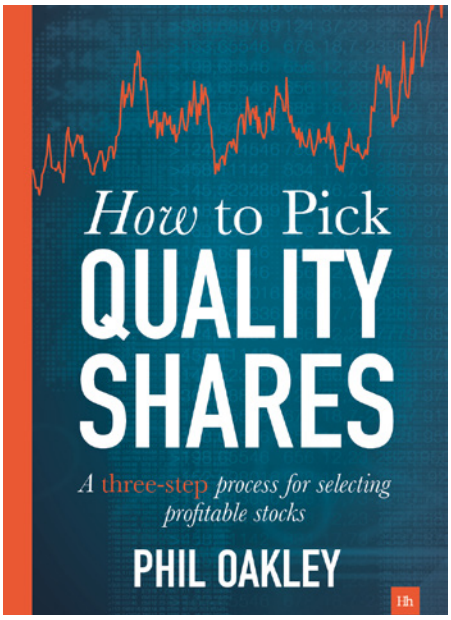

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BY JIM MELLON

MELLON ON THE MARKETS

ASSUME THE BRACE POSITION

In the past month, I've been going around the British Isles, talking to groups of people about my research into longevity, ahead of the launch of the Juvenescence book in July.

I know it's always a mistake to develop confirmation bias, but the more I talk on the subject, and the more I look into the fast-developing science, the more convinced I become. By convinced, I mean that I am quite sure that average life expectancy is going to go up sharply – and in the near future.

It may not feel like it today – what with life expectancy having stalled in the UK and in the US – but that is a temporary phenomenon, due to poor lifestyle choices. In the US, the death rate from prescription opioid drugs is phenomenal, marginally deflating average age at death.

But the fact is – and it will all be detailed in the book – that we are all going to live a lot longer (assuming we do some simple things and embrace some new technologies).

To pay for these extended lives, we are all going to be working much longer – and only now is that fact beginning to dawn on commentators. Moreover, we are going to have to save – and in a much smarter and aggressive way than we do now.

That means eschewing these tracker funds that have become the norm for so many investors – a sort of pass the parcel game for investment morons.

We all need – indeed, have to – select funds or shares that are going to reflect the future world – and not just slavishly mimic the current state of the markets. The US firm Vanguard is opening in the UK – and it is the key exponent and beneficiary of tracker (index) funds globally. It takes in so much money on a daily basis that its activities actually have an important market moving effect.

Vanguard and similar types of funds' main attraction is that they are super cheap in terms of fees and total costs, and they have benefited from the fact that indices have generally done better than active managers in the past decade or so, meaning that people are turning away from active management. Warren Buffet endorses them as his preferred way to invest (if he was an ordinary Joe Sixpack that is!), and who can doubt the great man? Well, I do, because I think copycat investment over the long term is a serious error.

The fact that you are reading this means that you are interested in investment, so why not translate that interest into actions that don't just reflect what everybody else is doing? And for heaven's sake, don't waste your time in low-grade chat rooms or by listening to market commentators who work out of seedy garrets and who have no or little money. If they haven't made anything in the course of their "careers", why would you follow anything that they say?

Stock picking has become a dying art, not helped by the fact that so-called active managers charge a lot more for their services than tracker man-

"THIS IS ABSOLUTELY NOT THE TIME TO BE RUSHING INTO STOCK MARKETS."

"ONE DAY THE WHOLE TRACKER INDUSTRY IS GOING TO COME DOWN LIKE A HOUSE OF CARDS. THAT DAY OF RECKONING MAY NOT BE SO FAR OFF."

agers do. But stock pick (or fund pick) we must, because one day the whole tracker industry is going to come down like a house of cards. That day of reckoning may not be so far off.

When everyone heads for the exits in these index funds, the decline in the indices will be amplified by the redemptions from panicked investors, and the whole thing will snowball out of control. Believe me, this will happen. It's only a question of when.

Who knows when this will happen? But the omens are telling me that it can't be too far away. After all, the key measure of volatility, the VIX, is at all time low levels, indicating that investors are far too complacent about market risk. PE ratios are high, particularly in the US, and especially for boring, slow growing so-called consumer staple stocks. And don't get me started on the FANG tech stocks, which are absolutely priced to a perfection that doesn't and won't exist.

Amazon is a great business, but its valuation beggars belief; Facebook and Alphabet can carry on growing, but I am certain they will end up being regulated, crimping profits; and Apple and its shiny repertoire of gewgaws, can surely only pedal away for a while longer. Toys get discarded, and new ones come along.

So, what should investors do? Well, I think we should all be looking at Juvenescence type investments, and the new book will detail three portfolios – conservative, medium risk and speculative – for people interested in the business of longevity. When we published *Cracking the Code* in 2012, Al and I suggested three portfolios, and all of them have at least doubled the performance of the broad indices, and provided great returns for investors.

Second, committed investors should make a list of companies that they really like, know about, and want to own – at the right price. If the shares of those firms are too high, put in limits, possibly 20-30% below current levels, and wait. Don't let cash burn a hole in your pocket – let the stocks come to you, and don't chase.

This is absolutely not the time to be rushing into stock markets; yes, maybe there is a little more upside, but the downside risk way outweighs that potential and fleeting upside.

Third, think strategically. What goes up in periods of market turmoil? Of course, it's gold and/or silver. What is the outlook for the US dollar and for sterling? Well, sterling looks undervalued and could rise another 5-10% against the dollar. The Euro, doomed at some date in the future, remains a speculative buy (see my last two letters) against the dollar, but not against the pound.

So, in a nutshell, cash is a good thing for now. Limits at way lower levels on the great companies you want to own a share of are good to establish – and do it now. Gold is a good thing, and sterling is a good thing. Sterling might actually become a safe haven in a world of turmoil.

But best of all, look at Juvenescence type stocks. Live long and prosper – i.e. benefit from the very things that will keep you alive to an age that would have been regarded as science fiction just one short generation ago.

I'm sitting on my terrace at my house in Ibiza; this house was the first purchase I ever made and next year will be the thirtieth anniversary of that transaction. It's a quiet Sunday morning, with birdsong the only sound for a long way around.

But I've been here for long enough to know that next month the peace and quiet ends and the mayhem that is Ibiza in the summer will begin.

And that makes it a bit like the markets – quiet at the moment, but the mayhem is just around the corner.

Assume the brace position.

Happy hunting!

Jim Mellon

Click here to follow Jim's trades on Twitter

BY VICTOR HILL

OPPORTUNITIES IN FOCUS

THE FORTHCOMING GLOBAL CYBER-WAR – AND WHO WILL WIN

On 12 May this year a virulent piece of *ransomware* was unleashed upon the globe by persons yet unknown. In the UK, hospital computers were rendered inoperable. Renault (EPA:RNO) was forced to shut down car production at some of its plants in France. Russian government websites went down. German railway station information panels were blanked and Spanish telephones operated by Telefónica (BME:TEF) went dead.

We all knew that cyber-security was a major issue in the current world, but this brought the issue to the front pages for the next few days. This was only the latest and most widespread manifestation of a problem that has been with us for some time – that of cyber-security. The issue raises so many questions. Can the big software powerhouses ever stop the hackers? What preventive action can we take – and who are the rising stars in cyber-security?

And who is the enemy anyway? Should we be more afraid of enemy governments that have the power to cripple our infrastructure at the press of a button; or are the ruthless cyber-pirates even worse?

But let's not panic – for now at least. It turns out that there are some astonishing companies out there working on solutions to this problem. And that means there are good investment opportunities for the sharp-witted.

12 May 2017: Black Cyber Friday

They named it *WannaCry*. Once installed on a computer, the malicious software (*malware*) encrypts all the user files that it can locate so that they cannot be accessed by users. It then displays a pop-up screen on the computer desktop informing users that their computer files will be deleted after seven days unless they pay a ransom in Bitcoin to the value of about US$300. But because the perpetrators are both unscrupulous and anonymous, there is no guarantee that the problem will even be resolved by paying the ransom.

The ransomware attack of Cyber Black Friday, which appears to have originated in the UK and Spain, affected an estimated 230,000 computers in 150 countries[i]. The rampant malware infected at least 60 NHS trusts in the UK, the Ministry of the Interior of the Russian Federation and even Chinese universities. British doctors were prevented from accessing patient records and were forced to cancel operations.

The advance of the malware across the planet was slowed when a 22-year old security analyst in the UK stumbled upon a "kill switch". The brilliant young hero who is known on Twitter as *Malware Tech* worked out that every time WannaCry runs it pings a request to a non-existent address (URL) in cyber-space. This is intended to verify that the malware is genuinely inside a new computer

> **"THE RANSOMWARE ATTACK OF CYBER BLACK FRIDAY, WHICH APPEARS TO HAVE ORIGINATED IN THE UK AND SPAIN, AFFECTED AN ESTIMATED 230,000 COMPUTERS IN 150 COUNTRIES."**

and is not contained within a cyber-security "sandbox". (Sandboxes simulate the internet in such a way as to convince the malware to reveal its evil intentions). If the ping returns from the non-existent web address then the malware works out that it is in a "sandbox" – and then immediately shuts down so as not to reveal anything about itself.

Malware Tech identified the non-existent web address in question, registered the domain name (at a cost of about £10) and then activated it. In so doing, he convinced every copy of WannaCry worming its way through the World Wide Web that they were inside a "sandbox" – and should thus go to sleep.

There is still some contention about just how sophisticated the attack was. Some say it was no coordinated blitzkrieg but more like a small-time hack that snowballed. According to *New Scientist*[ii], only about US$70,000 of ransom payments were actually paid out within a week of the event – so the criminals behind it did not make quite the killing they were hoping for.

The curse of ransomware

Most ransomware attacks follow the same general pattern. Victims are given a Bitcoin (or other cryptocurrency) payment address, and a deadline to make the payment. Most people incorrectly assume there is nothing that can be done to identify the perpetrator after payment is made.[iii]

Elliptic (see panel) is a company that works with clients to prepare for, and respond to, ransomware attacks and, ultimately, to identify the attackers. Not all ransoms are worth paying. There may even be indications that the attacker will not decrypt the affected machine even after payment. In the case of the WannaCry attack, there is currently no evidence that the attacker even had the capability to decrypt the computers that were compromised. Moreover, large Bitcoin payments are challenging for companies and entities that are not used to dealing in cryptocurrencies (like the NHS).

Bitcoin transactions are difficult – but not impossible – to trace. But Elliptic has developed advanced Bitcoin investigation software and employs a team of technical investigators with experience in the world's top law enforcement agencies. Its software and investigators have identified ransomware and cyber-extortion attackers in the US, the UK, and in Europe. "We are able to connect the dots between Bitcoin activity and real world actors," says Dr James Smith, Joint-CEO. "Our goal is to defeat ransomware by making it extremely difficult to launder the proceeds of these crimes."

Even if criminal entities remain unidentified, when and if the bitcoins paid are transferred out of the online bitcoin wallets and converted into Dollars or whatever, there may be some chance of tracing the culprits by alerting Bitcoin exchange counterparts.

It is quite possible, however, that the authors of this attack were not principally motivated by money at all. The amount of money demanded considering the depth of disruption was small. Maybe they just did it for the kicks of watching mayhem unfold across the globe at their instigation.

Had sophisticated cyber-criminals been at work the damage wrought might have been much more severe. But one is left pondering: if this much disruption could be wrought by (we now assume) a few spotty adolescents working from a computer in their bedroom, how vulnerable might we be to a serious attack from a government with huge resources at its disposal?

What exactly was the problem?

WannaCry was a combination of two strands of malware. The first strain was a *worm* which enables the malware to multiply itself from computer to computer. The second was the document-encrypting ransomware itself. Ransomware is normally delivered one-by-one, often through rogue emails which invite the recipient to click on an attachment. Once the attachment is clicked the malware is downloaded onto the victim's machine. In the case of WannaCry a single click was able to infect an entire network.

The techies are now saying that the worm was the clever part and that the ransomware – thank Heavens – was pretty clunky.

"WHAT MADE THE WANNACRY ATTACK UNIQUE WERE ITS GLOBAL SCALE AND THE HIGH PROFILE CHARACTER OF ITS VICTIMS."

Where did the malware come from?

It seems that the original version of WannaCry – or at least the worm part – was a hacking tool developed by the National Security Agency (NSA), a Federal agency of the US government, which was stolen by criminals last year. The NSA, which is in the business of creating *digital spyholes*, created a tool called *Eternal Blue* which exploits a vulnerability in older versions of MS Windows.

The NSA only informed Microsoft of the vulnerability in Windows after the theft took place. Microsoft responded by rushing out a software "patch" in April (MS17-010) this year. But this patch could only protect versions of Windows from Windows 7.0 (2009) or later. Microsoft President and Chief Legal Officer Brad Smith said the data security lapse was equivalent to the US navy having some of their Tomahawk missiles stolen by terrorists.

Computers communicate with one another through gates or "ports". Most computers have 1,024 ports each of which is assigned a specific task. Port 25, for example, is normally designated for sending email. The vulnerability identified by the NSA permits WannaCry to spread if port number 445 is left open.

Any computers running Windows 10.0 and later upgrades would not have been affected by the malware in question. The British NHS seems to have been particularly vulnerable since most of their hospital and general practitioner computer systems, plus equipment like MRI scanners, are still running on Windows XP. This version was originally launched back in 2001 and Microsoft withdrew all customer support for it in 2014!

Moreover, it was reported that UK Health Secretary Jeremy Hunt had axed the NHS's Windows service contract in 2015 – saving a paltry £5.5 million a year. Mr Hunt and NHS Chief Executive Simon Stevens were unavailable for comment until some days after the cyber-attack. True to form in multiple NHS scandals, no one was fired.

It later transpired that the Metropolitan Police (London's police force) runs computers at Scotland Yard on Windows XP. Extraordinarily, they remained unaffected on 12 May.

One lesson the UK government – and presumably Mr Hunt – has learnt from this is that cutting back on IT service contracts is a false economy. Of course, this was not the first large-scale cyber-attack. Previous types of malware – Conficker, SoBig, MyDoom, ILOVEYOU – infected millions of machines in the 2000s. What made the WannaCry attack unique were its global scale and the high profile character of its victims.

The white hat hackers

Many people were surprised that a US government agency would have been involved in developing malware. How

"THE TEAM WITHIN THE NSA WHICH DEVELOPED WANNACRY IS KNOWN AS THE EQUATION GROUP. WE CAN BE SURE THAT THIS SECRET TEAM HAVE ALL KINDS OF OTHER CYBER TRICKS UP THEIR SLEEVE."

could this be so? The simple answer is that, in order to secure cyber-security, the good guys have to stay at least one step ahead of the bad guys. Agencies and individuals who hack other people's computers for the common good are called *white hat hackers.*

When users of a paedophile website called Paradise Village, available only on the "dark net", tried to log on last February, they were greeted with a message which said: *Hello...you have been hacked. All your files have been copied and your database has been dumped*[iv]...

After the hack, personal details of the estimated 80,000 users of the site, including email addresses and private messages, were put up for sale to anyone paying the equivalent of about £100 in Bitcoin. The party behind the hack was supposedly the mysterious and amorphous group which goes by the name of **Anonymous** and whose supporters wear Guy Fawkes masks at demonstrations. Within hours, they abandoned their demand for payment and made the data available for free.

The web hosting service that offers web space on the dark net, called Freedom Hosting II, claims "zero tolerance" for child pornography but, according to Anonymous, most of the sites it was hosting were of that nature.

Using the data provided by Anonymous, *The Times* was able to identify provisionally 50 British individuals who had been using the site – though the newspaper admits that it is possible that some of these identities had been stolen. (Another reason to fear identity theft.) One such person was found to have worked for more than a decade at a children's hospital in England. In the case of another, an email address used to access the child pornography site was found to correspond to that used in a LinkedIn account for a British businessman who, until recently, had been the governor of a boarding school.

Also recently, the FBI shut down a child abuse forum which they claim had more than 150,000 users. Having seized control of its servers, FBI agents ran the site themselves for two weeks, modifying its code such that it was able to install tracking software on users' computers.

IP (Internet Protocol) addresses – basically an identification number – are uniquely assigned to each broadband connection. But when a computer user enters the *dark net* a system called *The Onion Router* or TOR anonymises the users' activity making it impossible for the authorities to verify their IP addresses.

In 2013 the FBI managed to seize control of a dark net server belonging to one Eric Eoin Marques, a US-born Irish citizen known to be engaged in internet child pornography. That server powered the original Freedom Hosting. The FBI temporarily kept that server going online and took advantage of a vulnerability in the TOR software to crack the anonymity of all visitors to it. Marques is currently fighting extradition from Ireland to the US on charges of conspiring to distribute child pornography.

Cyber spooks

Government agencies like the FBI in the US and the National Crime Agency in the UK are quite rightly using hacking techniques to fight criminals. But – more controversially – governments are also engaged in hacking for intelligence purposes. In plain English, they are engaged in online spying. The team within the NSA which developed WannaCry is known as The Equation Group. We can be sure that this secret team have all kinds of other cyber tricks up their sleeve.

The problem right now is that the spooks exploit vulnerabilities in software systems, but, being secretive, they are loath to tell the software developers of what they have found. Fixing those flaws might make it harder for the good guys (as they see themselves) to spy on criminals, terrorists... and unfriendly foreign governments. But the very same vulnerabilities make it possible for the criminals to remain in business.

Incidentally, Labour's election manifesto, which was itself leaked – or hacked, depending on your point of view – had nothing to say about cyber-security. But Dianne Abbott, the shadow Home Secretary, on the very day of the cyber-attack, described GCHQ's cyber-security capability as "snooping".

In contrast, Mrs May's government has pledged to spend £2 billion over the next few years on cyber-security (presumably including spying). The establishment of the National Cyber Security Centre (NCSC) which started formal operations in October 2016 is progress. The NCSC, located near Victoria Station in London, comes under the authority of GCHQ.

"THE UK ALONE HAS SEEN A 55 PERCENT YEAR-ON-YEAR INCREASE IN CYBER-FRAUD COSTING AN ESTIMATED £1.1 BILLION LAST YEAR AND AFFECTING ONE IN FIVE BRITISH BUSINESSES."

The scale of the problem

We increasingly live in a digitally connected world. Virtually all software now is designed to be accessed from third party systems, though of course using the appropriate authorisations or protocols; but there will always be gaps in the digital fence, so to speak. Computers increasingly control the functioning of large systems like the electricity grid or air traffic control. But they are also now to be found in every car, boiler or even fridge that you buy. All these systems, large and small, need to be kept up-to-date to minimise vulnerabilities.

Most security breaches – which cause financial loss and mental misery – go unreported. The UK alone has seen a 55 percent year-on-year increase in cyber-fraud costing an estimated £1.1 billion last year and affecting one in five British businesses. Ask micro-business managers: they will all have a story to tell about how they have been cyber-swindled.

I am increasingly concerned about how our senior citizens are vulnerable to cyber-crime. A senior friend of mine was telephoned by criminal parties recently while he was accessing his bank account online. They were already inside his computer...

What's more, if we want London to continue to be a global seedbed for Fintech, which is already contributing an estimated £6.6 billion to the economy, as a nation we must be more vigilant. It is positive news that the unicorns at Silicon Roundabout have formed the *UK Fintech Financial Crime Exchange*[v]. The fear is that some Fintech platforms may have been used to launder the proceeds of crime. Founder members include megastar start-ups **Transferwise, Ratesetter, Landbay** and **Market Invoice** (about which we have written in the past and to which we shall no doubt return in the future).

Microsoft: the mother of all software giants

Microsoft (NASDAQ:MSFT) can claim to be one of the most totemic companies in the history of capitalism. I am writing this article using MS products and you are probably reading it with the help of MS Windows. The overwhelming majority of PCs the world over are run using Windows as their operating system. Founded in 1975 by Bill Gates and Paul Allen, many analysts now regard MS as a mature company – and one which is incredibly cash-generative. The World Wide Web is still run on MS products even though the way we use the internet is now being shaped by **Alphabet/Google (NASDAQ:GOOGL)** and by **Facebook (NASDAQ:FB).**

Since Cyber Black Friday, Microsoft has come in for criticism. The *Financial Times* claimed that Microsoft withheld a free repair for older versions of its software, instead charging users $1,000 annually per device for protection against threats such as WannaCry. Microsoft's share price has been on an upward trend over the last twelve months and more. Earnings of 73 cents per share for Q1 2017 were better than expected. Revenue for the quarter of $23.56 billion exceeded the $22.08 billion the company generated in the same quarter last year. The consensus amongst brokers is that Microsoft's Indian-born CEO Satya Nadella's strategic vision for the iconic company is bearing fruit.

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"BEFORE ANY GUN IS FIRED OR MISSILE LAUNCHED BY AN UNFRIENDLY POWER, OUR UTILITIES AND COMMUNICATIONS SYSTEMS WILL HAVE ALREADY BEEN PARALYSED."

There is an army of freelance cyber-geeks out there who spend their time stress-testing new software, trying to find out if it has any vulnerabilities. Moreover, the big players pay them good money for what they find. Such payments are called "bug bounties". **Google (NASDAQ:GOOGL)** apparently pays out up to US$200,000[vi].

Cyber powers

You would have to have been living on the moon over the last two years if you do not know that one country – Russia – seems to be remarkably active in cyber-space. Russians will tell you that their government does nothing the CIA in America or GCHQ in the United Kingdom don't do. But the fact is that Russia stands accused of having actively intervened in the political processes of numerous countries by digital means – not least last year's US presidential election and, possibly, this year's French presidential election.

The cyber-attacks on Estonia on 27 April 2007 were mostly of the *distributed denial of service* variety. This is the kind of attack where a host computer is rendered inoperable by overloading the targeted machine with a huge volume of requests. Moreover, the attackers create millions of fake IP addresses so that they cannot be traced. The Estonians have absolutely no doubt that this was orchestrated from within Russia. But, by the nature of the beast, it is impossible to trace such an activity back to Mr Putin's personal laptop.

In August last year a mysterious gang (which some have said has possible links to the Kremlin) calling itself *Shadow Brokers* announced that it had hacked into a huge cache of NSA files which it would sell to the highest bidder. Within days of Shadow Brokers' announcement, the FBI raided the home of one Harold Thomas Martin, a US navy veteran who was on contract to the NSA. His arrest was kept secret until last October and he is currently awaiting trial[vii].

Further evidence that Shadow Brokers has political affiliations was that it published a very strange message on the internet after President Trump's 08 April missile attack on Syria. It read: *Respectfully, what the f*** are you doing? The Shadow Brokers voted for you. The Shadow Brokers are losing faith in you...*

Just six day later, on 14 April, the mysterious Shadow Brokers dumped the code of the NSA hacking software on an obscure website where it remained for any cyber-criminal to see it. The fact is, however, we cannot prove Shadow Brokers' links with the Kremlin as we know virtually nothing about them. Moreover, there is a lot of talk on the internet about the involvement of organised crime cartels in Eastern Europe. That could mean Ukraine, Poland (part of the EU) or whatever.

Washington's current obsession with computer hacking by the Russians has adumbrated the nefarious cyber-attacks of another, even greater power: China. But perhaps the most worrying use of cyber-warfare is the online activities of the fanatical Islamist group which controls large parts of Syria and Northern Iraq. I speak of the so-called Islamic State, which for all its vicious inhumanity has shown itself adept at recruiting supporters through social media.

The forthcoming global cyber-war

The military men, whose job it is to think the unthinkable, and plot war scenarios going forward, tell us that before any gun is fired or missile launched by an unfriendly power, our utilities and communications systems will have already been paralysed. We may not even be aware that the war has already started.

Three big beasts in the cyber jungle

Intel (NASDAQ:INTC) still makes much of the basic hardware that powers the internet, specifically microprocessors (chips) which it supplies to original equipment manufacturers. It has an entire division dedicated to cyber-security. On 17 May Intel announced the launch of the next generation of chips for servers, code-named Skylake SP.

IBM (NYSE:IBM). Many of us still think of IBM as a hardware company when in fact a large part of its revenue comes from software solutions. IBM's shares have not fared well this year. In fact, IBM's fundamentals have deteriorated over the last five years since Warren Buffett famously invested. Revenue and free cash flow have declined even while the dividend payout has increased. Currently its dividend yield is high, while its price-earnings ratio is low at around 12.5.

Trend Micro Inc. (TYO:4704) is a Japanese multinational security software company with global headquarters in Tokyo. The company develops security software for servers, cloud computing environments, consumers, and medium-sized businesses. Its cloud and virtualisation security products provide cloud security for customers of **VMware (NYSE:VMW), Amazon (NASDAQ:AMZN), Microsoft (NASDAQ:MSFT)** and others. Eva Chen is Trend Micro's CEO, a position she has held since 2005 when she succeeded founding CEO Steve Chang. Chang still serves as chairman. Over the last year its share price is up by nearly 40 percent.

Ten niche cyber-security champions to watch

Sophos PLC (LON:SOPH) is located in Abingdon, Oxfordshire. After the ransomware attack which he described as a "wake-up call", CEO Kris Hagerman revealed that Sophos is adding about 10,000 new customers every quarter. Revenues rose last year to £411 million though the company's operating loss deepened to £44 million. The company aims to grow annual sales to £1 billion by 2020. The company's share price has virtually doubled over the last twelve months and, at time of writing, stands at around the 400 pence mark.

Corero Network Security PLC (LON:CNS). On 17 May Corero announced that a leading US international website hosting and service provider was now its second US$1 million plus customer for its flagship *SmartWall* product. The US web hosting firm that signed up for Corero *Smartwall Threat Defence System* last year has also placed a new order worth US$700,000. Shares in the company rose by 0.24 pence to 8.99 pence. Be aware, however, that the share price has slid from around 25 pence this time last year.

Elliptic is a company that tracks illegal activity involving Bitcoin. Elliptic's technology traces Bitcoin transactions through the blockchain. It can uncover complex relationships between multiple entities making the most obscure transactions transparent. Elliptic's proprietary database delivers auditable proof of identity for millions of Bitcoin addresses across thousands of real world entities. This enables law enforcement agencies and financial institutions to investigate and evaluate suspicious activity on the Bitcoin blockchain. Elliptic's three British founders are all high-powered ex-academics with hands-on finance experience. Dr James Smith, Joint-CEO, has a PhD in computer science from Oxford. Dr Tom Robinson, Joint-CEO, has a PhD in atomic physics, also from Oxford. Dr Adam Joyce, Chief Scientist, has a PhD in mathematics from Imperial College, London. Their website reveals that they are recruiting expertise in both the UK and the US. Elliptic looks very much like a baby unicorn.

Check Point Software Technologies is an Israeli cyber-security company which works in tandem with a UK company based in Surrey (but with an office in the City of London) called **Qual Limited.** They worked out that WannaCry's encryption software is so badly constructed that decrypting users' data after the ransom had been paid would have been impossible. They offer a product called *SandBlast* which protects computer systems from malware attacks.

ZERODIUM is a Washington DC based company which was founded by cybersecurity specialists with unparalleled experience in advanced cyber-vulnerability research. It manufactures software which stress-tests other software products for vulnerabilities. The company pays premium bounties and rewards to security researchers to acquire their original research affecting major operating systems, software products and devices. ZERODIUM focuses on high-risk vulnerabilities. Their website states that: *Access to ZERODIUM solutions and capabilities is highly restricted and is only available to a limited number of organizations.*

P1 Security is based in Paris and maintains a Vulnerability Knowledge Base (VKB). This is a unique up-to-date database of all vulnerabilities that are identified by their experts.

CYR3CON of Phoenix Arizona assesses potential cyber-attacks by sifting through information published by known hackers across the world. Its machine learning software operates in 15 languages. On 15 April this year CYR3CON picked up internet chatter about malware that could be used against certain versions of MS Windows. Businesses that use the company's systems were already forewarned and forearmed against WannaCry.

Proofpoint has its HQ in Sunnyvale, California but has its EMEA hub in Reading, Berkshire. It is a top US cyber-security vendor with a global intelligence platform that monitors email traffic, social media and mobile telephony. The company collects and analyses more than 100 billion data points a day from more than 100 million email boxes, 200 million social media accounts, and 7 million mobile apps. The intelligence generated enables clients to evaluate the type and scale of an attack and to determine action required to resolve attacks quickly and effectively.

F-Secure Oyj (HEL:FSC1V) is a Finnish cyber security company based in Helsinki, Finland. The company has 20 country offices and a presence in more than 100 countries, with *Security Lab* operations in Helsinki and in Kuala Lumpur, Malaysia. Through more than 200 partners globally, millions of broadband customers use F-Secure services. Its flagship vulnerability scanning products are *Radar Managed Services* and *Rapid Detection Service.* F-Secure is publicly traded on the Helsinki Stock Exchange.

Nettitude was founded in 2003 and is an award winning provider of cyber-security, compliance, infrastructure and incident response services to organizations in the USA, Canada, and in the Asia Pacific region. Nettitude also delivers services across the UK, Europe, Africa and the Middle East from its EMEA headquarters in Warwickshire, England.
Nettitude specialises in penetration testing, vulnerability assessment and security accreditation.

The cyber arms race

Ultimately, software developers can patch, cyber-security specialists can digitally police, and governments (within very tight limits) can legislate. But we have to face up to the reality that in a computer-connected world we will have to remain vigilant to those who seek to undermine us for evermore. The world of the internet is a state of nature – but it doesn't have to be (in Thomas Hobbes famous phrase) *nasty, brutish and short* if only we can guard it vigilantly. We are now engaged in an arms race with the hackers whom we must assume will forever be with us.

Our computer systems are now the soft underbelly of the modern global economy. As time goes by there will be more and more vicious predators who seek to tear into its flesh. But in the not-so-distant future we shall have artificial intelligence (AI) enabled computers which never sleep to watch over the internet for us.

So long as they stay on our side… For what happens when the hyper-computers, endowed with AI decide to take out less advanced computers? Maybe we had better not go there.

"OUR COMPUTER SYSTEMS ARE NOW THE SOFT UNDERBELLY OF THE MODERN GLOBAL ECONOMY."

Action

Cyber-security is a niche sub-sector within the technology sector which has gargantuan growth potential and for the services of which the world at large will pay top dollar. Most of the entities featured in the panels this month are currently private – but there will be flotations in this sub-sector, to be sure. Make sure you have at least one cyber-security stock in your technology portfolio.

i The Economist reported 48 countries (20 May edition); I am going with the New Scientist figure (also 20 May).
ii New Scientist, 20 May 2017, leader on page 3.
iii See Elliptic's website at: https://www.elliptic.co/elliptics-rapid-response-ransomware-4-step-plan-readiness-resolution-identifying-attacker
iv The Times, Monday 08 May 2017, page 11.
v Ibid.
vi See: *The exploits of bug hunters*, The Economist, 20 May 2017, page 76.
vii See: *British spies in global hunt for gang who hit NHS* by Robert Mendick and Ben Farmer, Sunday Telegraph, 14 May 2017, pages 4-5.

BY JOHN KINGHAM

DIVIDEND HUNTER

WHO IS THE HEAVYWEIGHT DIVIDEND CHAMP: SHELL, HSBC OR BAT?

One common argument against investing in mega-cap stocks is that elephants don't gallop, and that's true – they don't. However, as a dividend investor I'm not necessarily looking for companies that can grow at ten or twenty percent each year. What's important to me is a market-beating combination of income today and potential growth tomorrow, from companies that are less risky than average. And many mega-cap stocks, including some of the biggest dividend payers in the market, fit that description nicely.

That's why this month I'll be looking at the three biggest companies on my stock screen. In other words, the three highest market cap companies from the FTSE 100 that paid dividends in every one of the last ten years. These are three very different companies, so which one will be the heavyweight dividend champion?

Royal Dutch Shell (LON:RDSB)

- **Market cap:** £176 billion
- **Sector:** Oil & Gas Producers
- **Share price:** 2165p
- **Dividend yield:** 6.7%
- **10Yr dividend growth rate:** 3.9%

Like many mega-cap stocks, Shell needs little introduction. Or if it does, then I'll just say its core business is finding and extracting oil and gas, processing them in order to create higher value products (such as petrol) and selling those products around the world.

Shell is popular with dividend investors because its yield is currently very high at 6.7%. Of course, unusually high yields are also usually temporary; either the dividend gets cut or the share price recovers. A price recovery is exactly what happened in 2016 after Shell's shares dropped to 1400p. Shell's dividend yield reached an incredible 9% and investors could not resist. They piled in, bought the shares and those who got in at the bottom saw capital gains over the next year of 70% or more. But will investors be quite so lucky this time around? I'm not so sure.

On the positive side and despite operating in a cyclical industry, Shell's track record of not cutting its dividend since World War II is impressive. However, the company's dividend now faces enormous pressure on several fronts.

One pressure is the mismatch between Shell's growing dividend and its falling revenues and profits. Since the financial crisis the dividend has grown by about 50% in sterling terms. In contrast, revenues have been flat and earnings have collapsed. Falling earnings aren't necessarily the end of the world for a cyclical company, as long as 1) it doesn't have lots of debt and 2) it doesn't have large capital expense requirements. Neither of those hold true for Shell.

In terms of debt, Shell has a colossal debt mountain of some £75 billion. That's 7.7-times its recent average profits of £9.8 billion, which is about twice as much as I would normally be willing to accept. But there's a catch. Shell took on over £30 billion of that debt in the last year in order to acquire BG Group, the oil and gas exploration and extraction arm of what used to be British Gas.

The catch is that Shell's new debts are on the balance sheet, but the profits from BG are yet to filter onto its income statement in a significant way. So the picture is skewed and is perhaps not as bad as it first appears. But it's still bad. Even including some generous estimates of BG's future profit contribution, the debt mountain still looks somewhat Everest-like. It's beyond what I would feel comfortable with.

"WHAT'S IMPORTANT TO ME IS A MARKET-BEATING COMBINATION OF INCOME TODAY AND POTENTIAL GROWTH TOMORROW, FROM COMPANIES THAT ARE LESS RISKY THAN AVERAGE."

Another worrying financial obligation is Shell's defined benefit pension scheme, which has an £11 billion deficit. If you count that as a debt (which it effectively is) then the debt mountain is even bigger.

My second worry is the fact that Shell must invest heavily to develop oil fields before a drop of oil or a drop of profit can be made. If profits and cash flows from existing operations fall (as they have during the current weak oil price environment) then the company is not able to invest for future growth. Or at least it can't invest for future growth without resorting to taking on even more debt.

This is why it's helpful for cyclical companies to adjust their debts counter-cyclically, i.e. lowering debts during a boom so that they can take on new debt to fuel expansion when demand and prices for things like oil rigs and workers is low. Perhaps this is what Shell is doing with the BG acquisition, but either way I wouldn't want to see it taking on any more expansion-related debt.

Another less acute problem is Shell's profitability, which has been very weak for many years relative to companies in other sectors.

It should be clear by now that I would not be comfortable investing in Shell, despite its attractive yield. I think the risks are high and I have little faith in the company's ability to maintain its dividend. Thanks to declining profits and weak profitability, Shell sits at position 155 on my stock screen out of 225 companies. That low rank and Shell's high debts are reason enough for me to avoid it for now.

"SHELL'S TRACK RECORD OF NOT CUTTING ITS DIVIDEND SINCE WORLD WAR II IS IMPRESSIVE."

J. Lekavicius / Shutterstock.com

HSBC (LON:HSBA)

- **Market cap:** £133 billion
- **Sector:** Banks
- **Share price:** 666p
- **Dividend yield:** 6.0%
- **10Yr dividend growth rate:** 5.5%

cornfield / Shutterstock.com

Like Shell, HSBC is a company that most people have heard of, whether they're investors or not. It is of course a bank, which means it's had a difficult time over the last decade. However, thanks to its focus on Asian rather than western economies, HSBC has managed to spare its shareholders from the enormous rights issues and dividend cuts seen at most other UK-listed banks.

The picture is not entirely rosy though, as there was a rights issue and dividend cut in 2009. But the impact of both was more positive than negative because they helped the company to de-risk its balance sheet quickly and extensively. That allowed HSBC to turn things around more rapidly than other banks, many of whom were – and still are – stuck in the quicksand of yesterday's mistakes.

Like Shell, HSBC is a very high yield investment which is primarily a bet on whether or not the dividend can be sustained. If it can't be sustained then perhaps the current share price is justified and investors will receive neither the 6% dividend nor any capital gains. On the other hand, if the dividend is sustained or even grown, then a yield of 6% is obviously too high and investors will pile in. That will drive up the share price and produce excellent short-term returns for those who were brave enough to buy at today's price or lower.

The key issue with HSBC – and banks in general – is the balance sheet. If a bank makes too many loans (which are assets on the balance sheet) relative to deposits (which are liabilities on the balance sheet) then bad loans could leave the bank with an insufficient capital buffer (which is assets minus liabilities, or shareholder equity). At worst, the bank could become insolvent and be unable to return all deposits. In reality banks rarely get to that stage; they simply increase their capital buffer through rights issues and dividend cuts. This is good for customers and the banking system, but less good for shareholders.

"HSBC HAS MANAGED TO SPARE ITS SHAREHOLDERS FROM THE ENORMOUS RIGHTS ISSUES AND DIVIDEND CUTS SEEN AT MOST OTHER UK-LISTED BANKS."

To measure capital strength I look at three key ratios: The common equity tier 1 ratio (CET1 – you can find this in the annual results), the leverage ratio (tangible assets to tangible equity) and the gross revenue ratio (total income to tangible equity). I don't have the space to go into the details, but these ratios are all good measures of the amount of risk a bank has taken on relative to the strength of its capital buffer. Before I'll invest, a bank must have a CET1 ratio above 12%, a leverage ratio of less than 15 and a gross revenue ratio of less than 0.5. The bank must also have met these criteria over each of the last five years.

Following its recent rights issue and dividend cut, Standard Chartered comes closest to achieving this standard today. HSBC also comes close, but fails (slightly) on the leverage ratio test. However, both of these banks have only recently come close to these targets, following a long process of deleveraging from the excesses of the 2003 – 2008 banking boom. Because of those excesses, none of the UK-listed banks has the five year track record of caution I'm looking for.

As well as failing to have the large and conservative capital buffer that I'd like to see, HSBC's relatively pedestrian growth rate and weak profitability mean that even with a 6% yield it only reaches position 112 on my stock screen. That's almost exactly average out of the 225 stocks that I track, which means I don't find it particularly attractive on a valuation basis either.

British American Tobacco (LON:BAT)

- **Market cap:** £101 billion
- **Sector:** Tobacco
- **Share price:** 5401p
- **Dividend yield:** 3.1%
- **10Yr dividend growth rate:** 8.0%

As one of the world's largest companies in one of the world's most defensive sectors, British American Tobacco (BAT) is an almost ideal defensive dividend investment. That is, as long as you don't mind the fact that the company's products can have some negative side effects (putting it very mildly).

If you are willing to invest in tobacco companies then BAT offers some compelling statistics. These include: very consistent growth of revenues, profits and dividends at almost double digit rates over many years; very high levels of profitability, with returns of around 20% on retained earnings, and products with extremely high levels of customer loyalty (thanks to the highly addictive properties of nicotine). On top of that, the company's current dividend yield is 3.1%. That isn't high, but it is only slightly lower than the FTSE 100's yield of 3.7%, and the FTSE 100's dividend is unlikely to grow anywhere near as fast as BAT's. This combination of yield, growth and profitability means that BAT currently sits at position 69 on my stock screen, putting it very close to the top 50, which is where I select new investments from.

As with any company where the combination of yield, growth and profitability is attractive, there are reasons why other investors have not pushed the price up further. One reason is that tobacco is a no-no for many ethical investors and funds. Those investors and funds must invest elsewhere, which increases demand (and prices)

for non-tobacco companies and decreases demand (and prices) for tobacco companies. Another reason is that traditional tobacco products such as cigarettes are gradually falling out of favour in developed markets. This is partly due to changes in culture and regulation. Personally I would be surprised if a significant portion of the UK population still smoked in 2050.

"BAT OFFERS EXACTLY THE SORT OF COMBINATION OF GROWTH, INCOME AND STABILITY THAT I AND MANY OTHER DIVIDEND INVESTORS ARE LOOKING FOR."

To offset this decline BAT is looking to less developed markets, where rising prosperity is allowing people to move from value cigarettes to premium cigarettes, a change which BAT's leading global brands are well-positioned to benefit from. Also, vaping and other less toxic "next generation" products are growing rapidly, albeit from a small base. Over the next several decades I expect these next generation products to become the company's core business, and BAT is already well-positioned globally.

One complicating factor is BAT's impending acquisition of Reynolds American, another major tobacco company. BAT already owns 42% of Reynolds, so as acquisitions go, this is a relatively low risk one. The reason for the acquisition is that Reynolds is focused on the US, which BAT isn't, and the combination will make a truly global tobacco company of enormous scale. The acquisition is expected to add around $25 billion of debt to the combined company's balance sheet, which is a lot. From my estimates, it looks like the combined company's debts will be borderline in terms of whether I would describe them as prudent or not (i.e. more than five-times their combined average earnings). However, if any company can handle lots of debt it's a tobacco company, with their typically steady and stable profits.

So having turned down Shell and HSBC, would I invest in BAT? The truth is I already have. I bought into BAT way back in 2013 and I'm happy to continue holding its shares, even with the debts from the Reynolds acquisition and the likely long-term decline of its core products.

At its current price and with its 3.1% yield, I think BAT offers exactly the sort of combination of growth, income and stability that I and many other dividend investors are looking for.

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

GLOBAL FUNDS THAT CAN CUSHION THE BLOW OF A HARD BREXIT

The fall in the pound since the EU referendum has provided a major boost to the value of overseas assets. One of the main beneficiaries has been the global equity sector whose holdings have appreciated significantly once translated back into sterling. If there's a hard Brexit and the UK economy suffers, these funds would be well-placed to provide a valuable source of returns.

Between the referendum on 23rd June and 15th May the pound was down by 11% against the US dollar, 8.5% versus the euro, and 4% when measured in Japanese yen. A global equity fund with investments in each of these markets would have experienced a considerable foreign exchange gain over the period as a result of these movements.

Exchange rates are notoriously difficult to predict and it's possible that these returns could be reversed, but if the uncertainty surrounding the Brexit negotiations undermines the UK economy there would be a reasonable chance that sterling could fall even further over the next few years.

Investing in a global equity fund allows you to benefit from better performing economies and companies elsewhere in the world and adds considerable diversification to your portfolio. It also enables you to delegate the asset allocation decisions to the investment manager so you don't have to decide how much to apportion to each of the various countries and regions.

Global investment trusts

According to FE Trustnet there are 23 investment trusts in the Global Equity sector and over the last five years they have generated an average share price return of 101.5%. Most of them concentrate mainly on capital growth with the yields typically between 1% and 3%.

> **"BRITISH EMPIRE IS AN UNUSUAL £805M TRUST THAT AIMS TO EXPLOIT VALUATION ANOMALIES IN SPECIFIC PARTS OF THE MARKET."**

The investment trust analysts at Winterflood Securities have included three global equity funds in their model portfolio for 2017. They are: **British Empire (LON:BTEM), Monks (LON:MNKS)** and **Scottish Mortgage (LON:SMT).**

British Empire is an unusual £805m trust that aims to exploit valuation anomalies in specific parts of the market. The portfolio typically contains 30 to 35 stocks and is divided into five areas: closed-ended funds, Asian holding companies, European holding companies, Japanese holding companies and property.

The lead manager is Joe Bauernfreund of Asset Value Investors who took over the role in October 2015 after several years as the co-manager. He has kept the same value orientated approach but moved to a more focused portfolio.

Bauernfreund and his team aim to identify companies that own assets of high intrinsic quality that are trading at a discount to their net asset value and that offer potential capital growth with a catalyst for the discount to narrow.

BTEM's performance has improved since Bauernfreund took over the lead role and the Winterflood view is that it is well-placed to generate long-term returns in this area. It would also act as a useful diversifier alongside more mainstream options. The shares are currently trading on a 12% discount.

Baillie Gifford

Monks is managed by Baillie Gifford and since March 2015 has been run on the same lines as their Global Alpha Strategy that has approximately £26bn of assets under management and is closed to new investors. The fund managers, Spencer Adair, Malcolm MacColl and Charles Plowden, aim to identify companies that can deliver sustainable above average earnings growth.

The £1.45bn fund has a portfolio of 108 stocks that represent the firm's 'best ideas', with the top ten accounting for about a quarter of the assets. These constitute a pretty diverse group and include the likes of Amazon, Prudential, Alphabet and the Taiwan Semiconductor Manufacturing Company.

Monks has an excellent long-term track record with a five-year share price return of 121%. It also has an extremely competitive fee structure with ongoing charges of just 0.59%. The shares are trading close to par value.

Winterflood's final selection is another Baillie Gifford fund. The £5.33bn Scottish Mortgage Investment Trust is run by James Anderson and Tom Slater. It is the largest closed-ended fund and has an excellent record with a share price gain of 216% over the last five years. This has helped to push the shares onto a 3% premium.

The management team aims to identify companies with the potential for strong long-term growth on at least a five-year view. They have a high conviction approach and have put together a concentrated 40 stock portfolio with the top 10 accounting for 55% of the assets. These include the likes of Amazon, Tesla Motors, Baidu and Facebook.

Monks and Scottish Mortgage are also recommended by the analysts at Numis Securities. They point out that the different strategies means that there is a relatively small overlap between the two portfolios with only about 20% of the combined value held in the same stocks.

Numis has a high regard for the Baillie Gifford funds as the firm's partnership structure provides a stable platform for their managers and enables them to focus on delivering long-term returns for their investors without being overly concerned about the short-term profitability.

The multi-manager approach

The other global equity fund recommended by Numis is **Witan (LON:WTAN).** It is differentiated from the rest of the sector by its low cost, multi-manager approach that is augmented by the active management of the asset allocation and the gearing.

Witan may appeal to investors who are looking for a growing level of income and capital growth. The £1.79bn fund is yielding 1.9% with quarterly distributions and has successfully increased its annual dividend for 42 consecutive years. Its shares are currently trading at a small discount.

The fund aims to generate outperformance of at least 2% per annum and it's done a pretty good job since the appointment of Andrew Bell as CEO in February 2010. Over the last five years it has produced an NAV total return of 124%, which is ahead of its global benchmark and the sector average.

It first adopted this active multi-manager approach back in 2004 with the money allocated to ten external managers acting alongside a directly managed portfolio of collective funds that is capped at 10% of the assets.

Witan would make a decent core holding for investors who are looking for capital and income growth from an internationally diversified portfolio. It provides access to a number of well-re-

"WITAN MAY APPEAL TO INVESTORS WHO ARE LOOKING FOR A GROWING LEVEL OF INCOME AND CAPITAL GROWTH."

"INVESTING IN A GLOBAL EQUITY FUND ALLOWS YOU TO BENEFIT FROM BETTER PERFORMING ECONOMIES AND COMPANIES ELSEWHERE IN THE WORLD AND ADDS CONSIDERABLE DIVERSIFICATION TO YOUR PORTFOLIO."

garded managers and has built up a proven track record with reasonable ongoing charges of 0.79%.

Open-ended funds

There is a much greater degree of choice amongst the open-ended funds with over 250 of them operating in the global equity sector. These have generated an average five-year gain of 89.1% with the individual returns ranging from the 171.6% achieved by Fundsmith Equity down to the loss of 28% recorded by the Schroder ISF Global Energy Z accumulation euro share class.

Terry Smith's Fundsmith Equity fund invests in high quality businesses that can sustain a high return on operating capital employed; whose advantages are difficult to replicate; that are resilient to change; and where the valuation is considered to be attractive. There are very few companies that meet these strict criteria, which is why the £10.5bn fund is invested in just 29 different stocks.

Two-thirds of the portfolio consists of US companies such as Microsoft, Paypal, Pepsico and Philip Morris. The other holdings are based in the UK or Continental Europe with the manager investing on a long-term view. Since it was created in November 2010 the fund has generated an impressive annualised return of 19.8%.

Fundsmith Equity is one of seven funds in the sector that have been awarded a top rating by Chelsea Financial Services. The others include M&G Global Dividend and Rathbone Global Opportunities Institutional.

Top selections

The £6.9bn M&G Global Dividend fund aims to deliver a dividend yield above that of the market average by investing at least 70% of the assets in company

shares from around the world. It also seeks to grow its income distributions over the long term and to generate capital growth.

The management team has put together a concentrated portfolio of 43 stocks with about half the assets invested in the US. Its largest holdings include the likes of British American Tobacco, Wells Fargo, Broadcom and Microsoft. M&G Global Dividend has returned 83.9% over five years and is yielding 2.89%.

Rathbone Global Opportunities Institutional focuses mainly on capital growth and has around £1bn of assets under management. It has a concentrated portfolio of 54 mostly large cap stocks with 60% of the assets in the US, 24% in Europe and 10% in the UK.

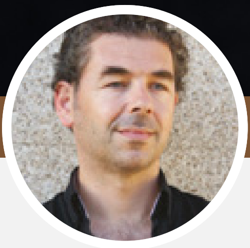
James Thomson and Sammy Dow, the managers, are stock pickers with a high conviction approach to their selections. They typically look for undiscovered, under the radar and out of favour growth companies and also attempt to identify strong global investment themes. The fund has returned 105% over five years.

Another strong performer is the Lindsell Train Global Equity fund that is up 157.5% over the same period. The managers invest in a concentrated portfolio of "exceptional" companies,

with the main emphasis being on those that have sustainable business models and/or established brands. Their primary focus is on companies that can demonstrate long-term, resilient cash flows and profits.

The 10 largest holdings of the £2.3bn fund account for a massive 60.4% of the assets and include stocks such as Unilever, Heineken, Diageo, PayPal, Walt Disney and PepsiCo. Many of these have been held for years and the portfolio turnover is very low.

The performance of a concentrated fund like this is driven by the stock selection decisions and will bear very little relation to the benchmark or the rest of the sector. It has recently benefited from the failed £120bn takeover bid by Kraft Heinz for its largest holding, Unilever, with the company surging in value.



BY FILIPE R. COSTA

THE MACRO INVESTOR

PRECIOUS METALS:
ARE THEY REALLY HEDGES?

"Indeed, there can be no other criterion, no other standard than gold. Yes, gold which never changes, which can be shaped into ingots, bars, coins, which has no nationality and which is eternally and universally accepted as the unalterable fiduciary value par excellence."

- Charles De Gaulle, former French President

Precious metals have been sought after since time immemorial. Their shiny appearance and limited supply allotted them the special role of helping to protect personal wealth against the monetary excesses of governments and, more recently, against financial panic and the ensuing market declines. After all, gold and silver are difficult to find, such that their supply hasn't changed much over the last 100 years. That's certainly not the case with fiat money, which saw supply quintuple in the U.S. and triple in the Eurozone during the last ten years. Gold and silver have a tradition of being used as money and have always been seen by the public as good stores of wealth.

In today's world, investors look to precious metals for insurance against rising inflation and bearish markets. Gold, silver, platinum and palladium are all in demand by investors. Some prefer gold, others prefer silver, while others look at their relative ratios to choose those that look cheaper in relative terms. Some just opt for a basket of precious metals to get overall exposure to the asset class. But while there is a high degree of substitutability between all precious metals due to the fact that they share a few similar features, they're far from perfect substitutes. Some are good hedges against inflation and risk, while others just rise and decline with the broad equity market; some help diversify portfolio risk, but others are correlated with the overall market and therefore add little value in that regard. In this edition of *The Macro Investor*, I'm going to look into the main features of gold, silver, platinum and palladium, to better discern how investors may use them in different situations. At the same time, at a junction where the ratio of gold to silver is near record highs, this is an opportunity to evaluate the attractiveness of such a trade.

"GOLD AND SILVER HAVE BEEN PLAYING CLOSELY RELATED ROLES THROUGHOUT HISTORY, WITH BOTH SEEN AS SUBSTITUTES IN HEDGING AGAINST MOUNTING RISKS."

All that glitters...

Gold and silver have been playing closely related roles throughout history, with both seen as substitutes in hedging against mounting risks. Two main reasons account for this: first, both metals have been extensively used as money in the past; second, their supply is tight and cannot be manipulated, unlike fiat money.

During the bimetallic era, gold and silver were circulating as money at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E PLURIBUS UNUM
IN GOD WE TRUST

the same time, with their ratio being fixed by the monetary authority (most often the monarch). Through changing the relative availability of the metals, some important discoveries of silver and gold created difficulties in keeping the ratio of exchange between gold and silver fixed. At times, there was a need for revaluation, but the ratio was kept more or less stable around 16 to 1, which means 1 part of gold was exchanging for 16 similar parts of silver. The U.S. Geological Survey estimates that there is 17.5 times more silver than gold in the Earth's crust, which helps explain the relative stability of the ratio of prices around 16 to 1 until the beginning of the 20th century. But then, during the 20th century, gold and silver were heavily influenced by the adoption of the gold standard and by central banks' and governments' interventions into markets, which contributed to an increase in the ratio to nearer 50 to 1.

The ratio of gold to silver has long since been followed by investors who believe in a mean-reversion feature. That means that when a ratio fluctuates outside some normal bands, a trading opportunity arises, as the ratio would later revert to its mean. With the current ratio showing a reading of 75, and its mean seen as 45-60, a good opportunity to buy silver and sell gold appears to be forming.

The idea that relative prices should revert to 16 or 17.5 because of supply constraints and historical norms should be discarded. Prices are formed by an interaction of supply and demand forces. If two commodities are supplied in equal quantities, but one of them is demanded 10x more heavily, there's no reason to expect prices to be equal. If the supply is tight, prices should change as demand changes. We shouldn't base price prediction solely on analysis of the supply side. The fact that precious metals are rare and heavily demanded is a good argument to justify their use as a store of wealth, in particular when compared with fiat money, which has no supply restrictions. But oscillations in demand may still lead to huge oscillations in price, in particular because supply takes time to adjust. Over short periods of time, some precious metals may be unfavourable as a store of wealth. Analysing what influences their demand is therefore crucial.

Different uses lead to different price behaviour

When looking at gold, silver, platinum and palladium there is one important characteristic we should take into account. Gold has fewer industrial uses than any of the others and is usually preferred as an investment or store of wealth. Central banks, for example, store a large part of their reserve

"WITH THE CURRENT RATIO SHOWING A READING OF 75, AND ITS MEAN SEEN AS 45-60, A GOOD OPPORTUNITY TO BUY SILVER AND SELL GOLD APPEARS TO BE FORMING."

holdings in gold. Silver, by its turn, is extremely reflective and used widely as a conductor of electricity, while also being used in photography and optics. Palladium is used in the auto industry, and has many applications in the electronics sector. Platinum is critical for the auto industry, with 50% of demand stemming from catalytic converters for cars, trucks and other vehicles.

While precious metals share some commonalities, the specific uses each of them have led to different demand functions and, therefore, different price formation. Gold in particular is expected to move very differently from the rest of the pack, due to the lack of industrial uses and its more appealing monetary element. Gold should work better as a hedge, while silver, platinum and palladium should be more correlated with the economic cycle. That being true, the power of silver, platinum and palladium as hedges, and their ability to reduce risk in a portfolio, is expected to be limited.

Gold is highly correlated with silver, less so with platinum, and shows almost no correlation with palladium. At the same time, its correlation with the broad equity market is highly negative. Silver exhibits similar behaviour. Palladium, meanwhile, seems to be the commodity least correlated with all the others and more positively correlated with the market.

Correlations Between Commodities and the Broad Market (Data for Last 5 Years)

	GOLD	PALLADIUM	PLATINUM	SILVER	SP500
GOLD	1.00	-0.04	0.77	0.98	-0.80
PALLADIUM	-0.04	1.00	0.36	0.01	0.19
PLATINUM	0.77	0.36	1.00	0.82	-0.80
SILVER	0.98	0.01	0.82	1.00	-0.83
SP500	-0.80	0.19	-0.80	-0.83	1.00

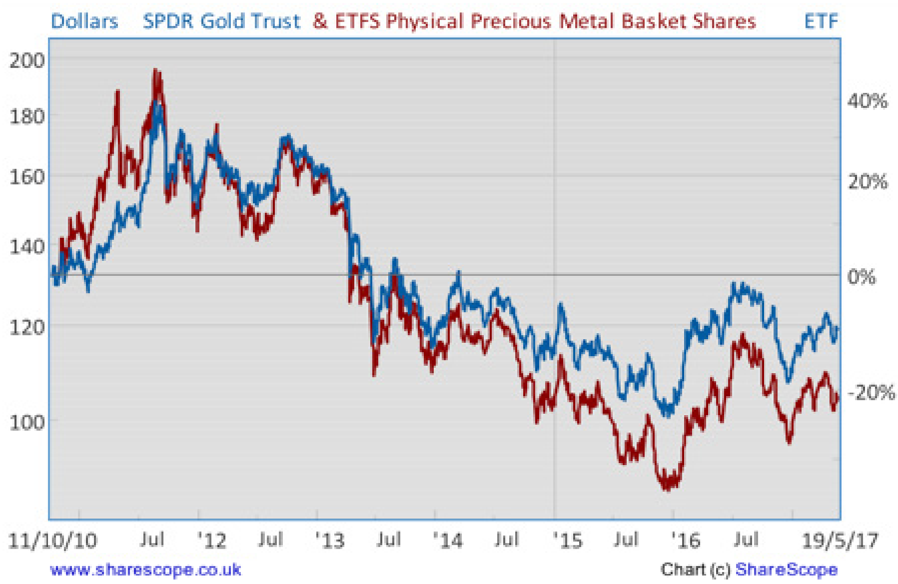
Source data: Sharescope

Another way of looking at the relationship between the commodities and the broader market is to determine beta for precious metals in a similar fashion as it is usually done for equities, using the Capital Asset Pricing Model (CAPM). The CAPM states that the return on any asset is a linear combination of the return of a risk-free asset and the return of the market portfolio. Regressing the returns of precious metals on a broad market index should give an idea of their beta. In this case I use daily data for the last five years. The results show a beta of zero for gold and positive betas for the other three precious metals. That means that the return for gold doesn't seem to be well explained by the return of the market. Betas for palladium, platinum and silver are 0.54, 0.28, and 0.24.

From the perspective of hedging against market risk, gold fits perfectly because its beta is zero. None of the other precious metals serve that purpose, as they all rise and decline with the market. These data just confirm the observations made above relative to demand. Except gold, the precious metals considered all have extensive industrial uses. Financial markets should rise when the economic prospects are good, which by its turn should be associated with greater industrial activity and then with a rise in demand for commodities like silver, platinum and palladium. The rise in equities should then explain (at least partially) the rise in commodities. This suggests that investors looking for hedging should therefore opt for a gold investment. The **SPDR Gold Trust ETF (NYSEARCA:GLD)** is possibly the best alternative to physical gold, offering a near perfect correlation with gold spot prices. An ETF like the **ETFS Physical Precious Metals Basket Shares ETF (NYSEARCA:GLTR)** would be less fit for the purpose of hedging as it holds all four precious metals and will be more positively correlated with the business cycle.

On the Gold-to-Silver ratio

Investors usually talk about a long-term relationship between gold and silver. With that in mind, some precious metals investors often adjust their holdings between gold and silver, depending on the value of this ratio. When it is too high, investors exchange their gold holdings for silver and when it is too low, they exchange silver holdings for gold. In academia, the relationship between gold and silver has been studied extensively, but research shows unclear and sometimes contradictory evidence. Ciner (2001)*, just to mention one of the studies, claims

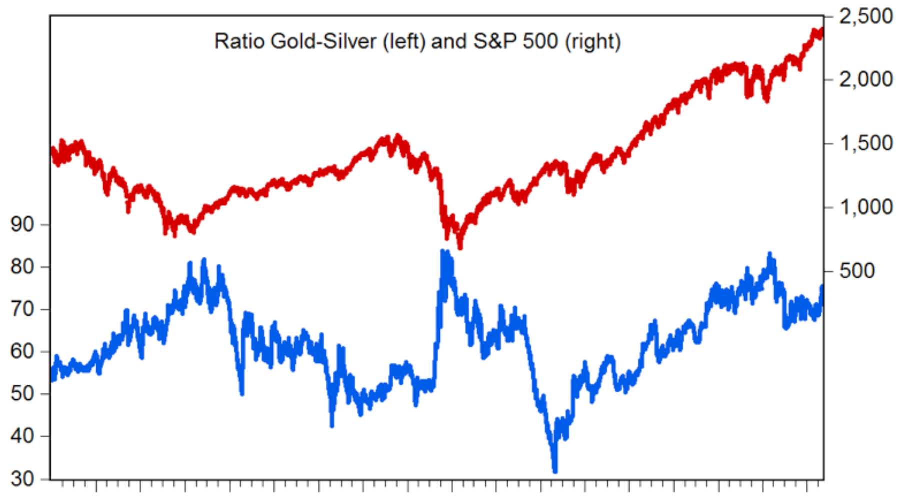


that gold and silver should be treated differently, each in accordance with its own fundamentals. His study corroborates the idea that since the 1990s the long-run relationship between gold and silver has been broken. If silver has become more commodity-driven, that could help explain the broken link. If that is the case, then investors should completely disregard the gold-to-silver ratio as an indicator to set trades.

But there is no agreement in academia. Lucey and Tully (2006)**, to cite another study, came to the conclusion that the long-run relationship between gold and silver is stable, even if the same relationship is weaker over shorter time periods.

In general, the ratio of gold to silver tends to fluctuate widely. When the economy is improving fast and there is not much inflation being generated in the process, then silver should see its demand increase while gold should lose its monetary element appeal. In these periods, the ratio should decline. When there are moments of financial panic, the economy is in recession, and/or inflation is rising quickly, the industrial appeal of silver should lose ground and the monetary element of gold should gain favour. Under these circumstances, the ratio should rise.

Silver was battered down in 2011, losing two thirds of its value since peaking in that year until today. Gold has also lost ground, but just one-third of its value. After a bull market that lasted for many years, commodities entered a bearish period in 2011. The financial and sovereign crisis hit Europe, damaged industrial production and weighed very negatively in all precious metals with significant industrial uses. But things are changing again. Industrial production is improving quickly in Europe and the risks that haunted Europe for years are now alleviating. Economic growth is just mild but improving, while inflation is still low. Under these circumstances, there is an appealing argument in favour of trading silver in exchange for gold, for those playing opportunities in the gold-to-silver ratio. Between the beginning of 2000 until today, the ratio averaged 66.9, peaking at 83.2 and bottoming at 50.4. The average for the 2000s is already high by historical means, but the current 75 ratio is unusually high. A way of getting exposure to silver is to buy the **iShares Silver Trust ETF (NYSEARCA:SLV)**.



Source data: Sharescope
Chart: eViews

"INVESTORS MUST BE CAREFUL IN SELECTIVELY PICKING PRECIOUS METALS."

Should you invest?

While precious metals make for a single asset class with its own dynamics, investors must be careful in selectively picking precious metals. Gold is mostly a kind of money, having a pronounced monetary element. Only 10% of gold is used in industry. Silver has much more industrial appeal, with 60% of it being used in industry, which exposes the metal to the business cycle. Other metals like palladium and platinum are also more exposed to the business cycle. This means that investors looking for portfolio diversification and a hedge against inflation should opt for gold alone. Investors who believe inflation is less of an issue and that industrial production is going to improve, should pass gold and opt for silver, which currently seems way undervalued relative to gold, by historical standards. Platinum and palladium are additional options to consider.

Notes

Ciner, C. "On the long run relationship between gold and silver prices A note." *Global Finance Journal* 12.2 (2001): 299-303.

Lucey, Brian M., and Edel Tully. "The evolving relationship between gold and silver 1978–2002: evidence from a dynamic cointegration analysis: a note." *Applied Financial Economics Letters* 2.1 (2006): 47-53.

BY RICHARD GILL, CFA

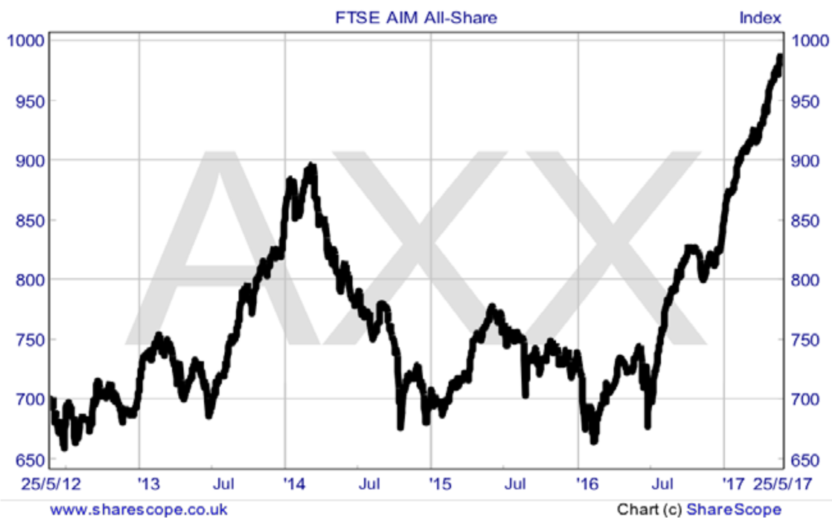
FROM ACORNS TO OAK TREES

THREE SMALL CAP MOMENTUM STOCKS

To date, 2017 has been an excellent year for investors in AIM companies. As I write (25th May) the AIM ALL Share Index has gained 17% so far this year to reach its highest level since June 2008 and looks like it will shortly break through the 1,000 mark for the first time since the Great Financial Crisis. The FTSE Small Cap Index has also performed well, up by 9.8% so far this year.

Amongst individual AIM stocks, 51 companies have seen their share price double or more in the year to date. At the top of the table Oil & Gas Producers and Mining companies are well represented, making up all of the top five best performers.

Echo Energy (LON:ECHO), the former Independent Resources, claims the number 1 spot with a huge 983% rise so far this year, driven by the appointment of a trio of board members from Sound Energy and a £10 million fundraising to support gas acquisitions in Central and South America. In second place is **Trinity Exploration & Production (LON:TRIN)**, shares in which have soared by 693% after it also saw new additions to the board and a balance sheet restructuring. The biggest non-resources gainer is Hong Kong based CCTV supplier **UniVision Engineering (LON:UVEL)** which zoomed ahead by 344% after announcing a contract win valued at £38.1 million – worth some 10 times its historic annual revenues!



AIM All Share five-year chart

Name	EPIC	Capital (£m)	Price% YTD	Sector
Echo Energy	ECHO	52	983.33	Oil & Gas Producers
Trinity Exploration & Production	TRIN	42	693.33	Oil & Gas Producers
Strategic Minerals	SML	38.3	635.29	Industrial Metals & Mining
Galileo Resources	GLR	17.4	472.58	Mining
Falcon Oil & Gas	FOG	218.9	352.38	Oil & Gas Producers
UniVision Engineering	UVEL	11.5	344.44	Electronic & Electrical Equip.
Red Leopard Holdings	RLH	3.1	315.38	Financial Services
Bushveld Minerals	BMN	60.6	312.99	Mining
Wey Education	WEY	15.1	287.1	Support Services
Uru Metals	URU	17.9	283.33	Industrial Metals & Mining

Table: Top 10 performing AIM stocks so far in 2017


0.67
2.68
+1.52
+1.52
0.68

Here follows three more small cap companies which have risen in value by at least 100% or more in the year to date but still look like they could deliver further returns for investors.

WARPAINT LONDON

There aren't many companies which had a better IPO in 2016 than colour cosmetics supplier **Warpaint London (LON:W7L)**. Having listed on AIM in November last year at a price of 97p, the shares have since risen to 295p, more than trebling the money of investors who got in at the IPO placing.

Founded in 2002 by Eoin Macleod and Sammy Bazini, a pair of former market traders and now joint-CEOs, Warpaint currently trades via two divisions. Close-out is a smaller operation which was acquired in November 2016. This business buys and sells excess stock of branded cosmetics and fragrances then sells it on to high street outlets, wholesalers and discount mass market retailers, mainly in the UK. However, the main focus of the group is upon the own-brand division and the flagship brand, W7 – named after the postcode of the company's first office in West London.

Targeted at the mass market and 16-30 age range, W7 positions itself as a creative, design-focussed brand, delivering high-quality cosmetics at affordable prices. The brand now contains over 500 cosmetic items ranging from foundation, blusher, lipstick, accessories, gift sets and everything in between, with sales made mainly to high street retailers and independent beauty shops across the UK, Europe, Australia and the US. In 2016, W7 was supplied to over 280 customers in more than 50 countries, with an online retail channel established during the year.

W7 products are manufactured by third-parties in Europe and China, which enables Warpaint to focus on spotting trends, developing new products and then quickly launching them to the market. The company claims that it is able to deliver "fast-track" launches of products in three to six-months, which it believes is much quicker than most other competitors in the colour cosmetics market.

Maiden results show good foundation for growth

The markets have only seen one real piece of trading news from Warpaint since it listed, this being results for the year to December 2016. Revenues for the period grew by 33.1% to £22.5 million on the back of customer numbers across the group growing from 270 to 319 by the end of the year, with increased export sales into the US and Europe being seen. In addition, an e-commerce platform launched in May and a number of celebrity-driven marketing campaigns translated into increased online ordering and brand awareness.

Pre-tax profits, adjusted for £1.7 million of IPO costs, were up by 10.9% at £6.1 million, growing at a slower rate than revenues as costs increased in preparation for the business going public. Total admin costs for the period rose by 291% to £4.4 million (including maiden salaries for the joint-CEOs) but should remain relatively stable now that the company is listed.

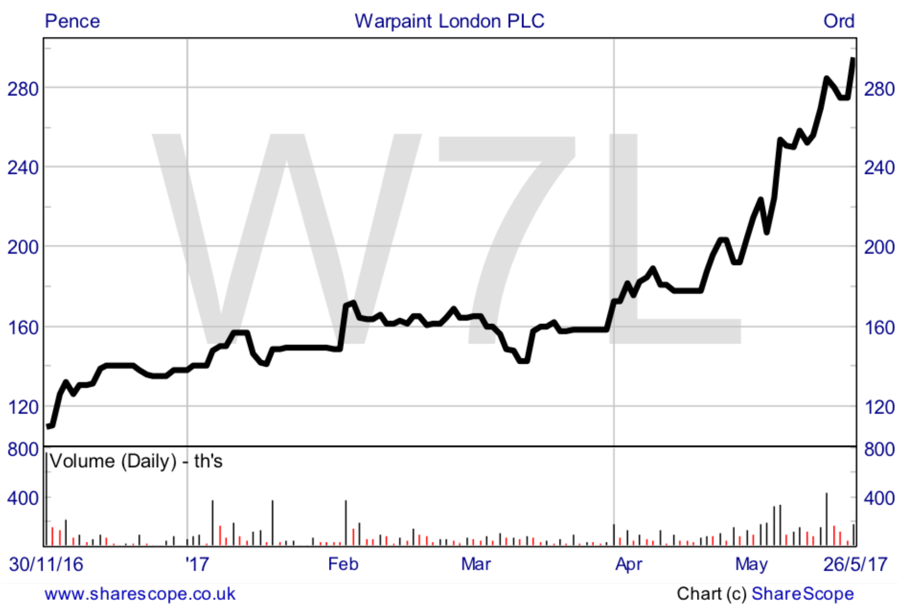
On the balance sheet, Warpaint had net cash of £3.5 million at the period end, with no debt. The business is extremely cash generative, with net cash from operations amounting to 95% of net profits for the year. Warpaint also has a progressive dividend policy and to that effect announced a final dividend for 2016 of 1.5p per share. This made a total dividend of 6.1p for the year, with an equivalent of 4.6p per share paid prior to the IPO.

No detailed trading update was given along with the annual accounts although the company did mention that the current financial year, *"has started well"*. Into 2017 and beyond the growth strategy will be focussed on further developing the business overseas as the company looks to gain a larger share of the growing global colour cosmetics market. In particular, new US and China focused e-commerce sites will be launched, with the ability to transact in local currencies.

The next AIM superstar?

With Warpaint shares up by 204% since IPO the company is now demanding a racy valuation of £190 million. On statutory basic earnings (before exceptional costs) of 7.9p per share in 2016 the historic earnings multiple is a chunky 37 times. But it is all about the growth here, with the earnings multiple falling to 31 times this year and to 25 times in 2018 on house broker Stockdale's forecasts. The PEG ratio for 2018, a more relevant multiple for val-

"WARPAINT CLEARLY LOOKS PRICED FOR NEAR PERFECTION."



uing growth companies, is 0.94 times, with a figure of 1 typically considered to be fair value.

So Warpaint clearly looks priced for near perfection and as such any bad news could send the price plunging.

But I see huge long-term potential here should management get it right, with the company having many similarities with small cap superstar stocks **boohoo (LON:BOO)** and **Asos (LON:ASC)**. The business is run by its founders, is highly cash generative, has low capex requirements (just £0.16 million in 2016), a scalable business model and a very high return on capital employed (ROCE) – c. 42% on an underlying basis in 2016 (see my book review this month for more on the ROCE).

What's more, Warpaint has a huge market to go for. Analysts at marketsandmarkets.com are looking for the global colour cosmetics market to grow at a CAGR of 4% between 2014 and 2019 to reach a value of $47 billion. The UK was the fourth largest retail colour cosmetics market in the world in 2015 and is forecast to grow from an estimated £1.8 billion to around £2.4 billion in 2021. Further opportunities are presented overseas where largest market the US had an estimated retail value of c.$11 billion in 2015, with second largest market China valued at c.$4 billion.

For brave investors, Warpaint London should "make up" a small percentage of a portfolio.

COINSILIUM

One of the investment buzzwords of the moment is "blockchain", a technology concept which is a lot more complicated to describe than its short name suggests. But I will give it a go.

Blockchain is a technology which is behind the way digital currency Bitcoin works. Put simply, it is a public (or distributed) ledger which records ownership of an asset. In contrast to current banking systems – which use a private and centralised ledger – copies of the blockchain are stored on thousands of computers across the world. Being distributed freely and openly the technology is able to approve transactions much more quickly by cutting out the middleman and obtaining a consensus approval. The blockchain industry has seen significant attention over the past few years, with a recent report from Allied Market Research suggesting that the global blockchain market will grow at a compound annual growth rate of 57.6% between 2017 and 2023 to reach a value of $5.43 billion.

One London quoted company which is looking to take advantage of the growth in this market is NEX Exchange listed **Coinsilium (COIN)**. Joining the market in December 2015 raising £1 million, the company is a business accelerator that finances and manages the development of early-stage blockchain technology companies thorough its consortium of investors and managers. The business model is focussed on identifying the early winners in the blockchain industry and using its knowledge and financial power to help these businesses grow.

Investee Companies

Amongst Coinsilium's portfolio of current investee companies, I highlight the following three as being the most interesting:

SatoshiPay – Coinsilium has a 12.08% stake in SatoshiPay, which is developing a two-way payment platform to enable online content providers to monetise their digital content through the acceptance of "nanopayments" – payments of less than a cent in value. SatoshiPay recently raised more than €1 million at a valuation 362% higher than Coinsilium's initial investment in the firm.

Factom – provides back-end infrastructure which allows corporations, governments and other organisations to integrate, manage and secure data. A recent investment into Factom from fellow blockchain investor Medici Ventures valued the company at $30 million and Coinsilium's shareholding at $473,040, 236.52% higher than at the time of Coinsilium's investment in 2015.

Magnr – Coinsilium has a 10% shareholding in Magnr, a financial services business which provides a leveraged trading platform for digital currencies such as Bitcoin.

coinsilium

"IT DOES HAVE ITS ATTRACTIONS, AS DEMONSTRATED BY THE 137% SHARE PRICE GAIN IN THE YEAR TO DATE."

Moving up the blockchain value chain

In March this year Coinsilium raised £187,985 at a price of 1p per share, with an additional £118,000 raised at 2p per share in April, the combined funds being used for investment and working capital purposes. April also saw the company announce its intention to enter into a strategic alliance with Oraclize, a London-based blockchain technology development company. The deal is to jointly develop and build a Smart Contract System for the next generation of blockchain-powered applications and develop commercial applications for third-parties.

A "Smart Contract" is a computer programme executed in a blockchain which can control the issuance, storage and transfer of digital assets (or Tokens). This is a fast growing area of the industry, with over $200 million raised via the issuance and sale of a range of new digital Tokens by various blockchain companies in 2016. In the first quarter of this year there were announcements for over $150 million in new Token issues during the first half of 2017, with multi-million-dollar hedge funds, such as Polychain Capital, emerging with the sole objective of acquiring and trading these blockchain-based Tokens which they consider to be a new asset class.

Make a Bit(of)coin

With a portfolio of investments in unlisted start-up companies, and having illiquid shares itself, Coinsilium is a high risk investment. However, it does have its attractions, as demonstrated by the 137% share price gain in the year to date. It is the only London listed company dedicated to investment in blockchain and as such provides investors with a pure play on the sector.

Valuing the business is a difficult task at this stage of its development but I note that the current market cap of £3.3 million compares against net assets of £2.07 million as at 30th June 2016 – we can also add in the recent fundraisings and rises in the value of the portfolio companies mentioned above. As such, I do not believe that the current premium to net assets is too much of a stretch given the long-term opportunities that could be unlocked in the rapidly growing blockchain sector.

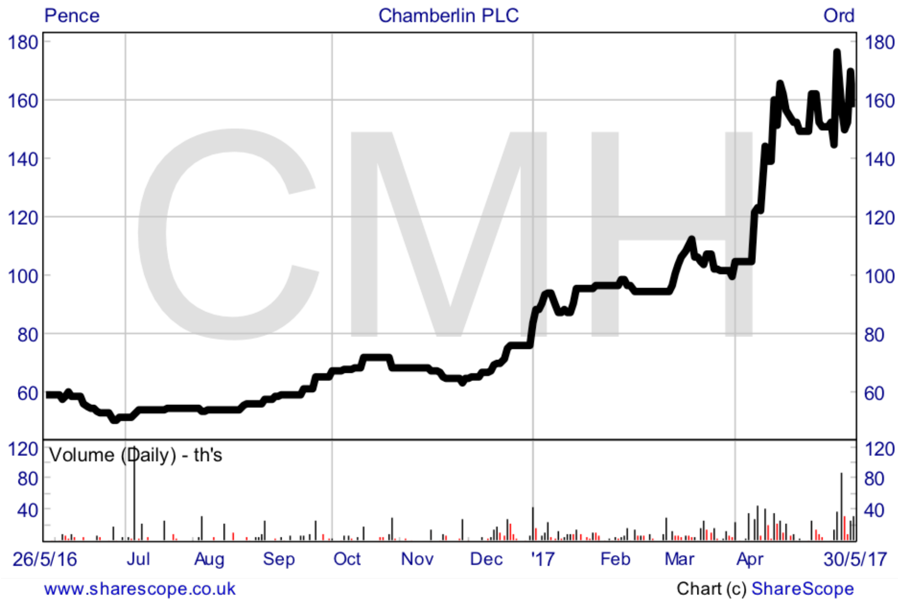
Coinsilium is a highly speculative buy.

CHAMBERLIN

Finally, away from the exotic worlds of make-up and fintech, we finish with a traditional British manufacturer. With a history going back to 1890, West Midlands based **Chamberlin (LON:CMH)** is a specialist castings and engineering group which operates via two divisions.

With its flagship plant located in Walsall, supported by an additional location in Scunthorpe, the Foundries division is a supplier of iron castings, in raw or machined form, to a variety of industrial customers who incorporate them into their own products or carry out further machining or assembly operations before selling them to their own clients. Chamberlin can produce high quality iron castings in various metal grades and weights, and supplies a number of sectors, including automotive, construction, power generation, steel and rail.

Secondly, Chamberlin's Engineering operations provide manufactured and imported products to distributors and end-users operating in the safety and security markets. The products fall into the categories of door hardware, hazardous area lighting and control gear. Subsidiary Exidor Limited, based in Staffordshire, is a leader in the exit and security door equipment and door furniture market, with Birmingham based Petrel Limited concentrating on the development and production of certified lighting and control systems for use in hazardous environments.



"CHAMBERLIN SAID THAT IT EXPECTS FURTHER PROFITABLE REVENUE GROWTH IN THE CURRENT FINANCIAL YEAR, SUPPORTED BY MAJOR NEW CONTRACTS COMING ON STREAM."

Recent trading

Chamberlin has experienced a difficult few years which culminated in the accounts for 2016 (to March) showing a 14% fall in revenues and a small statutory loss. This came after a downturn in the steel, oil & gas and mining sectors hit trading, with a weak Euro affecting export sales and resulting in a lower value of revenues on translation into sterling.

However, 2017 experienced a recovery, with underlying revenues up by an impressive 10% to £32.1 million and underlying pre-tax profits trebling to £0.6 million. The numbers did not include revenues from the company's foundry at Leicester, which stopped production in February 2017 (the decision to close the facility being taken due to a fall in demand).

In the Foundry business, revenues increased by 8% year-on-year to £21.3 million, with operating profits rising by 55% to £1.2 million, thus demonstrating the geared nature of the operations. Engineering saw revenues up by 15% at £10.8 million, with operating profits growing by 20% to £0.8 million.

Significant investment in capex was made during the year, with £2.1 million of spending applied to a new machining facility in Walsall which will enable the company to supply turbo charger bearing housings, which are fully machined in-house. With production at the new facility beginning in early 2017, Chamberlin is now the only fully integrated supplier of grey iron bearing housings in Europe, thus positioning the division for further growth. On the outlook, Chamberlin said that it expects further profitable revenue growth in the current financial year, supported by major new contracts coming on stream.

Valuation

Shares in Chamberlin have more than trebled since last year's lows of 50.5p and at the current price of 152.5p per share the company is valued at £12.14 million. That values the business on a multiple of just 7.8 times earnings forecasts for the year to March 2018 from analysts at Hardman. The multiple falls to 6.5 times for 2019, although there is no dividend expected in either year.

While the valuation remains relatively low here the balance sheet is not as strong as some investors might like. The net debt position as at end March 2017 was £6.8 million, up from £3.2 million 12 months earlier, mainly as a result of investing in the new machining facility. In addition, there is a pension deficit of £5.2 million to contend with, with the company making an annual deficit reduction contribution of c.£0.3 million. Nevertheless, these contributions are easily funded out of operating income and interest payments on borrowings were covered a comfortable 4.6 times by operating profits in the last financial year.

As a good value recovery play, Chamberlin shares look like a long-term buy and hold.

chamberlin plc

BY SAMUEL RAE

FORENSIC FOREX

HOW TO PLAY THE MAJORS

Political and economic uncertainty across the major developed nations dominates sentiment right now in the currency markets. A range of inputs, both expected and unexpected, is contributing to substantial volatility across pretty much the whole spectrum of currency pairs – from majors to commodity pairings – and the impact of these inputs is becoming less and less predictable as each new development adds to the stack.

Regular readers of this column will know that my strategic approach to the currency markets is rooted in price action primarily. I set up against any movement with a predefined entry and exit point, with both based on traditional candlestick charting patterns. However, I incorporate fundamental inputs into my operations as an aid to my risk calculations. Specifically, if I hold a biased outlook for a particular currency or a particular pair, I will be a little more aggressive in my target placement and be willing to take on a little more risk on entry in the direction of said bias. To put this another way, if I am bullish the US dollar, and my strategy signals a long entry, I will push for that little bit more profit. It doesn't stop me entering short, but with a bearish signal I'll keep my stop loss that little bit tighter and settle for a smaller target exit.

With the degree of uncertainty we have in the market right now, the incorporation of fundamentals becomes more difficult, but concurrently, more important. With this in mind, here is what I'm looking at as the key inputs in the majors going forward.

Let's kick things off with the dollar. It goes without saying that this one hinges on political activity, at least initially. The bullishness we have seen in the dollar is rooted in Donald Trump induced hawkishness – increased spending, tax cuts, all of that. There is some talk of impeachment based on certain Russian communication allegations, and while it is unlikely we will see anything like that happen, the talk alone is enough to get markets concerned about Trump's ability to put his policies in place. This may result in the Federal Reserve pushing a rate hike back as opposed to implementing late June, and this potential for delay, for me, serves up a near-term bearish bias in the US dollar.

Looking at sterling, it is all about the outcome of the election and said outcome's implications for Brexit. If Theresa May takes the top spot come election day, we're going to see some sterling strength. This is looking likely, but recent polls are suggesting that Corbyn is gaining a bit of ground. If he continues to do so – and I think there's a good chance this will happen (although I think May will ultimately win out) – then we could see some near-term weakness. UK economic data has been strong of late, and this will likely serve to limit any downside momentum, but we can't ignore the potential for a bit of lost strength – especially near-term. Bottom line here is that ahead of the election I am bearish on the pound, but subsequent to the election I am bullish – assuming May takes the top spot.

From a Euro perspective, things are a little more complicated. There have been some really strong num-

> **"I THINK WE'LL SEE A RETURN TO THE OVERARCHING BEARISH SENTIMENT IN THE EURO AND SOME STRENGTH IN THE CURRENCIES AGAINST WHICH IT'S PAIRED."**

bers hitting press of late, especially out of Germany, and this bodes well for the region and – by proxy – its currency. US uncertainty, as outlined above, and the potential for a bit of geopolitical volatility in the UK are also contributing to some temporary strength. For me, however, that's the key word – temporary. The ECB has gone on record as saying it's going to maintain loose policy for the foreseeable future. This really limits the potential upside on anything driven by uncertainty in the other assets, even if this uncertainty is compounded by positive numbers out of Germany and the likes. The Macron win in France has and will, again, translate to some near term strength, but only while markets settle into the relief of avoiding a Le Pen win and the turmoil that might have meant for the Eurozone going forward.

Once the political uncertainty in the US resolves, and especially if we see the Fed raise rates come the end of June, I think we'll see a return to the overarching bearish sentiment in the euro and some strength in the currencies against which it's paired.

To summarize, then, my outlook for the US dollar is near-term bearish, and hinges on the Fed taking action come raise-day. I'm looking at a similar sterling bias, with a pivot to strong bullish if the elections play out in favour of the Conservatives. My euro bias is the opposite: near-term strength, with a return to weakness longer term as the dollar and sterling appreciate.

It should be an interesting few months.

BY DAVID JONES

CHART NAVIGATOR

HOW TO TRADE MOMENTUM USING CHARTS

In last month's column I started off by having a gripe about those who approach charting from an academic point of view – and as some sort of mystical method to precisely forecast where a market is going to go next, trying to call every twist and turn. This way can only lead to frustration!

But there are plenty of simple techniques that can help us, as medium to longer term investors, without having to worry about Fibonacci retracements, Elliott Wave and even lunar cycles. It's an approach I have used for many years so this month we will look at a simple way of coming up with a shortlist of potential investment opportunities based on a couple of straightforward principles.

First of all – markets trend. I think this is an incontrovertible fact. Whatever we are looking at – the share price of BP, the Dow Jones, coffee or Bitcoin – they all trend. Now, these trends may be up, down or sideways depending on which time frame you are looking at, but trend they do. Trying to identify and jump on board a trend is at the core of many technical analysis approaches. But it is also one that many find hard to stick to – how many shares have you bought in the past that have been in a nosedive, believing it can't possibly go any lower, only to see that happen? The call of the counter-trend is a very strong one, despite the advice to not to try and catch falling knives.

There are some simple filters that can be used to identify potentially trending shares and I will share one I have been using for more than ten years now. It really is not rocket science – although there is a degree of subjectivity when it comes to picking which share to buy, but more of that later.

There are a few different ways to identify trends using charting and

"FOR ME AND PLENTY OF OTHERS, TRADING AND INVESTING IS A GAME OF PROBABILITIES. WHENEVER POSSIBLE I WANT TO PUT THE ODDS ON MY SIDE."

Filtered FTSE All-Share sorted by Yield (240 matches)

6 and 12 up Add criteria Exit

- % change since 12 months ago — Min: 0 — Max: — Edit
- % change since 6 months ago — Min: 0 — Max: — Edit
- Yield — Min: 2 — Max: — Edit

No.	TIDM	%chg 12m	%chg 6m	Market Cap. (current)	Index	Yield	Industry	Sector
1	CEY	▲51.5	▲28.2	£1956.9	FTSE 250, FTSE 3...	7.4	Basic Materials	Mining
2	RGL	▲2.64	▲0.708	£320.8	FTSE Small Cap, F...	7.2	Financials	Real Estate Investment T...
3	NCYF	▲10.2	▲7.1	£228.6	FTSE Small Cap, F...	7.0	Financials	Equity Investment Instru...
4	SMIF	▲11.3	▲9.72	£156.3	FTSE Small Cap, F...	6.9	Financials	Equity Investment Instru...
5	ADN	▲5.88	▲1.21	£3844.4	FTSE 250, FTSE 3...	6.7	Financials	Financial Services
6	RDSB	▲28.7	▲3.05	£176957.7	FTSE 100, FTSE 3...	6.7	Oil & Gas	Oil & Gas Producers
7	SQN	▲1.51	▲0.115	£390.3	FTSE Small Cap, F...	6.6	Financials	Equity Investment Instru...
8	MXF	▲3.13	▲0.833	£386.7	FTSE Small Cap, F...	6.6	Financials	Real Estate Investment &...
9	BBGI	▲9.79	▲1.67	£686.1	FTSE Small Cap, F...	6.5	Financials	Equity Investment Instru...
10	BP.	▲31.8	▲4.42	£93745.3	FT 30, FTSE 100, F...	6.5	Oil & Gas	Oil & Gas Producers

technical analysis. The moving average is one of these – if the market is above, for example, a 50 day moving average then the trend is said to be up – and if it is below then it's in a downtrend. This is pretty straightforward but we can make it simpler still. What decides the trend direction? It is of course the price of the market. So my filter (and for the purposes of this example, we will stick with the components of the FTSE All-Share index which is just over 600 companies) is to only first consider shares that have been rising for the past twelve months and the past six months.

Given the strong markets that have been seen recently this still gives a list of 450 shares to choose from. Let's have a look at the reasons behind those first two filters.

For me and plenty of others, trading and investing is a game of probabilities. Whenever possible I want to put the odds on my side. So if a share has been going up for the last 12 and 6 months then clearly investor sentiment has been positive. Let's look at the flip side of that – if something has been falling, what are the chances of picking the turning point? I assume the market knows more than I do and have no interest in being a brave pioneer and wading in against that sort of trend. Pioneers end up with arrows in their back!

My next filter is to add a yield component. This is hopefully a low-risk, steady return portfolio and I want to be paid for holding the shares, even if they go nowhere for a while. The minimum yield I am looking for in this example is 2% and this whittles the list down to 240 shares at the time of writing.

Here's a snapshot of the top ten, sorted by yield. You can see there is a mix of FTSE 100 (e.g. BP), FTSE 250 (e.g. Aberdeen Asset Management) and FTSE Small Cap (e.g. Regional REIT).

Now's the time to do some leg work. I am looking for solid trends and a good yield. But there is another very important part of the equation – the most important for me. If the trend changes, where am I going to get out? It's the all important stop-loss. Whether trading or investing, knowing where I am going to throw in the towel on an idea is still the critical consideration and will determine whether I buy the share or look for another better opportunity.

Let's take the highest yielder in this list, **Centamin (LON:CEY)**. it has certainly been a solid performer having risen 50% over the past 12 months and paying out a good dividend to shareholders. Let's see what the chart looks like.

You can see how much that trend accelerated from the beginning of last year, from around 60p to almost as high as 200p recently. That's great if you are a holder but is not so good for me looking to get in here – where does my stop go?

The more aggressive place for a stop-loss, assuming I thought the trend was going to rocket higher, would be under the recent low from earlier in May just ahead of 150p. But I would view that as more of a trader's stop loss. It was set less than a month ago. So my preferred stop loss would be beyond the low of last December which is around the 115p mark. If the share price slides below here it does look like a major change of sentiment. But the big problem I have with this is the percentage risk I am exposing myself to. With the shares trading around 170p, having a stop loss at 110p means the price would have to drop by 35% before I got out for a loss. That's just too much risk for me – I am happy to have a maximum of around 15% stop loss on these sorts of investments, so the search continues by flicking through the charts in this watch list.

There's an interesting one for the bottom fishers in this list, if you really can't help yourself! **Centrica (LON:CNA)** has scraped its way in thanks to a massive 1.2% rise over the last year, 0.7% over the past 6 months and a divi yield of 6%. Here's the chart.

"KNOWING WHERE I AM GOING TO THROW IN THE TOWEL ON AN IDEA IS STILL THE CRITICAL CONSIDERATION AND WILL DETERMINE WHETHER I BUY THE SHARE OR LOOK FOR ANOTHER BETTER OPPORTUNITY."

In its defence, it has had a few goes at breaking out of that downtrend that has dogged the price since late 2013 and has built a solid base ahead of 180p, giving a logical place for a stop-loss around 10% away from the current price. If you think this is the end of that longer term slide, it could be a possibility. Even if it takes a while to really start moving in the right direction you have that dividend coming in – assuming the company continues to pay it – to at least provide some sort of return for your patience.

And one last example – which is probably the "purest". FTSE 100 Media business **WPP (LON:WPP)** has had a strong trend for many years, rising by just over 8% over the past 12 months, and a dividend yield of 3.3%.

It set fresh all time highs once again in March this year – always a good sign for the health of a trend. There is good support ahead of 1600p over the past 6 months and even stronger previous support with that trendline in the 1470p/1550p area. The weakness seen

in recent months would be viewed by plenty of chartists as an opportunity to jump in on that longer term trend.

Hopefully all this demonstrates how simple charting techniques can make the work of the longer-term investor a little bit easier. Looking at what the price has done historically is one way we can aim to put ourselves on the right side of the major direction of sentiment. Like every other approach – whether trading or investing – it doesn't work all the time, which is why considering how far away a stop-loss will be is a critical part of the process. There will be losers along the way and cutting these as and when the level is hit is of course an all important contribution to overall portfolio performance.

"CONTRARY TO WHAT SOME PEOPLE MAY THINK ABOUT CHARTING IT IS NOT JUST ABOUT THE SHORT TERM."

The software I use for this is from ShareScope, which I am sure is a company that many of you are familiar with. It can be a way of identifying major trends that you may have missed in shares. And contrary to what some people may think about charting it is not just about the short term. One of my longer term holds that I still have is FTSE 100 company **Relx (LON:REL)** which was flagged up by this approach back in 2013. As the trend develops you need to think about trailing a stop loss behind the price to ensure you lock in profits as sentiment changes, but we are trying to stick with these major trends as long as possible so it is important, as ever, not to just snatch at profits but to keep your eye on the bigger picture.

BY ALAN STEEL

DEATH & TAXES

CULTURAL SELF-DEFENCE FOR INVESTORS:

HOW TO PROTECT YOUR WEALTH FROM THE PENSIONS 'FREEDOM' SCAMMERS

"Money it's a crime. Share it fairly but don't take a slice of my pie."

– Pink Floyd

When I started as an Independent Financial Advisor in January 1973, after vain attempts to lose any personality and thus qualify as an actuary, there was no formal investor protection. Nor was there disclosure of charges or costs when you invested in savings or pension plans either. None. Nada. It was the Wild West for investors. And things didn't improve until after a London based bunch of conmen with a name like a motorbike ripped off Pink Floyd.

But what really upset the Government of the time was that this bunch had also been appointed to look after the savings of Bank of England retired staff and their widows. And they'd done the same to them. That triggered the Gower Report which culminated (far too many years later) in the Financial Services Act, 31 years ago.

So what has all this "consumer protection" achieved after miles and miles of mumbo jumbo legislation and a cumulative multi-billion pound compliance spend? (The Financial Conduct Authority alone cost taxpayers over £500 million this year – and that doesn't even include the cost of keeping the banks in order.) Let's have a look shall we.

We had a recent visit at work from a retired couple who'd just turned 70 and had us recommended to them by their best friends, clients for 20 years. Their IFA, they explained, was a one man band and wasn't returning calls. Understandable they said, given they'd been led to believe he had terminal cancer.

So because they're receiving income from their pension plans that they described as SIPPs (Self Invested Personal Pensions), and as they weren't getting any younger, they felt they needed ongoing advice, so wanted us to take over the management of their financial affairs. And that's where the fun started. Perhaps not an apt expression, as you'll soon learn.

Despite almost forty years in a family business, they conceded that when it comes to investment, personal tax and pensions they were nowhere near being financially sophisticated. They described themselves as risk averse, perhaps cautious at best. So it came as a shock to all of us, them especially, to discover their SIPPS included "investments" that frankly were downright dangerous.

Three to four years earlier their pensions were with a well-known Scottish insurance company, in funds that while not exactly setting the heather on fire but neverthe-

"THE FINANCIAL CONDUCT AUTHORITY ALONE COST TAXPAYERS OVER £500 MILLION THIS YEAR – AND THAT DOESN'T EVEN INCLUDE THE COST OF KEEPING THE BANKS IN ORDER."

less sheltered them from any nasty surprises. But then their adviser suggested they needed a "high income" strategy to fund their lifestyle now they'd retired. Their dividend income would leave them well short and annuity returns were far too low to bridge their income gap. It was time for a change.

"The price to pay"
- Bruce Springsteen

As trusting souls they went along with his suggestions but it meant moving from the boring insurance company to a more up to date plan called a SIPP. They'd read often about SIPPs in the newspapers so it seemed to make sense. Could we see the reports of recommendation? ("Reason Why" letters the FCA likes to call them.) "We don't have any," came the reply. "But we've got copies of all these documents which aren't easy to decipher. But he knew we were cautious anyway and couldn't take any risks."

"CROOKS HAVE REACTED MUCH FASTER TO OPPORTUNITIES FOR MIS-SELLING THAN OUR REGULATOR."

Any details then of hard disclosure? "Such as?" Charges, costs to you or fees earned by him for the transfer and afterwards for ongoing advice/management? "No, but he was kind enough to pay all the lawyers' fees and the bills paid when the investments were bought inside the SIPP." So how much did that come to? "Don't know, but to be fair we never asked." Hmmm. How does that sound to you? Can you see where this is going?

For some unknown reason, despite years of the regulators insisting on transparency (or hard disclosure of costs etc. to investors) there's still ways for the dishonest to hide charges. Take SIPPs. If you end up as an investor in one, by law you need Trustees to act in your interests, and to ensure you don't run foul of HMRC rules. So how come the Trustees do not pass on to you details of charges/fees made at the expense of members (the fancy word for you)?

And why would Trustees of SIPPs allow this risk averse retired couple to invest all their funds in long stay airport car parking spaces, short-term loans to holiday lets and storage pod income schemes that have no guaranteed asset values? Why turn a blind eye to the purchase of unregulated investments that typically reward "advisers" with initial "commissions"? (I'm not supposed to use the word "commissions" these days, but hey what else is it?) What's more, these unregulated investments are most probably going to be almost worthless when you have to sell them, as in the event of a death for example.

If you think I'm being unfair to the previous "advisor", let me share some small print on the "holiday let" income investment:

"Investment in these bonds carries substantial risk. Potential investors should note these bonds are high risk. They are unlikely to be suitable for those who do not have experience or the understanding to be able to evaluate the chances of success of start-up companies."

Similar warnings were buried in the other documents regarding the storage pods and car park spaces. These are scary investments at best, and have no place in pension plans for low risk older investors. Unregulated Investments have no investor protection available from the FCA or compensation schemes. Anything unregulated should only attract ten-foot barge poles. You could say it's a scam, but this was advised by a registered IFA at the time (no longer the case it seems) who should have acted as agent of his clients, not agent of his own pocket.

SIPPs in our view are suitable for a minority of older investors who wish to invest in property or individual shares and who understand the risks in doing so. So be very careful. And if you already have a SIPP go ask the Trustees for hard disclosure of all costs. It's your money after all.

You may have heard about pension scams in the news. Since George Osborne dreamt up Pensions Freedom on the back of a fag packet a couple of years ago in a master plan to increase tax revenues without the usual complaints from taxpayers, crooks have reacted much faster to opportunities for mis-selling than our regulators, who are still thinking about the best guidance to give, but not, it seems, too busy to plan a £60 million spend on new offices, and blowing £66,000 on a new logo.

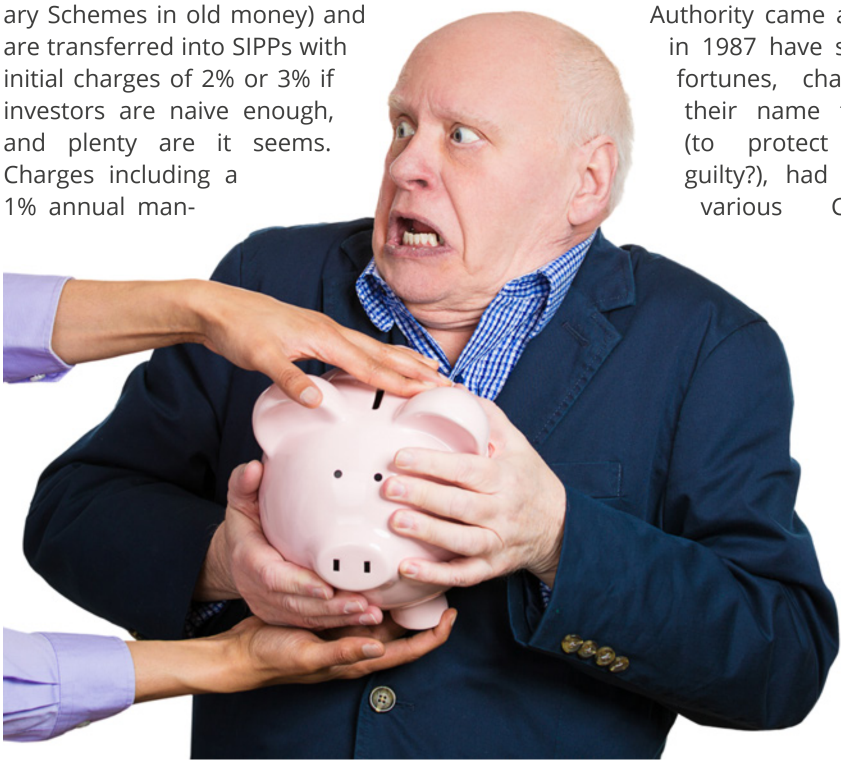
"Give me money, that's what I want."
- The Beatles

Millions of pounds have been stolen from those "benefiting" from Pensions Freedom according to various reports. Even well-known experienced pen-

“THIS TRANSFER EPIDEMIC IS BEING ORCHESTRATED BY REGISTERED IFAS UNDER THE NOSE OF THE FCA.”

sioner trustee specialists like James Hay, we understand, have been contacted by HMRC chasing a £1.8 million bill over another unregulated scheme into which 500 of their clients piled their pension fund money. Then on 23rd May the Serious Fraud Office announced an investigation into a £120 million unregulated storage pod fraud linked, yet again, to SIPPs.

In case you think that's the worse over I have further bad news to report. While the FCA dithers over whether or not to look further into charges of investments as against the "cheap" index trackers and passives the herd are so keen on, and while they argue the theories of risk with other academics, many millions of pounds pour out of Defined Benefit schemes (Final Salary Schemes in old money) and are transferred into SIPPs with initial charges of 2% or 3% if investors are naive enough, and plenty are it seems. Charges including a 1% annual management charge are conveniently hidden behind SIPP screens, and funds are being dumped willy-nilly into With Profits funds, which actually need no extra management whatsoever. This transfer epidemic is being orchestrated by registered IFAs under the nose of the FCA.



If this is a sensible place to plunk ex-DB money on transfer it might be worthwhile to examine the last 20 year performance numbers of said With Profits. Or go and ask thousands of With Profit Bond investors or former Equitable Life policyholders what they think of their With Profit plans purchased on the cheap in the 1980s and 1990s.

Regulators over the years since the Personal Investment Authority came along in 1987 have spent fortunes, changed their name twice (to protect the guilty?), had their various Chairmen/CEOs collect knighthoods and move to plum private sector jobs, despite failing consistently to spot dangers to investors until it's far too late. Think Equitable Life and the Split Cap Investment Trust fiasco in the 1990s, pensions mis-selling in the late 1980s, endowment mortgage mis-selling, and the Financial Crisis of 2007/08, for starters.

Meanwhile research by Fidelity confirms that despite scams and mis-selling fears, over 20% of the 55 to 64 year olds don't take any advice before choosing their retirement income strategy. Aargghh!

"Culture is more important than rules and regulations."
- Ruth Porat, CFO, Google

However, given the dismal record of financial regulators over the last 30 years – plus the bad experiences of too many investors when dealing even with trusted companies like Equitable Life – could there be a better way to protect your wealth?

As Josh Brown in the US recently wrote, "All the rules and regulations and disclaimers you can pack into the back of a prospectus aren't going to matter if people are determined to seek out loopholes or follow the letter of the law while completely violating the spirit of it. Examples of this are legion..."

His conclusion is that culture beats regulation every time – and probably will continue to do so. Like Pink Floyd I have "High Hopes" of that. So why not take your time as an investor, especially where it involves pension plans, to seek out those advisers who are rewarded emotionally and financially for being on your side. As Josh says, "There should not be a big glaring conflict of interest between what's best for them and what's best for you." And that's the truth.

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...

GERALDINE WEISS

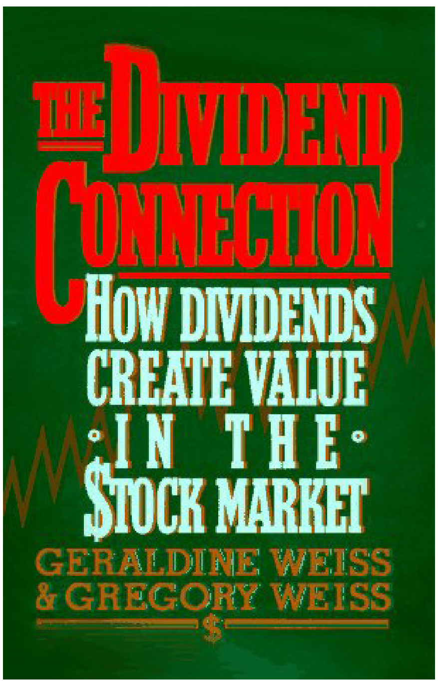
"Blue-chip stocks have always paid dividends, and they should – they should share their good fortune with their stockholders. And income is really the main reason why an investor would go into the stock market – to get a return on his investment dollar. We all hope for capital gains, but the only thing we can really count on is the dividend."

— G. Weiss, in an interview with *The Globe and Mail*, 2014

A bird in the hand is worth two in the bush

The equity market is forward-looking, such that current prices don't reflect the current profits of a corporation but instead its expected future profits. What this means is that if an investor were to wait for the realisation of expected profits, the investor's profit would amount to nothing, as by then every bit of information related to present profits would have been fully incorporated into share prices. In other words, investors must risk something to earn something, and that means paying for the expected, as opposed to paying for the realised. But sometimes expectations about the future are too optimistic while bottom-line profits can also be manipulated, meaning investors end up paying too much. The dot-com collapse saw many skyrocketing companies battered down, after their huge expected profits never materialised. At the same time, a few ostensibly profitable companies like Enron also taught investors a lesson on the difference between corporate profits and dividends.

Ultimately, the goal of investing is to get a return on the committed capital. While a property owner receives rent and a worker receives a salary, an investor expects to receive a profit. But, while the equivalent to rent or a salary payment is a dividend payment, investors concentrate their attention on corporate profits, as such money technically belongs to them and is expected to be paid out, in some form or other, in the future. But corporate profits are not exactly the same as shareholders' profits, with the first being an accounting realisation and the second real money received by investors.



A dividend payment is *"the hallmark of a blue chip stock. If a company doesn't pay a dividend, it's a speculation"*. Learning from Benjamin Graham, G. Weiss developed a profitable investment strategy based on dividends instead of earnings, which has been effective since 1966, delivering consistent profits above the market until today. Heavily criticised during the 1990s as growth stocks proliferated, Weiss' strategy survived the most eccentric of times to show that, over the long run, a sound dividend-yield strategy is able to capture value with substantially less risk than strategies based on corporate profits. Starting in 1966, the strategy developed by Weiss has been successfully presented to investors in the form of a newsletter, under the name "Investment Quality Trends".

"A DIVIDEND PAYMENT IS 'THE HALLMARK OF A BLUE CHIP STOCK. IF A COMPANY DOESN'T PAY A DIVIDEND, IT'S A SPECULATION'."

A tough start

Before starting the investment advisory service, Weiss and her male business partner tested their audience by sending identical promotional letters to prospective clients, each of them signing with their own name. In the end, they found that all the responses they got were for Weiss' business partner.

The advisory service was then started, but Weiss' business partner soon left to work for a brokerage house. Weiss was prepared to keep the newsletter going, but the promotional letters showed that she could never sign it as Geraldine Weiss. She therefore became known as G. Weiss, hiding her gender from investors for years.

Geraldine Weiss became the first woman to start an investment advisory service, in the process becoming a trailblazer for other woman and a major proponent of value investing, in particular the specific field of dividends and blue chip investment. She was latter dubbed as *"The Grande Dame of Dividends"* and sometimes also called *"The Dividend Detective"*.

"THE IDEA THAT DIVIDENDS AND PROFITS COULD LEAD TO DIFFERENT RESULTS – THAT IS, DIVIDEND POLICY *DOES* MATTER – WAS AT THE CENTRE OF WEISS' STRATEGY."

Weiss studied business and economics at the University of California and developed an avid interest in investment because her parents were also investors. She spent much of her time at the San Diego public library reading every book she could find on investing, while also listening to market talk every night at dinner. At first, she tried a few technical approaches to investment but with limited success. What really made the difference was Benjamin Graham and his seminal work on value investing. After reading *Security Analysis* and

The Intelligent Investor, Weiss realised that *"it was values that, in the long run, determine price more than anything else"*. From that point, she started developing her own strategy.

Dividends as opposed to profits

While financial theory has often claimed that capital structure doesn't matter and that in an efficient market paying dividends or retaining earnings should play out similarly (as prices would adjust accordingly), in practice there is evidence to refute those theories. Many years ago, before most of the real-world evidence was collected and scientifically validated, the idea that dividends and profits could lead to different results – that is, dividend policy *does* matter – was at the centre of Weiss' strategy development.

A dividend is a physical disbursement, like a salary or rent, which isn't the case with a retained profit. Weiss believes that dividends determine value not profits. Dividends are real money. While corporate profits can be manipulated, companies can't fake real money.

While there are many arguments that could be advanced against the dividend-based strategy and in favour of a profits-based alternative, Weiss' thinking relies on the main principles of value investing that were originally brought forward by Ben Graham. The dividend payment acts as an effective downside protection for investors, in a manner similar to how the margin of safety works for Graham. Weiss went through all past records available for stocks and realised that when the dividend yield was high, share prices tended to rise, and when the yield was low, prices tended to decline. Thus, the dividend yield seemed to be an indicator of over- and under-valuation. The rationale for this is relatively straight-forward. If a stock goes down too much, its dividend yield would rise substantially, as the dividend yield is the ratio between the annual dividends and the current stock price. All the rest held constant, an improved yield would attract more investors and boost the price higher again. Dividends offer downside protection. Symmetrically, when price rises significantly, the dividend yield declines, making the

"ONLY IN THE MID-1970s, WHEN SHE WAS INVITED ON LOUIS RUKEYSER'S SHOW 'WALL STREET WEEK', DID SHE FINALLY REVEAL HERSELF AS A WOMAN TO INVESTORS."

stock less attractive. Some investors would then start selling and the price would decline. The relationship is similar to that of a rental market, a jobs market, and a bond market.

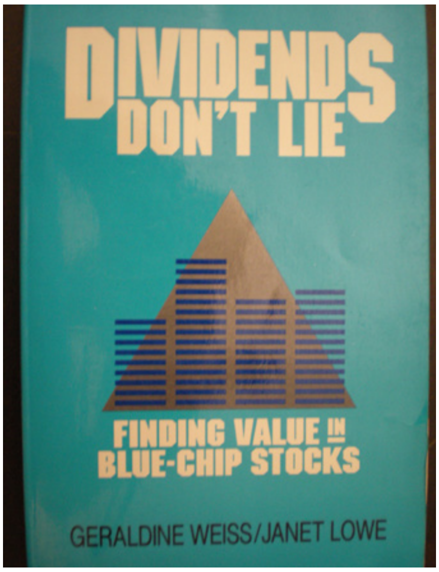
But in the above reasoning we assume that *"all the rest is held constant"*, to then assert that investors purchase the stock when the yield rises. Of course, if a change in risk profile is perceived, the rise in the yield may just represent an extra compensation demanded by investors. In that case, there wouldn't be a reason to believe the stock would rise again on increased demand. But Weiss certainly didn't ignore it, as her strategy is composed of several checks to assure she is buying companies that are very well established with a low probability of cutting dividends and of seeing their businesses impaired by the business cycle.

Weiss started tracking a list of 350 blue chip stocks to build a record of dividend yields for each of them across time. This way she could have an idea of what constituted a high and a low yield. When the relative measures went to their historical extremes, it was time to buy (when the yield was at a peak) or to sell (when the yield was at a trough).

After her business partner left the partnership, Weiss published the "Investment Quality Trends" newsletter under the name G. Weiss with great success. For years, she received letters from subscribers addressed to Mr. Weiss, as they didn't realise Weiss was a woman. Only in the mid-1970s, when she was invited on Louis Rukeyser's show *"Wall Street Week"*, did she finally reveal herself as a woman to investors. By then, it didn't really matter who was behind the service, as investors had already been making substantial profits from it for years.

Setting the strategy

Weiss' strategy is uncomplicated and can be replicated with ease after making a few adjustments. It can also be tweaked to fit any additional restrictions or requirements, if needed. In the end, what really matters is to pick value through dividends and create a low risk strategy. *"The Grande Dame of Dividends"* explained her strategy in the book *"Dividends Don't Lie: Finding Value in Blue-Chip Stocks"* and in *"The Dividend Connection: How Dividends Create Value in the Stock Market"*. More recently, Kelley Wright, the incumbent managing editor of *"Investment Quality Trends"* and successor of Weiss, wrote *"Dividends Still Don't Lie: The Truth About Investing in Blue Chip Stocks and Winning in the Stock Market"*, which further underpins the main points behind the strategy.



The first step an investor must take is to collect information for blue chip stocks (the analysis can be extended to other stocks as well) regarding dividend yields. All stocks in the list should be paying dividends, otherwise they're excluded from it. After collecting the data, the process of selecting stocks goes through a list of seven criteria. A stock:

1) Must be undervalued, as measured by its dividend yield on a historical basis

The strategy picks value using the dividend yield. At each point in time, an investor needs to look back and see how current yield compares with its historical values. When it is near the extremes, the stock is a candidate for buying (peak) or selling (trough).

2) Must be a growth stock that has raised dividends at a compound annual rate of at least 10% over the past 12 years

A growth stock with a good record of raising dividends increases the odds of successful investment, because the numerator of dividend yield would increase faster. If the yield is historically at a trough and the stock is raising dividends fast, the effect is amplified.

3) Must be selling at 2x book value at most

This criterion comes from the safety margin Ben Graham always placed in his strategy. When price to book value is low, investors are paying a low premium for the company as an ongoing concern. That means that if things go terribly wrong and the assets are sold separately investors can still recover a good share of their investment. When price to book values are too high, there's no safety margin.

4) Must be selling at 20x earnings at most

While earnings are not the main criterion to select stocks, Weiss always avoided any disconnect of price from reality. After all, the ability to pay dividends depends on earnings. When the price to earnings is too high, such ability decreases, which may mean a high dividend payment is unsustainable.

5) Must have a dividend payout ratio in the 50% area or less

While a 100% dividend payout ratio would seem great from the perspective of an investor receiving it, it would be unsustainable. The company should retain some profits to re-invest in the business and to weather the business cycle without having to cut the dividend. In the UK, this criterion corresponds to a dividend cover of 2 or more.

6) Must hold debt in a proportion less than 50% its total capitalisation

The main point is to assure the company isn't too geared such that debt may become an issue.

7) Must meet all six of the blue chip criteria

The blue chip criteria are composed of: dividend raised five times in the last 12 years; a rating of at least A from ratings agencies; at least 5 million shares outstanding; at least 80 institutional investors holding the stock; 25 uninterrupted years of dividend payments; and earnings improvements in seven of the last 12 years.

"THROUGH CHOOSING STOCKS WITH A GOOD RECORD OF PAYING DIVIDENDS UNINTERRUPTEDLY AND WITH SOUND FINANCES, INVESTORS ARE INCREASING THEIR PROTECTION AGAINST DOWNSIDE RISKS."

In the *"Investment Quality Trends"* letter, Weiss groups the list of stocks into four different categories: overvalued, undervalued, rising trend (if it rises at least 10% from its undervalued base), and declining trend (if it falls at least 10% from its overvalued peak).

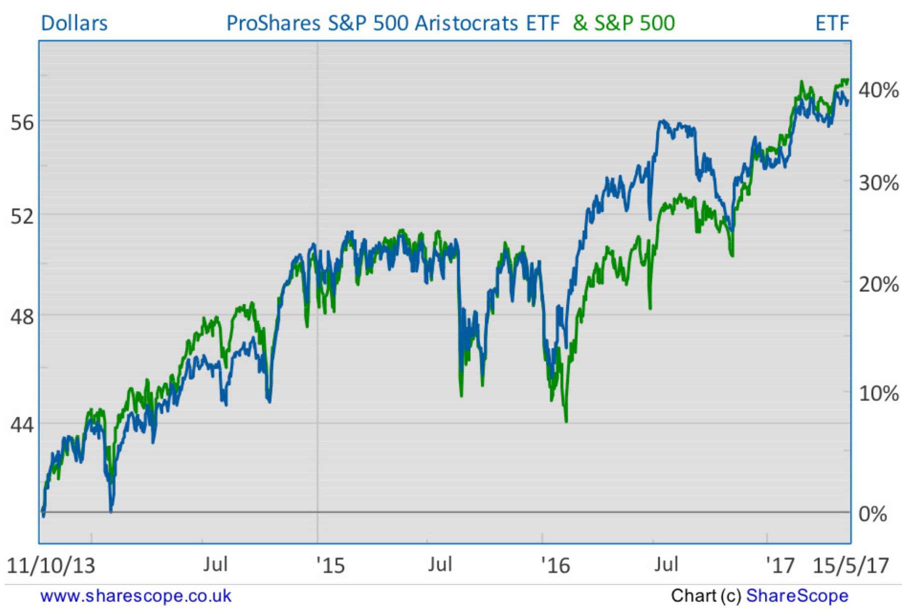
Developing a dividend-yield strategy in the real world

The filter resulting from applying Weiss' criteria will populate a list with just a few stocks at most. But investors have some alternatives. The simplest of the dividend strategies consists of just picking high-dividend paying blue chips. Such a strategy has been providing returns above the market over long periods of time.

One well known list of dividend-paying blue chips is the S&P 500 Dividend Aristocrats. It is composed of S&P 500 stocks that have increased their dividend payouts for 25 consecutive years. Spanning ten different business sectors with both growth and value holdings, this list offers a more balanced portfolio than many other dividend-yield based portfolios.

Currently the list is composed of 52 stocks. In the third quarter of 2013, the **ProShares S&P 500 Dividend Aristocrats ETF (BATS:NOBL)** was launched, which tracks the Dividend Aristocrats list, allowing investors to follow a dividend-yield strategy with ease.

Alternatively, investors may look for a screener or set up their own to select stocks. Sharescope software, for example, offers a pre-set filter for Weiss' strategy. In any case, the final filter would be a variation of the original strategy and should then be interpreted as such. An example filter, which attempts to mirror the main idea behind the strategy, is provided below. Nevertheless, none of the filtered companies can really be considered blue chips, except for Cisco Systems.



Lucky 13 Vs. S&P 500 Total Returns (2000-2016)

Year	Lucky 13	S&P 500
2000	31.20%	-9.11%
2001	15.20%	-11.98%
2002	10.90%	-22.27%
2003	30.20%	28.72%
2004	13.21%	10.82%
2005	8.00%	4.79%
2006	16.00%	15.74%
2007	-3.25%	5.46%
2008	-23.46%	-37.22%
2009	23.88%	27.11%
2010	11.43%	14.87%
2011	11.50%	2.07%
2012	15.28%	15.88%
2013	32.96%	32.43%
2014	5.60%	13.81%
2015	0.75%	1.31%
2016	16.30%	11.92%
CAGR	***11.83%***	***4.47%***

Source: Investment Quality Trends, Robert Schiller

Originally, Weiss said that blue-chip yields usually ranged between 3% and 6%, and generally reverted at these extremes. Thus, when the Dow Industrials shows an average yield of 6%, the market is broadly undervalued, as it is broadly overvalued at a yield of 2%. But later in 2014, she admitted that the interval may have changed to something like 2% and 4%, because of the technology stocks that have entered the indexes. Currently the average yield for the Dow components is around 2.6%; the same is 2.4% for the S&P 500 and 3.4% for the FTSE 100. Judging by Weiss' claims, the US market seems slightly overvalued.

Value will always be value

Companies in general avoid cutting dividends in the face of any difficulties created by the business cycle, because the impact on bond ratings, on the ability to borrow money or raise capital, and on shareholders' appetite to hold the stock is usually highly negative. Thus, unless they're really losing a lot of money, they would avoid cutting dividends. Through choosing stocks with a good record of paying dividends uninterruptedly and with sound finances, investors are increasing their protection against downside risks. In practice, Weiss' portfolios have performed very well over the long run and, in particular, have outperformed the market during downturns. A report from 2002 placed the *"Investment Quality Trends"* newsletter as the top performer of investment newsletters (in the US) on a risk-adjusted basis over the prior 15 years, earning 12.4% annualised. The Lucky 13 portfolio, which is a selection of the most promising stocks Weiss includes in the newsletter, has been outpacing the market for the last 17 years. Between 2000 and 2016, the Lucky 13 achieved a compound annualised return of 11.83%, which compares with 4.47% obtained by the S&P 500.

During the quick ascent of the technology companies in the 1990s, Weiss' strategies were criticised, as investors turned to alternative metrics to evaluate the prospects of companies that had never seen a cent in profits and thus couldn't be evaluated through a dividend model. But the quick ascent of the 1990s proved unsustainable, as the promised profits never translated into earnings, let alone dividends. By then, investors were reassessing their views and stock prices were crashing down to earth. Traditional metrics proved valuable again, and while the S&P 500 declined 38% between 2000 and 2002, the Lucky 13 portfolio skyrocketed 68%.

"What these investors forgot and what they are now realising is that dividends provide a cushion of safety when a stock starts going down."

This episode should serve as evidence that while traditional valuations are at times suppressed, they are quickly re-established when there is a return to reality. In the end, a bird in the hand is worth two in the bush.

"'WHAT THESE INVESTORS FORGOT AND WHAT THEY ARE NOW REALISING IS THAT DIVIDENDS PROVIDE A CUSHION OF SAFETY WHEN A STOCK STARTS GOING DOWN.'"

Weiss' Example Filter for the U.S. Market

Company	Close ($)	Capital ($m)	No. Shares Outst. (m)	Index	Sector	Dividend 5y Growth Rate % (annualised)	Dividend 1y Forecast	Div. Yield (%)	Debt to Capital	Current Ratio	Dividend Cover	Price to Book	Price to Earnings
American Railcar Ind Inc	3,742.00	714.10	19.1		Industrial Transportation		160.00	4.28	0.62	3.58	2.34	1.32	10.00
Cisco Systems Inc	3,423.00	171,971.50	5020.0	DJ 30, and others	Technology Hardware & Equip	40.60	108.73	3.18	0.48	3.16	2.13	2.74	16.20
MDC Holdings	3,563.00	1,840.30	51.6		Household Goods & Home Const	0.20	100.00	2.81	0.48	8.51	2.07	1.39	17.80
Cal-Maine Foods Inc	3,765.00	1,828.90	48.6		Food Producers	38.60	0.00		0.18	7.50	3.00	1.99	5.80

Source Data: Sharescope

Weiss' Example Filter for the U.K. Market

Company	Close (pence)	Capital (£m)	No. Shares Outst. (m)	Index	Sector	Dividend 5y Growth Rate % (annualised)	Dividend 1y Forecast	Div. Yield (%)	Debt to Capital	Current Ratio	Dividend Cover	Price to Book	Price to Earnings
Barratt Develop PLC	608.00	6,122.37	1010.0	FTSE 100	Household Goods & Home Const		40.45	6.65	0.38	3.30	2.98	1.54	11.20
Crest Nicholson Holds Ltd	636.50	1,625.49	255.0	FTSE Mid 250	Household Goods & Home Const		35.05	5.51	0.49	3.60	2.21	2.28	10.50
Bellway PLC	2,922.00	3,588.10	123.0	FTSE Mid 250	Household Goods & Home Const	53.90	115.00	3.94	0.31	3.55	2.90	1.92	9.30
MJ Gleeson PLC	638.00	345.29	54.1	FTSE Small Cap	Household Goods & Home Const		19.50	3.06	0.15	5.82	3.03	2.25	14.50
Boot (Henry) PLC	276.75	365.61	132.0	FTSE Small Cap	Construction & Materials	10.50	7.49	2.71	0.39	2.00	3.01	1.58	13.10
Redrow PLC	575.50	2,128.20	370.0	FTSE Mid 250	Household Goods & Home Const		15.00	2.61	0.50	3.12	5.52	2.05	10.40

Source Data: Sharescope

Filters Applied to Data: Current Ratio > 2, Dividend Cover > 2, P/E < 20, P/B < 3, 1y Forecast Dividend > 0, Capitalisation > 300m, Shares outstanding > 5m, Debt/Capital < 0.67

MAY 2017

BEST OF THE BLOG

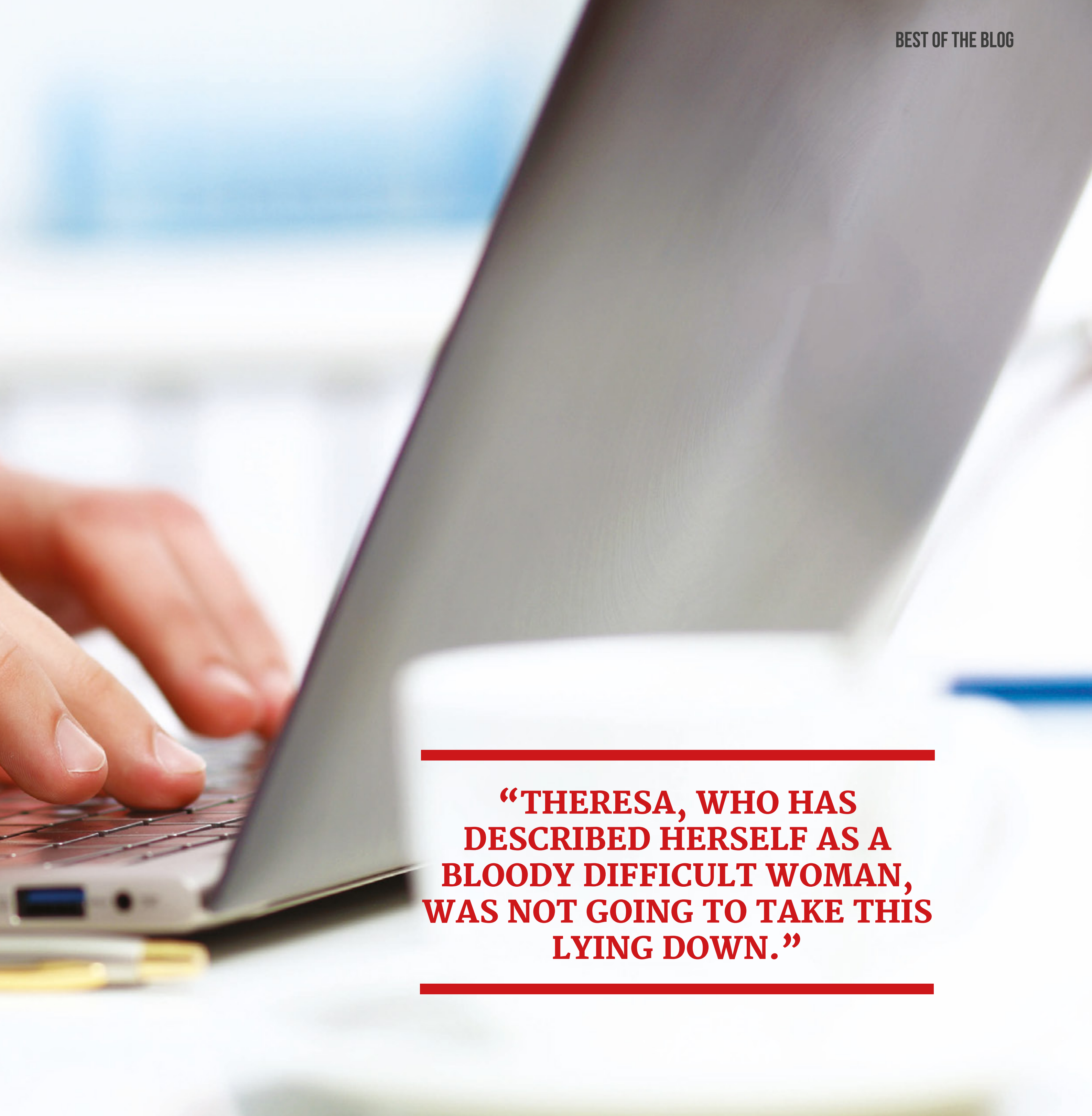
Brexit talks: Expect more unhappy dinner parties and prepare for a market shock

The Brexit talks-about-talks have started badly. What is the chance that there will be no deal at all? Are investors heading for the rapids...?

On 26 April Theresa hosted dinner at her well-appointed home in Downing Street for Jean-Claude (a louche Belgian gentleman whom she had met on a caravanning holiday in the Low Countries) and his French friend, Michel. Theresa also invited David, her live-in handyman, to make up numbers.

There was much double-kissing on the steps of Number Ten as the guests slipped off into the night in their shiny motors. Theresa thought that it has all gone rather well. The lamb had been succulent and the banoffee pie had had just the right balance of sweetness and astringency. There had been a few somewhat awkward pauses; but when conversation flags David can always be relied upon to jolly things up with one of his Scotsman-Englishman-Irishman jokes.

Imagine Theresa's consternation when she read in a German



"THERESA, WHO HAS DESCRIBED HERSELF AS A BLOODY DIFFICULT WOMAN, WAS NOT GOING TO TAKE THIS LYING DOWN."

newspaper a few days later that Jean-Claude had immediately called his friend Angela on her private mobile to complain that the peas had been frozen – and the wine served was the bottom-shelf plonk from ASDA. Worst of all: he'd told her that the conversation was inane: Theresa was on another planet and David was a bit of a tit.

Theresa, who has described herself as a *bloody difficult woman*, was not going to take this lying down. She set up a lectern outside her lovely terraced home and invited the world's media. She told them she is simply not going to put up with any more Eurotrash slagging off her dinner parties. She said: *There are some in Brussels who do not want our dinner parties to succeed...*

Whereupon Jean-Claude announced that he wasn't even going to speak English anymore...

By Victor Hill

Click here to read the full article

The fund offering uncorrelated returns with downside protection

There are not many funds that are capable of delivering decent returns regardless of the wider market, with one of the few exceptions being **Crystal Amber (LON:CRS)**. The £230m investment trust has a very small retail following, although many people will have an exposure to it via the Woodford Equity Income fund as Neil Woodford's investment management company is one of the largest holders with 16% of the shares.

The fund is managed by Richard Bernstein of Crystal Amber Asset Management who aims to provide shareholders with an attractive total return by investing in a concentrated portfolio of undervalued UK companies. These typically have a market value of between £100m and £1bn with most being towards the small and mid-cap end of the spectrum.

Bernstein is an activist investor that targets UK special situations where he thinks he can release value regardless of the direction of the wider market. He uses a screening process and his network of contacts to identify potential investments and will typically look for companies that will generate a return of 20% per annum over the holding period. This will normally be around four years.

The manager has a preference for cash or asset backed businesses and will look at the discount to net asset value (NAV), as well as any previous corporate activity and the presence of strategic shareholders to assess the likelihood of the company being bought out.

Wherever possible Bernstein attempts to create an activist angle so as to maximise shareholder value. Normally the reaction of the investee company management teams has been positive and he avoids businesses with serious problems or those with difficult people in charge...

By Nick Sudbury

Click here to read the full article

Ignore the FTSE 100 and buy Royal Mail

It's been a long road but, finally, the FTSE 100 has reached 7,500 points. This may prompt worry among some investors, since it could mean the index is overvalued and there is a lack of investment opportunities on offer. Risks such as Brexit, the general election, Trump's Presidency and numerous others could weigh on the UK's main index.

Likewise, those risks may fade and leave investors in an even more bullish mood. Therefore, in my view there is limited value in attempting to predict the short-term price movements of the index. During bull and bear markets, opportunities to buy and sell nearly always exist – no matter what the index's level.

One such opportunity at the moment could be **Royal Mail (LON:RMG)**. The company offers a very low valuation, high yield and a business model which has the potential to improve. Although risks do exist, the rewards suggest Royal Mail has investment appeal regardless of how the FTSE 100 performs in future.

Royal Mail is essentially a two-speed business. Its traditional UK operations account for 78% of revenue and have been struggling for some time. For example, in its full year to 26 March 2017, it recorded a decline in underlying revenue in its UK business of 2%. This was largely due to a continued downward trend in its letters segment, where revenue declined 5%.

Although the company is implementing what appears to be a sound strategy to avoid £600 million of annualised costs within its UK business by 2017/18, the overall picture is one of decline as posting letters simply becomes less popular. Therefore, further cuts to underlying operating costs in its UK division after three years of reductions is only likely to have a limited impact on overall profitability in the long run...

By Robert Stephens, CFA

"WHEREVER POSSIBLE BERNSTEIN ATTEMPTS TO CREATE AN ACTIVIST ANGLE SO AS TO MAXIMISE SHAREHOLDER VALUE."

Click here to read the full article

Searching for the next British 'unicorn'

Here's an experiment for you to try. Ask 10 random people on the street if they've heard of 'Global Switch' (www.globalswitch.com) and you'll likely be confronted with a vacant expression. You may well find a similar response if you mention 'Anaplan' (www.anaplan.com). Yet both are 'unicorns', an expression in the tech arena to describe a company that has attracted a valuation in excess of $1 billion.

> **"SO-CALLED 'INFORMED INVESTORS' HAVE BEEN CONTENT TO PAY SUMS THAT VALUE THESE STARTUPS AT A LEVEL SUFFICIENT TO PUT THEM INTO THE FTSE 100."**

Both are UK based businesses that have disrupted their way into the portfolios of venture capital firms and family offices around the world. Indeed, these so-called 'informed investors' have been content to pay sums that value these startups at a level sufficient to put them into the FTSE 100 and 250 respectively, yet both remain private businesses.

But still, the UK entrepreneurs that created them belong to a group of innovators that remain far, far behind their US counterparts in terms of volumes. The number of UK spawned unicorns, and their valuations, remains well below those achieved across the pond. Can the UK tech firms really compete for talent and capital in the Brexit era?

The billion-dollar threshold may seem an odd focal point but there is a logic behind it. Historically, the top venture funds have delivered returns from share ownership in just a few companies that have gone on to become uber-successful – the vast majority fail. And in turn, as these funds have grown in size, larger exits are required in order to deliver acceptable returns.

For example, a small $500 million fund would need to own 10% of five different unicorn companies at exit in order to merely break even in performance terms. In reality, the funds are looking to end up owning 10-20% of a unicorn that achieves multi-billion dollar status and becomes a part of the Silicon Valley establishment. Big is beautiful in the Valley.

By Richard Gill

Click here to read the full article

BY RICHARD GILL, CFA

READ TO SUCCEED

HOW TO PICK QUALITY SHARES

A THREE-STEP PROCESS FOR SELECTING PROFITABLE STOCKS

BY PHIL OAKLEY

There is a theory in finance, taught to student of economics, which argues that stock markets are efficient. The Efficient Markets Hypothesis (EMH), without going into too much detail, conceives that investors cannot beat the market in the long-run by basing their investment decisions on analysing historical charts or digging through company accounts.

This is because, according to the theory, current share prices *always* reflect all of the available information in the markets, with prices reacting to new information in an instant. In other words, shares are always trading at their theoretical "fair value", so applying technical or fundamental analysis to try to identify apparently undervalued shares is a fruitless task. So, as the theory goes, the only way to get returns higher than a market index is to put your money into riskier investments.

The theory is of course nonsense for a number of reasons.

Firstly, investors can interpret company information differently and make contrasting investment decisions on the back of it. For example, an announcement of a round of job cuts might be seen as a positive cost saving measure by one investor and as a sign of falling demand by another. Secondly, stocks can take time to reflect new information, so those who react early can, and do, profit. What's more, if stocks really were priced efficiently a whole industry of fund managers, stock tipsters, analysts and PR advisers would not exist. And neither would this book.

How to Pick Quality Shares is the first book from Phil Oakley, an investment analyst and private investor who is perhaps best known for writing on shares and investments at financial software business ShareScope. He is a fundamentals driven analyst and writes in great detail on a range of subjects from depreciation to industrial machinery and everything in between. Oakley spent 13 years as a professional investment analyst, with ten years working for fund managers and stockbrokers in the City. He left the Square Mile in 2009 and began writing educational articles for private investors, including in the role of senior investment writer for MoneyWeek.

The search for quality

How to Pick Quality Shares takes investors through a three step process which focusses on analysing companies and, hopefully at the end of it all, finding quality ones which are worthy of investment. In Part One Oakley outlines the characteristics which are exhibited by quality companies and how these can be identified in their accounts.

Oakley is a strong proponent of number crunching, arguing that you can quickly build up a picture of how good a company is by looking at its regulatory filings. Profits are one of the main signs of a quality company so chapter one kicks off with a discussion of what exactly profits are and how to analyse them.

He then brings in the concept of the company "interest rate", in other words how much a company earns on the money it invests. Just like comparing interest rates on savings accounts you can also see how good companies are by looking at the return they make on their capital. The higher the rate earned, the better the business tends to be. The main measure looked at in this section is the return on capital employed (ROCE) which the author suggests is a great way to identify high quality companies. He argues that companies with a consistent ROCE of 15% or more could be potential winners.

"SUCCESSFUL INVESTING IS AS MUCH ABOUT AVOIDING BIG LOSERS AS IT IS ABOUT FINDING WINNERS."

Throughout the book Oakley complements the text with real life examples of his concepts, with Domino's Pizza being one of the main case studies – it has after all been one of the best performing companies of the past decade for private investors.

Dangerous debts

While many investment books focused on stock picking tell you how to find shares that could do well, Oakley goes one step further in Part Two by teaching investors how to avoid potential investment dogs as well. After all, successful investing is as much about avoiding big losers as it is about finding winners.

Just like you would take a car for a test drive, or have a survey done on a house before making a purchase, Oakley advises that you should always look to see if a company has any "nasties" before buying its shares. This section focusses on the dangers of debt, including the kind which might not be so obvious at first glance. This includes "hidden" debt such as operating leases and onerous pension deficits, such as that held by BT.

Finally, Part Three looks at how to value shares in order to work out a reasonable price to pay for an investment. A company may have passed the quality and safety tests in the previous two parts but if the price is too high it is less likely to be a good investment. Just like a decent bottle of wine might be a little more pricey than a budget version, you wouldn't pay over the odds for it.

However, you do have to pay a price for quality, so Oakley looks at valuation measures including the PE ratio, cash yield and the more exotic earnings power value (EPV). He teaches how to calculate a maximum price that should be paid for a share and suggests that you should be looking to buy at a discount of at least 15% to this level in order to increase the probability of investment success.

Stick it on your shelf

This is an excellent first book from Phil Oakley. While it is not aimed at complete newcomers to the stock market (a basic knowledge of investment jargon and how to read and interpret company accounts is needed) amateurs will still be able to add to their knowledge due to the clear language used. Rather, it is aimed at those who already invest in shares and perhaps manage their own portfolio but want to learn more about gaining an edge in the markets – some of the concepts are advanced and even reach the level of the professional analyst. The book is also aimed at the long-term investor, not those who want to be quickly in an out of a share to bank a short-term gain. It is a worthy addition to any investment library.

BY TIM PRICE

THE FINAL WORD

THINK SMALL

Adam Smith's 1776 masterpiece, *The Wealth of Nations*, is rightly regarded as a seminal work of classical economics. But there is also a darker counterpoint. In September 1941, Leopold Kohr wrote the first part of what would become his own classic text, *The Breakdown of Nations*. While Kohr was beginning his book, the mass murder of the Jewish inhabitants of Vilnius was beginning. Kohr, an Austrian Jew who only narrowly escaped the Holocaust, would go on to study at the London School of Economics alongside fellow Austrian thinker Friedrich von Hayek, and he would ultimately leave Europe for America, where he would make his home for the next 25 years.

The village in which Kohr was born, Oberndorf in central Austria, with a population of just 2,000 or so, would come to exert a disproportionate influence on his thinking. Within his book he argued that Europe should be "cantonized" back into the sort of small political regions from which it had emerged and which live on today in true democratic hold-outs like Switzerland. Kohr would show that there are unavoidable limits to the growth of societies:

"...social problems have the unfortunate tendency to grow at a geometric ratio with the growth of an organism of which they are a part, while the ability of man to cope with them, if it can be extended at all, grows only at an arithmetic ratio."

In the real world, there are finite limits beyond which it does not make sense to grow.

Kohr argued that only small states can have true democracies, because only in small states can the citizen have

> **"IN THE REAL WORLD, THERE ARE FINITE LIMITS BEYOND WHICH IT DOES NOT MAKE SENSE TO GROW."**

some direct influence over the governing authorities.

When asked what had most influenced his political and social ideas, Kohr replied:

"Mostly that I was born in a small village."

(In the interests of full transparency, I voted Leave. Not because I hate Europe, or Europeans, but because I hate what the EU has become. The euro zone in particular is an object lesson in an unwieldy, oversized, dysfunctional political construct haphazardly cobbled together among irreconcilable cultural entities.)

Wherever something is wrong, wrote Kohr, something is too big. The answer is not to grow, embracing even more disparate states within a failing currency union with make-it-up-as- you-go-along rules. The answer is to stop growing.

The answer to the 'too big' problem lies not in ever greater union, but in division.

"We have ridiculed the many little states," wrote Kohr, sadly; "Now we are terrorized by their few successors."

It all comes down to scale. As Kirkpatrick Sale puts it in his foreword to *The Breakdown of Nations*,

"What matters in the affairs of a nation, just as in the affairs of a building, say, is the size of the unit.

"A building is too big when it can no longer provide its dwellers with the services they expect – running water, waste disposal, heat, electricity, elevators and the like – without these taking up so much room that there is not enough left over for living space, a phenomenon that actually begins to happen in a building over about ninety or a hundred floors.

"A nation becomes too big when it can no longer provide its citizens with the services they expect – defence, roads, post, health, coins, courts and the like – without amassing such complex institutions and bureaucracies that they actually end up preventing the very ends they are intending to achieve, a phenomenon that is now commonplace in the modern industrialized world.

"THE ANSWER TO THE 'TOO BIG' PROBLEM LIES NOT IN EVER GREATER UNION, BUT IN DIVISION."

"It is not the character of the building or the nation that matters, nor is it the virtue of the agents or leaders that matters, but rather the size of the unit: even saints asked to administer a building of 400 floors or a nation of 200 million people would find the job impossible."

It is taking time for the logic of the more reflective Leave voters to surface, but their opinions are slowly rising to the top of this still fractious debate. I was struck recently by the quiet articulacy of Theodore Dalrymple – the pen-name of the retired doctor Anthony Daniels – demonstrated in this recent discussion (you can hear Dalrymple himself after about a minute or so into this YouTube clip). In England, there is now, in his words,

"a sense that the political and intellectual élite has formed itself into a caste that is completely separate from the rest of the population."

Dalrymple himself voted Leave in the 2016 EU membership referendum

"..for political reasons. The EU is a political project which will reinforce this tendency to have a small caste that is separate. You only have to go to Brussels or Strasbourg to see people who haven't paid for their own lunch for 40 years, who've never seen anything except from the back of an official car. There's no possible way of the EU being even minimally democratic, of having checks and balances."

I was also struck by the statistic – yet to be challenged by any informed source – that I came across during the referendum campaign, that there are 10,000 bureaucrats at the European Commission who are each paid more than the British Prime Minister.

Perhaps the most stringent observer of Brexit and the existential turmoil it has unleashed on today's liberals is the English philosopher John Gray. Writing for The New Statesman shortly after the verdict of last year's referendum came in, Gray made the brilliant observation that

"Predictably, there is speculation that Brexit will not happen. If Britain can vote for Brexit, it is being argued, surely anything is possible. But those who think the vote can be overturned or ignored are telling us more about their own state of mind than developments in the real world. Like bedraggled courtiers fleeing Versailles after the French Revolution, they are unable to process the reversal that has occurred. Locked in a psychology of despair, anger and denial, they cannot help believing there will be a restoration of an order they believed was unshakeable."

The single most influential presentation I have ever seen in my life is by the late Dr Albert Bartlett, formerly emeritus professor of physics at the University of Colorado at Boulder, USA. The presentation, which you can watch in its entirety here, is titled 'Arithmetic, Population and Energy'. That may sound somewhat daunting. It isn't. Bartlett gave this presentation hundreds of times during the course of his career, and I guarantee you will find it extraordinarily powerful.

Bartlett's thesis is straightforward. Mankind's biggest failing, he argues, is our inability to understand the power of the exponential function – of something growing at a steady percentage rate over a prolonged period of time. To sum up this thesis, Bartlett makes a startling assertion: beyond maturity, for any entity, further growth equates to either obesity or cancer.

Size, in other words, *really matters*. I would argue that the EU project has metastasized and is now perhaps already out of control. The voters of the UK may end up doing the citizens of Europe a profound favour if they manage to halt or, better yet, reverse this political and bureaucratic metastasis. But Bartlett's thesis transcends politics and maintains a relevance, well beyond his death, in the world of economics and finance too. Our bond markets have also metastasized. Ever since President Nixon took the dollar off gold in 1971, global credit creation has exploded. We are now living with the legacy of a 40-year experiment in uncontrolled debt expansion. 2008 was only a tremor. The real earthquake is yet to come – but since 2008 the debt mountain has simply gone on growing. Simon Mikhailovich, founder of the Tocqueville Bullion Reserve, recently tweeted some basic mathematics:

"With global debt / GDP at 320%, and [the cost of] average debt service at 2%, it takes 6.4% growth per annum just to service the debt. Not happening."

This is a predicament that dwarfs any other in our world today. There is too much debt in the system, and at some point the markets will say 'Enough !' The sort of free market cleansing that might otherwise have occurred has been prevented by central banks driving interest rates down to zero – and in some cases below it. It has also been prevented by the *ex nihilo* printing of trillions of dollars, pounds, euros and yen, much of which has been flushed into the bond market.

"THE VOTERS OF THE UK MAY END UP DOING THE CITIZENS OF EUROPE A PROFOUND FAVOUR IF THEY MANAGE TO HALT OR, BETTER YET, REVERSE THIS POLITICAL AND BUREAUCRATIC METASTASIS."

Those trillions have bought our heavily indebted governments time, but not much else. They have also acted like morphine on the animal spirits of investors: the Vix index of US stock market volatility began May 2017 at its lowest level since 1993. As Warren Buffett sagely observed,

"Nothing sedates rationality like large doses of effortless money."

There are only three ways of resolving the global debt predicament. One is to engineer enough economic growth to service the debt. See Simon Mikhailovich's tweet for more on this. One is to default. A widespread repudiation of government debt might seem like an easy way out, except that it would instantaneously bankrupt the global banking and pension fund industries. There is a third option, and it happens to be the option that all heavily indebted governments have resorted to since time immemorial. That option is to inflate.

Given the extraordinary monetary accommodation that exists to this day on the part of governments and central banks, it may still be some time before that final inflationary crisis hits, but hit it surely must.

Investors today – especially in the bond market – are dancing on the rim of an active volcano. Got gold?

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

MAY 2017

GLOBAL EQUITIES

Index	Last Month %	YTD %	Proximity to 52w High*
FTSE 100	4.4	5.3	
Hang Seng	4.2	17.3	
NASDAQ 100	3.7	19.0	
Nikkei 225	2.4	3.9	
IBEX 35	1.5	16.3	
DAX Xetra	1.4	9.9	
S&P 500	1.2	7.7	
Euronext 100	0.9	9.2	
CAC 40	0.3	8.7	
Dow Jones	0.3	6.3	
S&P/ASX 200	-3.4	1.3	
Bovespa	-4.1	4.1	
Russian Trading System	-5.6	-8.4	

COMMODITIES

Commodity	Last Month %	YTD %	Proximity to 52w High*
Cocoa	9.6	-5.4	
Silver	0.7	8.6	
Platinum	0.3	4.9	
Gold	0.1	10.4	
Coffee	-0.1	-4.5	
Copper	-0.1	4.0	
Crude oil (Light Sweet)	-0.8	-9.5	
Palladium	-1.2	20.1	
Crude oil (Brent)	-1.4	-10.2	
Sugar (No. 11)	-3.6	-23.7	
Soybean	-4.1	-8.9	
Natural Gas	-5.6	-17.6	
Iron Ore	-16.7	-28.8	

FOREX

Pair/Cross	Last Month %	YTD %	Proximity to 52w High*
EUR/GBP	3.8	2.4	
EUR/USD	3.2	6.9	
EUR/JPY	2.5	1.2	
EUR/CHF	0.5	1.6	
GBP/AUD	0.4	1.3	
GBP/USD	-0.6	4.3	
USD/JPY	-0.6	-5.3	
AUD/USD	-0.8	3.1	
USD/CAD	-1.2	0.5	
USD/CHF	-2.6	-4.9	

CENTRAL BANKS - RATES & MEETINGS

Central Bank	Key Rate	Next	After
BOE	0.25%	Jun 15	Aug 03
ECB	0.00%	Jun 08	Jul 20
FED	1.00%	Jun 14	Jul 26
BOJ	-0.10%	Jun 16	Jul 20
SNB	-0.75%	Jun 15	Dec 14
BOC	0.50%	Jul 12	Sep 06
RBA	1.50%	Jun 06	Jul 04
RBNZ	1.75%	Jun 22	Aug 10
BOS	-0.50%	Jul 03	Sep 06
BON	0.50%	Jun 22	Sep 21

FTSE 350 TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Sophos Group PLC	33.7	72.9	
Berendsen PLC	30.9	26.1	
Wizz Air Holding PLC	29.1	27.3	
SIG PLC	28.8	49.4	
Ocado Group PLC	25.4	19.2	

FTSE 350 BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Petrofac Ltd	-53.3	-56.3	
Acacia Mining PLC	-27.4	-23.1	
Vectura Group PLC	-16.6	-14.2	
Galliford Try PLC	-13.2	-3.2	
Great Portland Est PLC	-12.9	-9.8	

FTSE 350 SECTORS TOP

Sector	Last Month %	YTD %	Proximity to 52w High*
Mobile Telecom	15.1	15.3	
Personal Goods	8.9	28.4	
Electricity	8.1	-3.6	
Hous. Good & Home C.	7.6	19.7	
Pharma & Biotechnology	7.6	8.5	

FTSE 350 SECTORS BOTTOM

Sector	Last Month %	YTD %	Proximity to 52w High*
Oil Equip, Services & Dist	-19.2	-22.9	
Industrial Metals	-5.8	-3.1	
Automobiles & Parts	-2.5	5.5	
Mining	-1.8	-1.2	
Industrial Engineering	-1.3	13.4