THE AVIATION REVOLUTION
AND HOW TO PROFIT FROM IT

PLUS...

JIM MELLON
THE MASTER INVESTOR SOUNDS
THE BLACK SWAN ALERT

NEIL WOODFORD
WAS THE STAR MANAGER RIGHT TO SELL
GLAXO AND HOLD ASTRAZENECA?

PRIVATE EQUITY RENAISSANCE
WHY INVESTORS ARE FLOCKING BACK TO
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Dear Reader,

Master Investor is a great believer in the power of personal meetings and one-to-one connections. That’s why, on June 20th, we launched our new series of smaller, more intimate, thought leadership events.

Our launch event happened on one of the hottest days of the year, but still, the event space was packed and it was standing-only for those who arrived late.

The panel discussion about “Investing in Health Care – learn from the masters” featured our very own Jim Mellon, Neil Shah of Edison Research, and Andrew Parry of Hermes Investment Management. Check our YouTube channel during the next few days, where the 90 minute discussion will be available for viewing.

One of the less visible, but equally valuable, features of the event was the networking after the discussion. Most of the nearly 100 delegates stayed on, enjoying a selection of chilled drinks (Laurent Perrier kindly sponsored the evening’s champagne) and talking investments, markets, and emerging trends.

Despite promoting the evening to only a fraction of our readers, we had over two times as many requests for tickets as we were able to accommodate. Clearly, active and informed investors enjoy meeting up to listen to the insights of proven experts and to network with one another.

Our launch event was a great success and you’ll no doubt soon hear about further events being hosted by Master Investor.

Stay tuned for further announcements!

Best regards,

Swen Lorenz
Editor, Master Investor Magazine
Opportunities in Focus — The aviation revolution — and how to profit from it

Things are changing in the aviation business. This month, Victor Hill pinpoints opportunities across the aviation universe.

Mellon on the Markets — The times they are a changin'

Inside the mind of a Master Investor: Nobody knows what black swan lurks, but in Jim’s opinion, there’s a whole flock hiding round the bend in the river.

Dividend Hunter — Was Woodford right to sell GlaxoSmithKline and hold AstraZeneca?

With star fund manager Neil Woodford having sold his holding in GSK while holding on to AstraZeneca, John Kingham asks if this was really a wise decision.

Funds in Focus — Why investors are flocking back to private equity

Investors have been reluctant to return to private equity after the poor performance during the financial crisis. But the sector’s fundamentals are now much stronger, writes Nick Sudbury.

From Acorns to Oak Trees — Profit from freshly funded small cap stars

Richard Gill, CFA, looks at three AIM companies which have recently raised a substantial amount of funds to boost their operations. Will they deliver for shareholders?

The Macro Investor — Prepare to embrace volatility

Volatility has hit record lows — but for how long? Filipe R. Costa explains why now could be a good time to take a bet on a future spike in the VIX volatility index.

Forensic Forex — Crossroads for the major currency pairs

Author and trader Samuel Rae reveals the factors that he views as crucial to his trading in the near term and where he stands on each of the major pairs.
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This month, veteran trader David Jones looks at a couple of ways charts can help when it comes to taking profits on a longer-term investment or shorter-term trade.

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Alan Steel of Alan Steel Asset Management looks at why you should think twice before transferring out of your final salary pension scheme.

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070 The Final Word – The wisdom in books
While we can learn from our own experience, it is a far more efficient use of our time to learn from the hard-won experiences of others. Tim Price explores the books that fundamentally changed his outlook on investing.

074 Markets in Focus
Market data for the month of June.
I was recently invited to a Conservative Party lunch hosted by the City and Westminster Tory Association. It was a jolly affair, with hundreds of well-oiled attendees, and despite the recent electoral setback, the mood appeared quite upbeat.

Mrs May, to her credit given the recent events, made a formulaic speech that was well received, despite the fact that it was a riff on the strong and stable campaign speeches (but with stable and strong being the new inverted word flourish!).

But of course, everyone knows she’s on the way out – the only question is: When? And who will succeed her? It’s interesting watching Conservatives at work – they really are a ruthless bunch. They do smile while they’re knifing you in the back, which is a consolation.

It’s pretty clear to me that the successor will be David Davis, with Boris running a couple of lengths behind. I’ve met Davis, and think quite highly of him; he’s a pragmatic fellow, and despite being an ardent Brexiteer, seems to get on well with the Eurocracy, being of a similar vintage to the leaders of the Brussels empire.

I quite like the way the UK government is now going to have to work hard, to compromise and to be innovative to get some sort of programme into law. Modest stress (see the upcoming Juvenescence book!) is good for us, and it will probably be good for the government, notwithstanding the chaos that seems to be its current hallmark.

A more reasoned version of Brexit, without bombast and idiocy, a less assertive industrial policy than the one previously advocated by May and her Rasputin like advisers, and a reformed welfare strategy may well be a positive outcome as a result of the electoral shock on 8th June.

The idea that Labour will get into power is fanciful; we have probably reached peak Corbynism, and although the economy may be softening slightly due to consumer fatigue, manufacturers and exporters are experiencing record orders, and UK Plc is generally doing well.

Sure, there is some modest, albeit unbalanced, growth happening in the Eurozone, and an obvious retreat is underway for the forces of anti-European populism. There is also a possibility that France just might institute some urgently needed reforms – but all of these positives pale in comparison to the fact that the Euro is doomed.

That doesn’t mean to say that European stocks aren’t much better value than US shares; there are some really good companies in Europe, and a few of them are cheaply valued. As examples, I like German company
“THE UK GOVERNMENT IS NOW GOING TO HAVE TO WORK HARD, TO COMPROMISE AND TO BE INNOVATIVE TO GET SOME SORT OF PROGRAMME INTO LAW.”
hugely inflated valuation to acquire old world assets, a clever standby trick for bubble companies. The effect of this will be to reduce Amazon's return on equity, which is already low, down to even lower levels. I know they are not paying in stock, but believe me they will do something soon to raise cash opportunistically on the back of a 100x plus PE ratio.

Google (NASDAQ:GOOGL), Apple (NASDAQ:AAPL) and Facebook (NASDAQ:FB) have plenty of cash – but also plenty of problems. My advice is to sell them all, and if you can, to go short. This might seem dangerous, but when these big stocks fall, they will really go to earth with a big thump. Meanwhile, every fund manager and their granny owns them, so watch the rush to the exits when the bad news hits.

Last month, I wrote that big biotech was super cheap, at least relative to the general market in the US, and since then there has been quite a big rally. I advise readers to hold on to my big stocks fall, they will really go to earth with a big thump. Meanwhile, every fund manager and their granny owns them, so watch the rush to the exits when the bad news hits.

I am also looking at Swiss company Novartis (VTX:NOVN), which looks increasingly like the best of the bunch among Big Pharma companies, overtaking Roche (VTX:ROG) as the best positioned in the behemoth rankings. AstraZeneca (LON:AZN) of the UK is also cheap and well managed.

We still love gold at Burnbrae and at Master Investor, and I cannot emphasise enough how at this juncture every investor should have precious metals in his or her portfolio. Nobody knows what black swan lurks, but in my opinion, there's a whole flock hiding around the bend in the river, and they are coming to surprise all the ETF investors and other herd followers. The fact that the VIX, the principal indicator of volatility is at record low levels should not be taken as a comforting sign.

Nor should the fact that my relatives can talk of little else than cryptocurrencies and the daily rise and falls in Bitcoin and in Ethereum be any kind of solace to investors. The times they are a changin’. And it’s best to sit this particular dance out.

Happy hunting!

Jim Mellon
NEW BOOK AVAILABLE IN SEPTEMBER!

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What’s more, just as self-driving cars are about to become reality – not everyone will like this – self-flying passenger aeroplanes are about to be tested. Future pilots will be robots.

This month, I want to pinpoint opportunities across the aviation universe: airframe manufacturers, aircraft engine manufacturers and the airlines that will profit most from the new technology. There are some surprising implications; and, as usual, there are winners and losers.

**Non-stop to Perth, the new gateway to Australia**

Western Australia’s capital has long suffered from a reputation for isolation. It’s more than 1,200 miles from the nearest other Australian state capital, Adelaide. A five-hour internal flight from Sydney, most inbound tourists to Australia hitherto started and finished their Australian adventure in Sydney – and maybe took in Melbourne and Brisbane if they had time. Beautiful Western Australia has been overlooked by visitors from Europe and America. This is about to change.

Starting on 25 March next year Qantas Airways (ASX:QAN) is launching the first-ever non-stop service to Australia from the UK. Its flights will leave London Heathrow and will arrive in Perth seventeen hours later after a journey of 14,500 kilometres. This exciting city, which boasts gourmet restaurants, artisanal food courts and hip hotels, will be no more than a longish overnight hop away from London.

What makes this alluring prospect possible is that Qantas has invested in a brand new fleet of 45 Boeing (NYSE:BA) 787-9 Dreamliners which will carry 236 passengers across Business, Premium Economy and Economy cabins – fewer than other airlines using this aircraft in order to maximise comfort.

Qantas’s Dreamliners will be powered by two GEnx aircraft engines manufactured by General Electric (NYSE:GE). This engine is described by its manufacturer as a giant leap
forward in propulsion technology. It uses the latest materials and design processes to reduce weight, improve performance and increase fuel-efficiency. It employs just 18 carbon fibre composite fan blades. The GE9x engine will offer up to 15 percent improved fuel efficiency and 15 percent less CO2 as compared to GE’s CF6 engine which it supersedes.

Thanks to its lighter carbon fibre body, the GE9x engines and advanced on-board systems, the Dreamliner uses an impressive 20 per cent less fuel than a similarly sized aircraft – which opens up a whole new world of destination opportunities.

The A350 XWB and the A321 Neo are pushing the boundaries for aircraft performance and increase fuel-efficiency. It employs just 18 carbon fibre composite fan blades. The GE9x engine will offer up to 15 percent improved fuel efficiency and 15 percent less CO2 as compared to GE’s CF6 engine which it supersedes.

Qantas has been operating a service from Sydney to Dallas (15 hours and 30 minutes) since 2014, using the Airbus A380-800. Up until now the world’s longest non-stop long-haul flight is Emirates’ service from Dubai to Auckland, New Zealand, which takes 16 hours and 35 minutes to cover a distance of more than 14,000 kilometres – also in the Airbus A380.

So, here’s the point for investors. This new generation of super long-haul airliners will tip the balance of commercial advantage away from established hub-centric airlines (“super-connectors”) in favour of extreme long-haul operators.

**Consequences of ultra long-haul flights**

The last decade has seen the irresistible rise of the four big “Super-Connectors” airlines (see panel) of which three are based in the Gulf. Between the four of them they carried 155 million passengers in 2015, dominating most long-haul routes between Europe and Asia”. Many passengers change planes at their hubs, though in the case of Dubai and Istanbul, many also take the opportunity to visit these increasingly must-see destinations.

However, in the last year or more the growth of the Super-Connectors has slowed and profits flagged. There are three main reasons for this.

First, the Gulf-based airlines in particular have been hit by the collapse in the oil price since the summer of 2014. This has severely cut demand for air travel on the part of Middle Eastern private individuals as their spending power has waned. In particular, passengers who traditionally may have travelled Business Class are now opting for Economy. Clearly, margins are higher in the Business and First Class compartments.

Second, the increasing instability in the region – with bitter civil wars raging in both Syria and Yemen – has deterred many Western, and especially American, travellers. The aborted coup in Turkey and its aftermath last year did nothing to raise Istanbul’s profile as a tourist destination. This is unfortunate as the UAE is a haven of stability within a troubled region of the world. Figures available in March this year show that capacity utilisation by the top Middles Eastern airlines was down to 73 percent – the lowest recorded since 2006, and even worse than during the financial crisis of 2008-09.
The third setback was the travel restrictions on citizens of certain Muslim-majority nations introduced by the Trump administration. Despite the various legal challenges and the overall confusion about their applicability, the result has been to discourage many perfectly upright citizens of Muslim countries from travelling to the USA. US visas are certainly more difficult to obtain for citizens of these countries as a result of “extreme vetting”. Also, in the spring of this year both the US and the UK banned passengers coming from eight Middle Eastern countries from carrying any electronic device bigger than a smartphone – so laptops have to be carried in hold luggage.

After the January travel ban, demand fell on Emirates’ routes to the US by 35 percent. The laptop issue has obliged business folk to route their journey to the US via Europe. Emirates have tried to overcome this by offering their own on-board laptops to Business Class passengers; but demand is still well down. In April Emirates cut the number of flights to the US by 20 percent, wiping out several years of sustained expansion.

For a Super-Connector each lost fare on a flight to or from the USA is, in fact the loss of two fares, including the flight from the traveller’s original destination. On the plus side, air travellers are beginning to reflect that the current generation of terrorists do not seem to carry out attacks on aeroplanes.

The rise of super long-range aircraft means that it will be possible for airlines (like Qantas) to carry smaller numbers of passengers to secondary cities (like Perth) half a world away – and profitably. That eliminates the need to change planes or just refuel in such hubs as Dubai.

### Airbus: The British connection

When Airbus was incorporated as a joint-stock company in 2001, BAE Systems PLC (LON:BA) made over its UK Airbus facilities in return for a 20 per cent share of the new company. These facilities became Airbus UK. Airbus UK has two main sites responsible for the design and manufacture of the wings for all Airbus models as well as overall design and supply of the fuel system. For most Airbus models the company is responsible for overall design and supply of landing gear as well. Airbus UK employs around 13,000 people at two sites: Filton, where the engineering and design activity takes place along with some manufacturing, and Broughton, Flintshire (near Chester) where all wing assembly takes place.

In 2006, BAE announced its intention to sell its stake in Airbus to EADS (the Airbus holding entity) for an agreed £1.87 billion. This must be one of the most egregious management errors of recent British corporate history – since currently Airbus/EADS is valued at around £50 billion.

Broughton currently manufactures the wings for the Airbus A320 and A321 short-haul workhorses, the A330 long-haul airliner and the new super fuel-efficient A350 plus the A380 “super-jumbo” – amounting to about 60 pairs of wings per month. The wings are assembled using components from Spain, Germany, France and elsewhere, and, once complete, they are despatched to special plants in Bremen and Hamburg. All this makes Airbus UK highly vulnerable to an adverse Brexit deal. In particular, there are currently rumours that Airbus could decide to relocate the entire wing production operation to its growing production hub in Mobile, Alabama. That would be a catastrophe for Broughton, as indeed for the UK as a whole.

The UK aerospace industry is worth £31 billion a year and is the world’s second largest – only America’s is bigger. According to a recent report by the manufacturer’s organisation EEF and Banco Santander there are 2,400 aerospace companies in the UK making engines and complex components for aircraft, spaceships and satellites, exports of which are worth £28.4 billion a year to the British economy. Both Airbus and Boeing rely on essential British-made components. One possible source of reassurance is that, in the event of a “hard” Brexit, under WTO rules, aerospace components are exempt from tariffs. But even if Britain were to create its own aerospace regulation regime, exporters would still have to comply with European Aviation Safety Agency (EASA) regulations, which are determined by the EU.
The "Super-Connectors"

Qatar Airways (private) has enjoyed over a decade of expansion driven by superior service and good-value fares routing passengers across the globe through its glittering hub in Doha. Qatar Airways is – jointly with Emirates – the world's largest airline by passenger kilometres travelled. It is still growing thanks to the apparently bottomless resources of the Qatari state. Qatar has secured a 20 percent stake in International Consolidated Airlines Group SA (LON:IAG) – the owner of BA – with which it operates a strategic alliance. (Incidentally, despite the recent BA bank holiday computer meltdown, IAG shareholders are up nearly 65 percent over twelve months!). But the mood music for Qatar Airways is not good at present. A recent slowdown in bookings will not have been helped by the outbreak of a new Cold War between Saudi Arabia (and its allies) and Qatar. Flight links have been affected from Doha to destinations across the Arab world.

Emirates Airlines (private) based in Dubai, UAE is largely owned by the Investment Corporation of Dubai – the main vehicle of the ruling Al-Maktoum family. It has built up a formidable brand for quality service based on a state-of-the-art fleet. Emirates operate more Airbus A-380s than any other airline. When British aviation guru Sir Timothy Clark advised the Maktoum family on the establishment of an airline back in 1985, his business plan observed that a third of the world's population lives within a four-hour flight from Dubai, and two thirds within an eight-hour flight. Its rise has been unstoppable – until now. On 11 May, however, the airline revealed a drop in profits of 82 percent as compared to the previous year. But Dubai is set to remain a destination. Eight million passengers a month pass through Dubai airport – a figure that is expected to rise during the World Expo in 2020.

Etihad Airways (private) based in Abu Dhabi, UAE has its own futuristic hub airport. The company pursued a strategy of growth by acquisition under its former CEO, James Hogan, which has left it financially overstretched. Mr Hogan has now been despatched. Its investments in Alitalia, Italy’s national carrier, which finally went broke in May, and in Germany’s Air Berlin (ETR:AB1), in which it has a 30 percent stake, have been disastrous. Air Berlin announced a record loss of €667 million for 2016 in early May. It seems that Etihad did not understand the implications of investing in European airlines which have such weird things as trade unions. Some voices have called for the merger of Etihad with her more glamorous sister airline, Emirates. Some have even suggested that it be liquidated – although there are issues of prestige involved for Abu Dhabi's ruling family, the house of Al-Nahyan. At some point, the UAE will collectively have to face up to the fact that it does not make sense to have two international hub airports just 100 kilometres apart.

Turkish Airlines – Turk Hava Yollari AO (IST:THYAO) was wholly owned by the Turkish state until its partial privatisation in 2004. In March, THY revealed its first annual loss since privatisation. THY's route network is majestic. For a UK-based traveller, there are many places that you will easily get to only on one of their aircraft – Kathmandu, Samarkand, Bishkek, Yerevan, Tbilisi. (It's extraordinary how many outlying capitals are not served directly from Heathrow and Gatwick.) THY’s service and customer care are both stylish and efficient. The growth trajectory is impressive but the core strategy – building Istanbul Atatürk Airport as a global hub – may have run its course. Plus we have to acknowledge that political risk is increasing in Turkey and indeed the region as a whole. If you hold THY shares you have probably done well and may want to consider cashing out.

One can also think of International Airlines Group (LON:IAG) as a Super-Connector. Passengers flying from Tel Aviv to Chicago will often route through London on BA. And passengers travelling from Santiago (Chile) to Berlin may route via Madrid on Iberia. More super long-haul point-to-point routes could take business away.
Efficiency wars

In May, EasyJet (LON:EZJ) announced that it had cut its carbon emissions per flight to a new record low. The metric airlines use to compare their green credentials is that of grams of CO2 per passenger kilometre. For the year to September 2016, EasyJet’s emissions amounted to 78.98 grams per passenger kilometre – down 1.3 percent on the year before and 31 percent below year 2000 levels.

By comparison, the latest figure for International Airlines Group (LON:IAG), the owner of British Airways, Iberia and Aer Lingus is 93.7 grams; for Air France-KLM (EPA:AF) it is 85 grams; and for Germany’s Lufthansa (ETR:LHA) it is 96.9 grams.

EasyJet was able to continue to reduce emissions with simple, sensible innovations. For example, they have fitted lighter seats in most of their aircraft, their aircraft only use one engine while taxiing to the runway and EasyJet’s pilots now consult their navigational charts on tablets rather than using heavy print-outs. Since EasyJet’s passengers already have to pay to take hold luggage, presumably further restrictions on hand luggage would also impact this metric. Currently, EasyJet imposes no theoretical weight restriction on hand luggage, only on size.

Chris Foster, Head of Carbon Efficiency at EasyJet, has stated that the airline’s target is to get emissions down to 77 grams per passenger kilometre by 2020. By using modern aircraft and flying them optimally, EasyJet will have reduced the carbon impact of its flights by over a third in 20 years.

This kind of progress is obviously good PR for a popular airline like EasyJet; and it also impacts the bottom line in terms of reduced fuel costs. It is clear that the airline industry has become very much aware of its environmental reputation, given that, collectively, it is a major contributor to global warming.

EasyJet and others are currently working on a hybrid aircraft which would use a hydrogen fuel cell powered electric motor to propel the jet around airports. Similarly, heavy mechanically-controlled systems are being replaced by electrical systems using lightweight lithium batteries.

The older generation of aircraft used – literally – cables and pulleys to control the wings by extending the flaps and ailerons. Modern aircraft use electronic hydraulic flight control systems which are more sensitive, lighter and more reliable.

The economics of air travel is being transformed by the fact that both Airbus and Boeing (see panels) are producing jets which are substantially lighter and which therefore burn less fuel, equipped with more and more efficient engines. Ultimately, everything will have to be re-engineered to keep weight down – including windows, seats, wings, the tail, rudder, and even the cockpit controls (which are now mostly touch-screen operated).

This can involve departures from traditional fixtures. WestJet Airlines Ltd (TSE:WJA) (see panel), which flies between the UK (Gatwick and Glasgow) and Canada, stripped out the conventional seatback screens in favour of streaming films to passengers’ smartphones and tablet computers. That saved about 660 kilograms of “unnecessary” weight on each plane!

“THE ECONOMICS OF AIR TRAVEL IS BEING TRANSFORMED BY THE FACT THAT BOTH AIRBUS AND BOEING ARE PRODUCING JETS WHICH ARE SUBSTANTIALLY LIGHTER AND WHICH THEREFORE BURN LESS FUEL.”
The dirty and the clean

A survey released by Heathrow airport recently alleged that 24 out of 50 airlines examined violated at least one performance target. El Al (TLV:ELAL), the Israeli flag carrier came bottom of the league after falling short of five out of seven measures including noise, nitrogen oxide (NOX) emissions, efficient landings and out-of-hours arrivals. It was closely followed by a number of other Middle Eastern airlines – Kuwait Airlines, Pakistan International (PIA), Oman Air, Jet Airways (NSE:JETAIRWAYS), Turkish Airlines and Air India (private).

Heathrow intends to publish such a survey every three months in order to name and shame the worst offenders. The airport now charges airlines landing charges in accordance with emissions, which gives them a financial incentive to raise their game.

The top four performers in Heathrow’s survey were British Airways, Aer Lingus, Etihad and Scandinavian Airlines Systems. Just as shoppers judge consumer products by ethical considerations, so travellers are likely to become more conscious of the environmental impact of the airlines they use.

The future of short-haul aviation is electric – and pilotless...

On 21 March this year Wright Electric, a California-based start-up announced that it is building a 150-seat electric-powered airliner to disrupt the short-haul airliner sector currently dominated by the Boeing 737 and the A320. It has struck a deal with Easyjet, which could put its design in the air. Exactly how the planes will work depends on advances in battery technology. While Wright’s design is still at the conceptual stage, they envisage that electric fans would be housed inside the wings.

Boeing announced in early June that it is researching the possibility of commercial-passenger jets that will rely on artificial intelligence rather than pilots. Initial experimental flights, without passengers, are planned next year, with such systems taking over pilot decisions. At a briefing before the Paris Air Show, Mike Sinnett, former chief systems engineer on the 787 Dreamliner, now responsible for innovative future technologies, said: “The basic building blocks of the technology are clearly available”. Arguably, pilots already mostly monitor the functions of automated in-flight systems.

Two aero-engine giants

General Electric (NYSE:GE). The GE9X is the fastest-selling, high-thrust jet engine in GE Aviation’s history with more than 1,600 engines on order. In addition to powering the four-engine Boeing 747-8, the GE9X engine is also the best-selling engine for the Boeing 787 Dreamliner. GE is a huge and diversified conglomerate of which GE Aviation is just one unit.

Rolls-Royce Holdings PLC (LON:RR.) has pioneered the use of lighter alloys in its aircraft engines. Ceramic materials in the hottest part of the engine turbine can cut an engine’s weight by 340 kilograms. Rolls-Royce is the global number two in aero-engine manufacture and currently has a market cap of £17 billion. Its shares have had a good run this year, being up about 40 percent YTD, despite losses last year which put a stop to dividends.

Both of these champions are working on revolutionary production technology. For example, 3-D printers will soon be used to produce components made of composite materials which do not require rivets or fasteners. This could reduce future engine weight by another 20 percent.
The budget airline giants

RyanAir (LON:RYA) and Easyjet (LON:EZJ) have been the two dominant players in the European budget airline market for nearly a quarter of a century now. What is remarkable is that they are both still growing.

Ryanair announced on 06 June that passenger growth exceeded that of Easyjet in May 2017. Passengers flown by Ryanair that month rose by 11 percent as compared with twelve months earlier to 11.8 million, while those travelling with Easyjet jumped by 9.5 percent to 7.5 million. These two budget airline giants are both dynamic businesses with potentially very long-term longevity that should be included in any diversified European equity portfolio.

Yet, globally, the budget airline business model is still overwhelmingly confined to the short-haul sector of which intra-EU and intra-China air travel are major markets. Norwegian Air (see panel) is one of the few operators to roll out the no-frills budget airline model over long-haul routes. Actually, this concept has been around since Sir Freddie Laker launched the Skytrain between London and New York way back in 1977. Sadly, Sir Freddie was ahead of his time, and in 1982 went bust.

Forthcoming innovations in air travel: skylights, airships and drones...

In ten years’ time your flight from London to San Francisco, Tokyo or Sydney may boast some amazing innovations. Skylights in the aircraft roof will allow natural light to flood into the cabin in daytime and will also act as solar panels to power many of the aircraft’s systems. Thanks to advances in glass technology, windows will be much larger. (Great news – I always grab a window seat as I am fascinated by physical geography.) Your seat will incorporate a massage machine to prevent deep vein thrombosis (DVT) and your in-flight TV screen will be replaced by a virtual reality headset.

And what about airships? Hydrogen-filled airships, amongst which Zeppelins, were the most advanced craft around more than one century ago – but they were discarded because of their volatile safety record. The return of the airship has been predicted in recent years; but while numerous helium-filled proto-types have been developed none have actually gone into commercial service.

Lockheed Martin (NYSE:LMT) plans to launch its first helium-powered airship for commercial use in 2018 for which it already has (we are told) twelve orders. The giant craft will be able to carry 21-tonne cargo payloads and will be used by the oil, gas and mining sectors to deliver bulky supplies to remote destinations in places like Alaska and Western Australia.

Apparantly, the development of helium-filled airships has only recently become possible because military patents have transferred into the public domain. What other investible technologies are those military types hiding?

And then there are drones. Hitherto we have thought of them as principally military kit, used for surveillance and occasionally for targeted hits. Now we are beginning to think of them as a means of delivering light cargo in an amazingly precise way. Your Amazon (NASDAQ:AMZN) order in ten years’ time will arrive on one of these beasties within minutes!
And expect the unexpected. New players will venture into the aviation universe in the years to come. The Russians used to manufacture airframes and aero-engines in the days of the Soviet Union (which had unenviable reputations) but have been out of the sectors for more than 25 years. But on 28 May, Russia completed the maiden flight of its new MS-21 medium range passenger jet – a direct competitor to the A321. Watch out: the Russians are coming! Though – haven’t we heard that one before?

Action

If you have exposure to the airline sector, prefer the super long-haul operators to the Super-Connectors whose hubs may have already begun to decline in value.

**Qantas** is a profitable airline, based in a country that has not had a negative growth number for more than 80 quarters – one of the few to have escaped the blight of the Credit Crunch. Currently, its share price is at a five-year high. At a price of AU$5.50 per share, Qantas is priced at an estimated 12 times earnings and pays a 1.3% trailing dividend. Similarly, **United Airlines** (owned by United Continental Holdings (NYSE:UAL)) in the US is using Dreamliners on super long-haul routes such as Denver-Tokyo. In contrast, **Turkish Airlines** has already had a good run for its money on the back of Turkey’s re-discovery of the Turkic Asian heartland.

And don’t ignore engine technology. I am wary of **GE** because of its conglomerate discount; but (not just out of patriotism) I think **Rolls-Royce** is well positioned to thrive as turbine design and production technology advance further.

The real gamble is the future of the budget airlines. I am very impressed by evidence of EasyJet future-proofing its customer offer through aviation technology; and I note that its share price has been in recovery mode of late. Not all will prosper; but some will endure long-term. I have offered here a quintet (see panel) of likely budget airline winners where the upside is exciting.

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**About Victor**

Victor is a financial economist, consultant, trainer and writer, with extensive experience in commercial and investment banking and fund management. His career includes stints at JP Morgan, Argyll Investment Management and World Bank IFC.
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AstraZeneca (LON:AZN) and GlaxoSmithKline (LON:GSK) are the two pharmaceutical giants of the FTSE 100. They are also both high yield dividend stocks with yields of more than 4%. Another notable fact is that both companies have been long-term holdings of a certain Mr Neil Woodford. But no more. Following a 15-year holding period, Woodford sold Glaxo earlier this year, partly due to fears about the dividend’s sustainability. Meanwhile, AstraZeneca remains in Woodford’s equity income portfolio with a hefty 8% weighting. So is AstraZeneca really a better bet than Glaxo? Let’s take a look.

AstraZeneca: A company facing a difficult period

- Share price: 5284p
- Dividend yield: 4.1%

In many ways, AstraZeneca and Glaxo are very similar. Their core business is to develop new and better medicines and then sell them all over the world. The process of developing better medicines can be hugely expensive. It can take vast armies of scientists beavering away in laboratories for years on end, all hoping to develop the next “blockbuster” product. Once developed and approved by various regulatory bodies, it would then be extremely easy for competitors to manufacture exactly the same medicine, without all that pesky upfront R&D expense. Medicine prices and profit margins would be driven down to the point where AstraZeneca or Glaxo would struggle to make a decent return on their original R&D investment. If that were allowed to happen, there would be little financial incentive to develop newer and better medicines in the first place.

The answer to this conundrum is to use patents and intellectual property law. These effectively block generic competitors (i.e. low cost manufacturers who specialise in manufacturing existing medicines at low cost, rather than developing new medi-
DIVIDEND HUNTER

“IN RECENT YEARS BOTH ASTRazeneca AND GLAXO HAVE SUFFERED FROM THE TYRANNY OF THE ‘PATENT CLIFF’.”

cines) and allow the original developer of a medicine to charge higher prices. Companies like Glaxo and AstraZeneca can then generate the profits they need to make the original R&D investment worthwhile.

However, patents do not last forever, and in recent years both AstraZeneca and Glaxo have suffered from the tyranny of the "patent cliff". This is a period where several blockbuster medicines go off-patent at approximately the same time. This is very bad because low-cost competitors will be able to produce the same medicine at much lower prices, driving higher margin companies like Glaxo and AstraZeneca out of the market. To replace those lost revenues and profits, Glaxo and AstraZeneca must then invent new medicines to replace the old, which entails a lot of expense with no guarantees of success.

Financial performance has suffered from the patent cliff

I've included a chart of AstraZeneca's financial results over the last few
years and the impact of the patent cliff is clear to see.

There has been a small decline in revenues in recent years (thanks to the patent cliff) and this has led to a substantial decline in profits. Despite this, the board have chosen not to cut the dividend.

I look for three things when first investigating a company. These are: 1) long-term growth (averaged across revenues, earnings and dividends), 2) long-term growth quality (i.e. consistency) and 3) good long-term profitability (i.e. above average return on capital employed).

Here are the relevant numbers for AstraZeneca, compared to those of the FTSE 100:

- **Growth rate:** -3.7% (FTSE 100: 2.5%)
- **Growth quality:** 71% (FTSE 100: 50%)
- **Profitability:** 15% (FTSE 100: 10%)

So from a high level, and somewhat simplistically, AstraZeneca has negative growth, reasonable growth quality (mostly thanks to its progressive dividend) and good profitability.

That isn’t exactly a brilliant track record. Woodford must believe that AstraZeneca’s future will be better than its recent past, but its future depends almost entirely on how it deals with its ongoing patent cliff. Will revenues and profits continue to decline, or will Astra be able to offset the loss of old medicines with new and better ones?

**AstraZeneca is struggling to turn its patent cliff around**

AstraZeneca has been in the grip of its patent cliff for more than five years, a period where up to half of its revenues were expected to be at risk from competitors as patents expired. Fortunately, the end of this patent cliff is in sight. The patent for Crestor (which helps patients lower their cholesterol levels) has just expired in the US, and Crestor is the last of AstraZeneca’s old blockbuster drugs to go off-patent. This will drive revenues and profits lower, but it also marks a potential turning point for the company.

Now all eyes are on the company’s pipeline of new drugs, which it has been investing in heavily, and upon which its future prospects, dividend and share price depend.

In some ways the picture is rosy, at least according to the CEO who recently said, “Three years ago we had a lot of money and not enough projects. Now we have a lot of projects and not enough money to fund all of it”. He also said, “2017 has the potential to be a turning point for our company as we near the end of our patent-expiry period and bring new medicines to patients across the globe.”

**“IF ASTRAZENECA CANNOT SUCCESSFULLY REPLACE PROFITS LOST FROM CRESTOR, THEN IT MAY HAVE TO REDUCE OR SUSPEND THE DIVIDEND IN ORDER TO KEEP ITS LENDERS HAPPY.”**

But these are just words. The reality is that nobody really has the faintest idea whether these new medicines will perform as hoped. There is quite simply an enormous amount of uncertainty.

When there is a lot of uncertainty, it’s best to have a strong balance sheet with little or no borrowings. Unfortunately, AstraZeneca has not followed that basic principle. Instead, its debts are currently over £13bn. That’s almost six-times the company’s recent average profits and generally I’m not happy if that debt ratio is above five. This adds another layer of risk. If AstraZeneca cannot successfully replace profits lost from Crestor, then it may have to re-
duce or suspend the dividend in order to keep its lenders happy.

Overall, I think AstraZeneca is a good and highly profitable business, but its dependence on patents makes it risky, despite the defensiveness of its individual products. I think AstraZeneca’s dividend is under threat and so its share price would need to reflect that, otherwise I don’t think it would be worth the risk.

At what price is AstraZeneca good or fair value?

Given that Woodford still holds AstraZeneca he must think it is at least reasonable value at its current price of 5284p.

And he could be right. The shares have a dividend yield of 4.1% compared to the FTSE 100’s yield of 3.7% (and more like 3.2% from an index tracking fund), so it’s clear that investors are demanding an above average yield to offset the above average risks.

For me, good value and fair value are defined primarily by my stock screen, which ranks stocks according to their combined growth, income, quality and value characteristics. If a company is in the top quartile (top 50, more or less) then it’s good value, if it’s close to halfway down the list then it’s fair value, and if it languishes towards the bottom it’s poor value.

Today, AstraZeneca is in position 108 out of 222 dividend-paying stocks, so it’s very close to but slightly better than the halfway point of 111. The implication is that it’s priced below but very close to fair value.

- **Fair value for AstraZeneca:**
  - Approx. 5300p

If I was Woodford then I might continue to hold AstraZeneca at this price, but I certainly wouldn’t want to open a position at this price. I would also probably halve its position size from 8% to 4% in order to reduce risk.

To be good value (and a potential buy), AstraZeneca would need to be substantially cheaper. To get into the top 50 stocks on my stock screen (which is where I typically search for new investment opportunities), the share price would have to fall below 3500p.

- **Good value for AstraZeneca:**
  - Below 3500p

At 3500p AstraZeneca would have a yield of 6.3%, which I think is a more attractive yield given the uncertainty about the company’s future and its dividend.

So broadly, I agree with Woodford so far. I think AstraZeneca is a weak hold if it’s already in a portfolio, but it isn’t something I would want to buy today. And if the share price went up by another 20% or so with no improvement in the fundamentals, I would almost certainly sell.

**GlaxoSmithKline: Big pharma with a consumer defensive twist**

- **Share price:** 1685p
- **Dividend yield:** 4.7%

Glaxo’s core business is very similar to AstraZeneca’s. It invests heavily in R&D in the hope of inventing novel (and patentable) medicines which will improve peoples’ lives.

But they’re not identical. Glaxo also has a significant consumer healthcare and wellness business, selling products such as Panadol headache tablets, Sensodyne toothpaste and even Horlicks the bedtime drink. This part of Glaxo, which generates 26% of the company’s total revenues and 14% of total pre-tax profit, is very defensive. Most people will use Horlicks, Panadol or Sensodyne regardless of whether there’s a recession or not. This gives Glaxo a stabiliser that AstraZeneca lacks, which could help Glaxo cope with its own long-running patent cliff.

**In recent years Glaxo has flatlined**

With many of its leading products going off-patent in recent years, Glaxo has struggled to move forward against
this headwind. If you look at Glaxo's chart, you'll see that revenues and earnings have been declining for most of the last few years. Even management have had to face up to this reality and as a result they've held the dividend flat for several years.

Here are my big three numbers for Glaxo, based on the last few years and again compared to those of the FTSE 100:

- **Growth rate:** -1.3% (FTSE 100: 2.5%)
- **Growth quality:** 63% (FTSE 100: 50%)
- **Profitability:** 14% (FTSE 100: 10%)

Glaxo's results are very similar to those of AstraZeneca: Negative growth, reasonable growth quality (mostly thanks to the dividend) and good profitability. On the face of it there isn't much to choose between the two in terms of their accounting results, so why is Woodford more negative about Glaxo than AstraZeneca?

**Glaxo: A highly indebted jack of all trades?**

There are many potential reasons, not least of which is Glaxo's patent cliff. On that gloomy subject, Advair (a treatment for asthma and Glaxo's biggest seller for many years) is already off-patent and could see more than £1 billion of revenues evaporate over the next few years as generic competitors enter the market.

But there are other problems too. In particular, I want to focus on the company's enormous debt pile and its potentially inefficient combination of pharmaceutical and consumer healthcare businesses.

For many years, Glaxo has carried borrowings of around £15 billion. That was a lot, even when the company was earning close to £5 billion. More recently, the company's average profits have fallen below £3 billion and today the company's debts stand at more than six times its recent average profits. Woodford called the balance sheet "stretched", but I think it's simply too much debt for this company. Yes, if things go well for Glaxo then its debt mountain could be sustainable, but if Advair's revenues collapse and there isn't a good replacement then dividend cuts or suspensions could be unavoidable.

As if that wasn't bad enough, the company also has a near-£20 billion pension liability and a £2 billion pension deficit. This is effectively another debt and pushes up the ratio of debts to profits to more than seven, which is well above my preferred limit of five-times.

Another potential problem, which Woodford is famously negative on, is the company's mix of businesses. Put simply, a developer of cutting edge medicines (which is Glaxo's core business) may not be the best owner of a toothpaste and bedtime beverage manufacturer (i.e. Glaxo's consumer healthcare business).

The company's line is that these different businesses benefit from shared corporate infrastructure, global supply networks and R&D. But many others, including Woodford, think Glaxo would be better off splitting into several highly focused companies, and I tend to agree. Glaxo's diversity does make it a more stable company, but the price of that stability could be an inability to compete with more singularly focused competitors.

Of the two companies, I would agree with Woodford. Glaxo looks riskier because of its higher debt levels, large pension obligations and relative lack of focus. Even so, if the price were low enough it could be worth hanging on to.

**Good value and fair value for Glaxo**

Glaxo has a higher yield than AstraZeneca, which makes sense as it's a potentially riskier investment. According to my stock screen though, this additional yield is not enough to offset Glaxo's weak financial track record.

Glaxo currently sits at position 119 out of 222 stocks on my screen, slightly worse than AstraZeneca's position at 108 and very slightly worse than the fair value halfway point of 111. As with AstraZeneca, Glaxo is basically at fair value:

- **Fair value for Glaxo:** Approx. 1650p

Good value, i.e. where Glaxo becomes one of my top-50 dividend-paying stocks, requires a much lower price than that:

- **Good value for Glaxo:** Below 1000p

**AstraZeneca wins, but neither offers compelling value**

To paraphrase Gordon Brown, I agree with Neil. I think AstraZeneca is the better choice, but it's a very close run thing. I also think neither company is obviously good value at their current prices. Despite this, I remain a shareholder in both companies, although both of them are fairly close to being kicked out of my portfolio, with Glaxo being slightly closer to the exit than AstraZeneca.

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**About John**

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

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

His website can be found at: [www.ukvalueinvestor.com](http://www.ukvalueinvestor.com).
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Private Equity funds are investment trusts that invest in portfolios of unquoted companies. They normally target more mature businesses than Venture Capital Trusts and then work alongside the management teams to enhance the value. The typical holding period is between four and seven years and they will then try to exit the position by finding a buyer for the company or floating it on the stock market via an IPO.

According to the investment trust analysts at Canaccord Genuity, the listed Private Equity sector went into the financial crisis with high levels of debt, significant unfunded commitments and immature portfolios. This made the funds intensely vulnerable and resulted in poor performance with the shares sliding to large discounts to net asset value (NAV) in excess of 35%.

Listed Private Equity funds have delivered strong returns in the last few years, but despite this most are still trading on double-digit discounts. Many investors have been reluctant to return after the poor performance during the 2008 financial crisis, although the fundamentals across the sector are now much stronger.

Over the last few years there has been a significant improvement and Canaccord has a high conviction overweight recommendation on the sector. The firm highlights the fact that most of the constituent funds now have net cash on the balance sheet with medium-term debt facilities in place and that the commitments are at much more sensible levels.

They say that the portfolios are maturing well and that the focus in the last few years has been to work with the management to improve operational performance. This has resulted in higher cash flows and earnings that have enabled significant levels of realisations at prices well above the carrying value of the investments.

The turnaround in performance has started to attract corporate interest with the sector experiencing a degree of consolidation that could result in a further re-rating.

“The turnaround in performance has started to attract corporate interest with the sector experiencing a degree of consolidation that could result in a further re-rating. The main transactions include HarbourVest’s purchase of Conversus for $1.4bn and the acquisition of the SVG Capital portfolio for £807m, with JPEL Private Equity electing to go into realisation mode and Electra migrating to a corporate structure.”

“THE TURNAROUND IN PERFORMANCE HAS STARTED TO ATTRACT CORPORATE INTEREST WITH THE SECTOR EXPERIENCING A DEGREE OF CONSOLIDATION THAT COULD RESULT IN A FURTHER RE-RATING.”
Diverse sector

Data from the investment trust team at Winterflood Securities reveals that there are nine Private Equity investment trusts that invest directly in the underlying companies. By far the largest of these with a market value of around £9bn is the 3i Group (LON:III), which is trading on an estimated premium to NAV of 45%.

All of the others are valued at less than £1bn and are trading below NAV. The better performers such as Apax Global Alpha (LON:APAX), Electra Private Equity (LON:ELTA) and the HgCapital Trust (LON:HGT) are typically on single-digit discounts, whereas the laggards like Better Capital (LON:BC12), LMS Capital (LON:LMS) and JZ Capital Partners (LON:JZCP) are available at 30% to 50% below their net asset values.

There are also eight Private Equity fund-of-funds that include the likes of F&C Private Equity (LON:FPEO), HarbourVest Global Private Equity (LON:HVPE) and Pantheon International (LON:PIN). Most of them have a market value of up to £500m and are trading on a 10% to 16% discount.

Over the last five years the direct Private Equity funds have delivered an average NAV total return of 91%, with the fund-of-funds coming in at 74%. The share price returns have been much higher as the discounts have narrowed with the five-year gains being 169% and 142% respectively.

Traditionally it has not been an area that would appeal to income investors, although that is beginning to change with dividends becoming a more prominent feature since the financial crisis. Funds such as Apax Global Alpha, Princess Private Equity (LON:PEY) and Electra Private Equity are all now yielding more than 5.7%.
“TRADITIONALLY IT HAS NOT BEEN AN AREA THAT WOULD APPEAL TO INCOME INVESTORS, ALTHOUGH THAT IS BEGINNING TO CHANGE WITH DIVIDENDS BECOMING A MORE PROMINENT FEATURE SINCE THE FINANCIAL CRISIS.”

Positive outlook

Alan Brierley and his team at Canaccord Genuity have included two listed Private Equity funds in their model portfolio for 2017. These are the investment trusts that they believe have the potential to deliver superior risk-adjusted returns and to outperform their benchmarks.

The first of their selections is HarbourVest Global Private Equity, which has a market value of just over £1bn and is trading on a 14% discount to NAV. It has been on a strong run with a five-year share price return of 172%.

HarbourVest is a well-diversified fund-of-funds and at the end of April it provided exposure to 235 primary managers and over 7,000 underlying companies. Its aim is to become the default option for investors who want listed Private Equity exposure, although it is more expensive than some of its peers.

Canaccord says that HarbourVest gives investors a highly diversified and lower-risk exposure to the asset class. The fund has a strong balance sheet with high cash levels and significant amounts of undrawn credit. It has a mature underlying portfolio that is performing well and the recent realisations suggest that the carrying values are quite conservative.

Canaccord’s other recommendation from the sector is Pantheon International. The fund-of-funds has a market value of £1.1bn and has generated a five-year share price return of 145% with the shares trading on a 16% discount to NAV.

They say that Pantheon gives investors exposure to leading private equity managers, and a highly diversified and increasingly mature portfolio of conservatively valued companies. The fund has consistently delivered superior revenue and earnings growth and the realisations over the last five years have been achieved at a 30% weighted average uplift on the carrying value.

Pantheon also has plenty of liquidity to take advantage of new opportunities. At the end of December 2016 it had cash of £173m (13% of NAV) and undrawn medium-term debt facilities of £172m.

Pace of returns likely to moderate

Many of the listed Private Equity funds achieved a strong performance in 2016. This was partly due to the fall in the pound following Brexit that boosted the value of their overseas holdings, but was also assisted by the corporate activity that helped to reduce the discounts.

The investment trust team at Numis believes that the tightening of discounts means that the sector no longer offers an outstanding value opportunity. They do not expect the recent corporate action in this area to be repeated, although further NAV growth is likely due to improvements in the underlying earnings and realisations.

Despite their more cautious outlook, they still believe that there are attractive investments in the sector and have included both Pantheon and HarbourVest in their model portfolio for 2017. They have also recommended three of the direct Private Equity funds, with the first of them being the HgCapital Trust.

The £580m fund has had a decent run with the shares up 30% in the last 12 months and the discount tightening to 6.5%, but Numis believes that it is a unique vehicle that is well-positioned to deliver double-digit NAV growth over the next few years. Its portfolio has little economic sensitivity and...
HgCapital has a track record of delivering significant uplifts to the carrying value when it sells its holdings.

Their second selection is the £675m Princess Private Equity fund that they say is differentiated by its global investment approach focused on mid-market companies, and its attractive yield of 5.7%.

The fund provides exposure to a mature, cash-generative portfolio of legacy third-party funds as well as a number of direct investments that are becoming the main source of realisation proceeds. There have been three full exits to-date and Numis expect that others will follow over the next year or so. The shares are up 40% over the last 12 months and the dividend that is dependent on the portfolio cash flows is thought to be sustainable.

**Further upside potential**

The firm's third and final selection is the £8.8bn 3i Group, which they believe has been transformed since Simon Borrows took over as CEO in mid-2012. They say that the balance sheet is in good shape, costs are under control, and there is a clear distribution policy with the shares yielding almost 3%.

The company's shares are up 74% in the last 12 months with the key driver of NAV growth being the Dutch-based non-food discount retailer, Action. This accounted for 25% of net assets at the end of 2016 and Numis believes that there could be further significant upside with the possibility of an IPO or sale in the next 12 to 18 months.

The 3i Group is trading on a 45% premium to NAV, although this is a bit misleading as it owns a valuable infrastructure asset management business that is not included in the asset value.

The investment trust team at Winterflood have included three funds from the sector in their model portfolio with their selections being HgCapital, Pantheon and the Standard Life Private Equity Trust (LON:SLPE). They think that Private Equity remains highly attractive and that SLPE provides exposure to a number of its best regarded managers. The fund mainly invests in European Private Equity funds that are focused on mid and large cap buyouts.

SLPE has recently changed its name from Standard Life European Private Equity and has removed the previous size and geographic restrictions from its mandate, although it will retain its focus on the European market. It has also increased its dividend so that the shares now yield 3.8%.

The fund has delivered a 12-month gain of 36% via a diversified portfolio of 49 third-party interests and 452 underlying companies. Of these the largest is Action, which accounted for 6.1% of the NAV at the end of September. Numis believes that there could be further significant upside with the possibility of an IPO or sale in the next 12 to 18 months.

Private Equity is an unusual area that many investors have tended to overlook despite the strong returns of the last few years. The impressive recent performance is unlikely to be repeated, although the sector is still capable of generating healthy gains. This makes it an area that is well worth considering for those who are comfortable with the high risks associated with the underlying exposure to unquoted companies.

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**About Nick**

Nick Sudbury is an experienced financial journalist and trader/investor who has worked both as a fund manager and as a consultant to the industry. He has an MBA and is also a chartered accountant.
Record high share prices on record low volatility

Financial markets are a surprising bunch. One day, investors hit the panic button and everything starts being sold off in an apocalyptic manner. The next day, investors are highly optimistic and no price is too high to prevent a purchase. I remember how much agony the collapse of Lehman Brothers caused to Americans, who traditionally hold a fair share of their wealth in equities. And it was not only about individuals. Banks, for example, were filled with unrecoverable loans. Ratings agencies were blamed for failing to highlight risk. Governments became highly indebted for having to bailout their banks. Sound businesses faced bankruptcy while still solvent for failing to secure the necessary credit.

During such massive upheaval, equity markets experienced severe losses, with the S&P 500 recording single-day declines of 4%, 5%, 7% and even 9% at times, as a consequence of the Lehman Brothers collapse. In just one and a half months, the S&P 500 lost one-third of its value while volatility rose by a factor of three. The S&P 500 retreated to 12-year lows while the VIX hit all-time highs at the 80 level. But, soon after, while the world economy was still rotating and struggling to find a way out of the gloom, financial markets accelerated into a massive recovery that pushed equity prices way beyond their pre-crisis levels.

Those holding equities for the very long term should therefore dismiss the turmoil and remain unfazed by financial catastrophe, as equity prices are characterised by a positive long-term trend, which assures that what goes down ends up higher over time. But those trading over shorter periods shouldn’t trust in time, as in those periods time is a source of risk, leading markets to coil around peaks and troughs.

A financial collapse is a trough where traders want to buy, while a burst bubble is the point just after a peak where traders should have exited. But human nature is influenced by sentiment and is thus biased. The boom-bust nature of prices is the result of the trend-following that characterises markets. Everybody buys when prices are rising, only to sell when prices are declining. It’s tough to identify peaks and troughs in a forward-looking manner for effective trading. Fundamental analysis should help discern the state of prices and evaluate the magnitude

"...The most important of these rules is the first one: the eternal law of reversion to the mean in the financial markets."


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PREPARE TO EMBRACE VOLATILITY

“THE CBOE VOLATILITY INDEX DECLINED 25.8% IN THE YEAR AND TRADES CLOSE TO SINGLE DIGITS, A VALUE RARELY SEEN OVER THE LAST 27 YEARS OF DATA.”
“GLOBAL RISKS ARE MOUNTING, WHICH CONTRASTS MARKEDLY WITH THE HUGE COMPLACENCY SEEN IN FINANCIAL MARKETS.”
of the deviation of prices from intrinsic values, but it is still insufficient for the purposes of timing the market. Technology stocks remained overvalued for most of the 1990s. Only in the 2000s did investors realise how overvalued these shares were. Sentiment indicators can give an idea about how far we have departed from reality. In particular, volatility indicators are good bellwethers for what is going on in the market, and may therefore complement fundamental analysis.

**From optimism to complacency**

Over the last nine years, there has been a significant economic recovery in both the U.S. and Europe, which has translated into more confidence. Consumers are buying more, investors are purchasing everything they can, banks are lending money again. As forward-looking machines, financial markets have recovered more enthusiastically than the overall economy, as investors foresee a prolonged economic recovery. The S&P 500 is up 9% in the year and 26% over the last three years; the Nasdaq 100 is up 18.3% and 52.3% in the same periods; and the Dow 30 is up 7.9% and 27.1%, respectively. All of them are at, or very near, record highs.

But while equities are at record highs, the VIX is near record lows. The CBOE volatility index declined 25.8% in the year and trades close to single digits, a value rarely seen over the last 27 years of data. Over that period the lowest close has been 9.31. Volatility and prices usually move in opposite directions, such that record high equity prices are usually observed when volatility is declining. But a prolonged period of record high equity prices, mixed with a prolonged period of record low volatility levels is worrying, and potentially the sign traders need to identify a peak.

**The fundamentals**

The fundamentals behind the bull market in the U.S. support some price increases. In October 2009, unemployment hit a level of 10.0% while the economy was in recession. Today, the unemployment rate is at 4.3% and GDP is growing. Current growth is certainly modest at 1.2% (1Q2017), but the economy has avoided a technical recession for 30 straight quarters now. Since the last recession, corporate profits have almost tripled and the dollar amount of dividends paid has almost doubled. However, during the same period the Shiller CAPE ratio (cyclically adjusted price earnings ratio) has more than doubled, from 13x to 30x. It is still well below the NASDAQ-bubble peak at 45x, but it is already at the level of the 1929 peak. If, on the one hand, there is a significant improvement in economic data, on the other hand equity prices seem to have increased at a faster pace than the underlying data supports.

More than anything, markets are led by sentiment, with reality checks occurring only from time to time. A positive shock usually boosts sentiment and triggers a buying frenzy. Examples of positive shocks are unexpected interest rate cuts, an ultra-lose monetary policy stance, a decrease in corporate taxes, and a bold fiscal package.

**“A PROLONGED PERIOD OF RECORD HIGH EQUITIES PRICES, MIXED WITH A PROLONGED PERIOD OF RECORD LOW VOLATILITY LEVELS IS WORRYING.”**

Unexpectedly elected in November 2016, Donald Trump has been a trigger for rising equity prices. The U.S. President has been promising bold
action that is seen as highly favourable to corporate America. The so-called Trump effect is well reflected in the Dow’s 16.3% rise and the VIX’s 44.4% decline since the election on 8 November 2016.

An improvement at the international level due to Marine Le Pen’s defeat in the French presidential election and the emergence of a moderate and pro-European president, the improvement in the EU economy, the resilience of the UK after the Brexit vote outcome, and a moderation in Trump’s speech about protectionism have all contributed to a reduction of uncertainty, a decrease in the VIX and an increase in equity prices. But global risks are mounting, which contrasts markedly with the huge complacency seen in financial markets. Trump is still one of the most unpredictable presidents the U.S. has seen in decades, North Korea tensions are escalating, the UK is in a political mess that makes Brexit more unpredictable than before the general election, and Europe still has many thorns in its side. At the same time, there is a major reversion in monetary policy taking place, with the FED having hiked its key rate three times since December 2015 and hinting at further hikes. Under this scenario, we may be experiencing a self-fulfilling market bubble, just waiting to be popped.

Developing a trade

Unlike the equity market, which trends higher over time, volatility has a more stationary nature. The price of a car or of a share in a corporation may rise indefinitely. But that’s not the case with optimism and pessimism. Moods change and the more tilted they are towards one side, the larger the eventual movement towards the other. Volatility can fluctuate widely over short periods of time, but the more it deviates from a mean value, the stronger the pullback and reversion to that mean.

We are currently at a point where volatility is near record lows, which is a strong clue that the current complacency will revert and volatility will experience a correction, and there is a strong chance that markets will also experience a correction at the same time.

According to a report from the FT, some hedge funds are now betting on a “Black Swan” event that will prompt a sudden and unexpected market decline. The main reason for this is the low volatility level. On the one hand, volatility can’t stay at this level forever and therefore the likelihood of a rise in volatility is high. On the other hand, this makes options cheaper than usual. The cost of insurance against a market decline is at the cheapest level since well before the financial crisis, as most investors are still betting on a continuation of the current calm and complacency. As option prices derive a large part of their value from volatility, it is relatively cheap to build a strategy around options, in order to protect a long portfolio or speculate on a sudden market decline. With August being a low volume month, daily market movements may be more extreme, and as time passes the patience regarding Trump’s policies may also run low. With all this in mind, investors may wish to bet on a rise in volatility or on a market decline.
One way of getting exposure to volatility is through spreadbetting or using an ETF or ETN. The VIX is not directly tradeable. Some possible indirect trades on volatility include:

- iPath S&P 500 VIX Short Term Futures TM ETN (NYSEARCA:VXX) – tracks 1-2 months volatility;
- iPath S&P 500 VIX Mid-Term Futures ETN (NYSEARCA:VXZ) – tracks 4-7 months volatility;
- VelocityShares Daily 2x VIX Short Term ETN (NASDAQ:TVIX) – tracks 1-2 months volatility (2x);
- VelocityShares Daily 2x VIX Medium Term ETN (NASDAQ:TVIZ) – tracks 4-7 months volatility (2x).

The main problem with all those instruments is their negative trend over time. In contrast to the equities market, these instruments trend lower and lower because of the loss caused by the rollover of futures contracts. These instruments also have to reverse split from time to time to be worth something per share. They’re good instruments to track the VIX for days to weeks, but not for months. Spreadbetting suffers from a similar problem, as traders suffer daily losses from the rollover of their bets.

Another group of possibilities consists of options strategies. As I mentioned above, with volatility near record lows, options become cheaper, which means that protecting portfolio returns or speculating on a market correction may be worth a punt. While there are dozens of options strategies that come in several different flavours, I’m going to consider here four different alternatives and their payoffs: (1) a naked/married/protective put; (2) a 3-month 97-93 percent put spread; (3) a reverse iron condor; and (4) a straddle.

To better explain how each one works, I’m using real data for the S&P 500 to show the respective payoffs under different scenarios. The initial data regarding prices and strikes is summarised in the table below.

### Options strategies summary

1. **Naked put**

   This strategy involves buying one long put and may be used either for speculation or to protect a long portfolio against downside risks. When used as protection, it’s often best to choose an at-the-money put. For speculation, the choice may be an out-of-the-money put instead. As the *moneyness* increases, price also increases, limiting profit potential. Depending on the exact usage, the strategy may be called a naked, married or protective put. The first would better reflect a speculative situation in which the trader just buys the option; the second depicts a situation in which the trader buys the underlying asset and the put at the same time, as protection; and the third occurs when the trader owns the underlying and buys the put at a later time. For the purpose of evaluating the payoffs, let’s choose put option 2, with a strike of 2365.

<table>
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<tr>
<th>Instrument</th>
<th>Strike</th>
<th>Price</th>
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<tr>
<td>Call Option 1</td>
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<td>Call Option 2</td>
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<td>Call Option 3</td>
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<td>2265</td>
<td>16.50</td>
<td>90</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>N/A</td>
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</tr>
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</table>


**“THE REVERSE IRON CONDOR AND STRADDLE ARE GOOD STRATEGIES TO EXPLOIT VOLATILITY WHEN MARKET DIRECTION IS HIGHLY UNCERTAIN.”**

(2) 3-month 97-93 percent put spread

This strategy involves purchasing an out-of-the-money put with strike 3% below the current underlying price and selling an out-of-the-money put with strike 7% below the current underlying price. Comparing it with the naked put, this strategy reduces costs, at the expense of capping potential profit (with maximum profit achieved when the underlying declines 7% or more). The main idea is to exploit a sudden market decline for a better price than a naked put costs. For the purpose of establishing the strategy, we buy put option 2 and sell put option 3. The money raised through writing the more out-of-the-money put reduces the cost of exploiting a downfall in the underlying asset. Basically, we are benefiting from a decline in the S&P 500 with a smaller initial outlay.

(3) Reverse iron condor

This strategy is more expensive than the 3-month 97-93 put spread because it adds a 3-month call spread to the 3-month put spread. Relative to the previous strategy, a trader is giving up part of the return when the underlying declines in exchange for a positive return when the underlying increases. This strategy is a market neutral volatility play, as it achieves a profit either side. To build the strategy we buy the call option 2 and the put option 2 and write the call option 3 and the put option 3.

(4) Straddle

This strategy is a market neutral volatility play like the reverse iron condor but much more expensive because it doesn’t involve writing any options and involves buying at-the-money, more expensive, options instead of out-of-the-money options. This strategy is rarely used by traders because it requires a large movement in the underlying asset to be profitable. In general the reverse iron condor provides better returns for more moderate underlying changes. But if the underlying rises or declines very quickly, and by a significant amount, then the straddle would provide unlimited returns. To set this trade, we buy call option 1 and put option 1.

Table 2 summarises the payoffs for the four options strategies. All the strategies require a relatively large movement in the S&P 500 to be profitable. The 97-93 percent spread is the strategy requiring the smaller change in the underlying. In a three-month period, as it explores just one side (a decline) and finances its cost with the written put. This strategy can still deliver a seven-fold increase over the initial outlay if the S&P 500 declines 7% in a three-month period. This is possibly the best strategy to set up in order to exploit a potential increase in volatility and most likely resulting market decline.

The outright put offers virtually unlimited profits but requires a larger change in the underlying. At maturity date (i.e. in three months’ time), for a 7% decline in the S&P 500, the 97-93 percent put spread still offers better returns. Of course, a trader could have purchased a deep out-of-the-money put in order to minimise the initial outlay, but those options just expire worthless most of the time.

The reverse iron condor and straddle are good strategies to exploit volatility when market direction is highly uncertain. With September often being a busy month, any of these strategies can do well. Still, with volatility now at a multi-year low, I would buy just one side of the trade and opt for the 97-93 put spread to reduce the cost of the trade.

**Final thoughts**

Whether you want to protect a portfolio against uncertainty or just want to exploit the mean-reversion feature of VIX, the timing may be favourable to set up a long play in volatility or a short play on the S&P 500. While there are a few ETFs and ETNs that allow for it, options strategies may be worth considering given that volatility is at a low. While there is a significant likelihood of the four strategies depicted above expiring worthless, they offer a good potential reward for the risk, which makes them worthwhile. And the best bit is that you don’t need to wait until maturity; if the market moves faster, you can just take profits before maturity.

About Filipe

Filipe’s specialisation is monetary policy, macro issues and behavioural finance where he allies the practical experience of several years of trading with academic credentials. Filipe in fact teaches courses on Financial Markets and Monetary Economics at the University of Oporto, Faculty of Economics, helping traders maximise profits and better manage risk.
Companies might make the decision to list their shares on a stock exchange for a number of reasons. Whether it be an exit opportunity for existing shareholders, to raise the profile of the business amongst its customers, or to set a value for the stock, there are many benefits of making the move from being a private business to being a public one.

But by far the main reason given by companies for going public is to raise money for expansion. After all, one of the primary functions of a stock exchange is to bring together companies which are looking for capital with investors who can provide the funds.

There haven’t been many growth exchanges in the world which have been better at raising funds for small businesses than AIM. Since being formed in 1995 the junior market has seen its constituents raise a total of £101.58 billion (as at end May 2017) to spend on expanding their operations – whether all those funds have been spent productively is a different matter!

While fundraising activities are well down on the heady days of 2006/7, as the chart below shows, AIM is still an important fundraising destination for small cap companies. Last year saw a total of £4.77 billion raised on the market, with AIM fighting off competition from alternative lenders such as peer-to-peer and crowdfunding platforms.

So far in 2017 we have seen a number of decent sized secondary fund raisings from some of the market’s larger players. Notable transactions include respiratory drug business Verona Pharma (LON:VRP) raising £62.4 million from a secondary placing.

Data source: London Stock Exchange. 2017 figure to end May.
“THE MAIN REASON GIVEN BY COMPANIES FOR GOING PUBLIC IS TO RAISE MONEY FOR EXPANSION.”
a total of $89.9 million (£70.3 million) and co-listing on the NASDAQ, with identity data specialist GB Group (LON:GBG) raising £58 million to help fund the acquisition of address validation and data quality services firm PCA Predict.

Since the end of May online fashion group boohoo.com (LON:BOO) has announced a £50 million raise, with the money to be spent on a new warehouse to provide up to £2 billion of total sales capacity. Topping the lot, venture capital investor Draper Esprit (LON:GROW), which I covered in the February edition of Master Investor Magazine, announced at the start of June that it had raised £100 million to spend on further investment opportunities.

Here follows three AIM companies which have recently raised a substantial amount of funds to boost their operations. But will they deliver for shareholders?

**TELIT COMMUNICATIONS**

Telit Communications (LON:TCM) is at the forefront of the phenomenon known as the Internet of Things (IoT). Put very simply, this refers to everyday physical objects, such as cars, telecommunication equipment, kitchen devices etc. being inter-connected via the internet, thus enabling them to exchange data with one another. The application of this technology has the potential to transform the way we live and work, from simple tasks such as a fridge being able to order more milk online when a sensor realises it is running low, to more grand schemes such as self driving cars and efficient energy usage.

So it’s no surprise that the IoT industry, across a range of sectors, is expected to show huge growth in the coming years. Demonstrating this, analysts at Gartner forecast that 8.4 billion connected “things” will be in use worldwide in 2017, up 31% from last year, and will reach 20.4 billion by 2020. Further, Boston Consulting Group estimates that by 2020 the market for IoT technologies, products, and services will be $267 billion.

Telit describes itself as a global leader in Internet of Things enablement, selling its products and services to c. 7,000 customers in more than 80 countries around the world. These include cellular communication modules, Global Navigation Satellite Systems (GNSS), short-to-long range wireless modules, low power Wi-Fi and Bluetooth, IoT connectivity and IoT platform services.

**Cash for communications**

Telit has been experiencing rapid growth over recent years, partly boosted by a number of acquisitions. Revenues grew by a CAGR of 15.9% over the five years to 2016 to $370.3 million and pre-tax profits were up by a CAGR of 27.4% to $19.1 million. In reaction, the shares have also performed very well, up over 500% over the past five years. A brief update at the end of April revealed that trading had been in line with expectations since the start of 2017, putting the company on track to once again post double-digit revenue growth for the current financial year.

In order to further advance growth, at the beginning of May Telit announced a £39.2 million fundraising at a price of 340p per share. This was at only a 5.6% discount to the previous day’s close and increased the shares in issue by around 10%. For the time being at least that should put the firm into a positive cash position, with net debt as at 31st December 2016 standing at $17.7...
million, supported by $110 million of credit facilities. The money raised has been earmarked by the company to fund several identified acquisition opportunities, mainly in the IoT Services sector, which it is looking to execute in the near to medium term.

Telit like it is

With Telit currently trading at 317p and capitalised at £405 million there is both a strong bear case and bull case for the shares. The bull case is focussed on the company’s strong operational growth and leading position in the IoT market, which as discussed above, is set to boom in the coming years. Growth expectations are set in a current year price earnings multiple of 16.5 times, falling to 11.4 times for 2018. Amongst analysts who cover the stock, Telit’s joint-broker Berenberg Bank has a 415p target price, implying upside of 31%.

But on the bear side we have a few red flags in the company’s accounts.

Telit is one of those companies which (quite legitimately according to accounting rules) capitalises its development expenditures. Some would argue that to more properly reflect the business these should instead be treated as operating expenses. If that were to be the case the company’s $47.7 million of net operating cash flow in 2016 comes down to a much less impressive figure of $16.9 million. A 46% rise in trade receivables in 2016 is also a concern after revenues only rose by 11% in the year.

Adding further unease, CEO Oozi Cats recently sold just over £24 million worth of shares in the company at a price of 340p to pay back a loan he took out three years earlier in order to buy them at an effective price of 280p. He does, however, retain a beneficial interest of 11.59% of the company.

These concerns have been picked up on by a number of investors. As I write, the FCA’s daily short positions update shows a total of four institutions, including Old Mutual Global Investors and Ennismore Fund Management, having a combined short position amounting to 8.08% of Telit shares. This makes it one of the most heavily shorted companies on the whole of the London market, although the total net position has been falling slightly over the past few weeks. Of course, other parties have a different view, with institutional clients fully funding the recent placing and major banks HSBC and Bank Hapoalim providing the $110 million of credit facilities as recently as last October.

On balance, Telit is a highly speculative buy.

CARETECH

I first covered AIM listed social care services provider CareTech (LON:CTH) in March last year, arguing that the company provided growth, value and income attractions for investors. Since then the shares have gained 88%, and while they are now looking more expensive, growth opportunities remain abundant.

Founded in 1993 and listing on AIM in 2005, CareTech supports adults and children with more than 260 specialist social care services through the five divisions of adult learning disabilities, mental health, young people residential services, foster care and learning services. These are provided to end customers via a portfolio of over 200 homes throughout the country, with CareTech being paid for its work by local authorities and health service commissioners.

Despite some difficult years following the financial crisis of 2008/09, when public sector funding cuts hit the sector, CareTech has performed very well since IPO, with underlying EBITDA and diluted earnings having grown at a compound annual rate (CAGR) of 30% and 25% respectively. This has come via a mixture of organic growth and a strategy focussed on boosting earnings via complementary acquisitions.

Growth has been driven by a number of factors including increased outsourcing by local authorities, shortfalls of specialist beds and higher regulatory burdens. But despite annual revenues having grown from £22.5 million to £149 million from 2005 to 2016 CareTech still only has a small share of what is a fragmented market for social care in the UK, estimated by the company to be worth £12.6 billion per annum. So, there is plenty of room for further growth for ambitious companies with strong financial backing like CareTech.
Caring about growth

In March this year CareTech raised just over £39 million gross by issuing new shares at a price of 355p each. While this was a discount of 4.7% to the average closing mid-market price over the previous 30 trading days it was well above prices seen since the end of 2010 and at a higher price than the last major fundraising in February 2015, which raised £21 million at 210p. The placing was completed to accelerate the company’s growth strategy through the funding of its current acquisition pipeline, organic growth projects and further potential bolt-on acquisition opportunities.

CareTech said that it intends to deploy the proceeds within one year and to that effect has already completed one major deal. In June CareTech announced the £16.9 million acquisition of Selborne Care, a provider of specialist residential care, supported living and day care services for adults with learning disabilities and challenging behaviours. The business, which runs 57 residential beds in eight freehold sites, has delivered year-on-year growth since it was founded in 2006 and for calendar 2016 reported revenues of £13.3 million and EBITDA of £2.4 million. The deal is expected to be immediately earnings enhancing. Of the placing proceeds another £3.8 million has been committed to the acquisition and development of Beacon Reach, a children’s education and residential facility near Preston.

Worth a punt?

Following a recent surge, shares in CareTech now trade at an eight year high of 442p, capitalising the business at £334 million. The modest discount to net assets which existed at the time of my original article has now been eliminated; but with net assets of £195 million on the balance sheet as at 31st March 2017, and freehold property independently valued at £304 million, the company retains strong asset backing.

“THERE IS PLENTY OF ROOM FOR FURTHER GROWTH FOR AMBITIOUS COMPANIES WITH STRONG FINANCIAL BACKING LIKE CARETECH.”
CareTech has an objective of delivering double-digit growth in underlying earnings per share. For the current financial year to September 2017 that will be held back by the recent increase in shares, with the market looking for earnings of around 34.2p. Nevertheless, that still puts the company on a relatively modest price/earnings multiple of just under 13 times. I believe that looks good value given the growth opportunities available and that the company has built up a steady and predictable annuity like stream of revenues. There is also an expected dividend yield of around 2.16%.

All in all, CareTech looks like an ideal stock to buy and hold for the long-term.

1PM

One business which has made very good use of the public markets in recent years is specialist lender 1PM (LON:OPM). It has completed several fundraisings which, crucially, have been used to increase earnings per share and therefore value for shareholders. Over the five financial years to 2016 1PM grew earnings from 0.71p to 5.87p per share (that’s a CAGR of 52.6%), with the company beating market expectations on several occasions.

1PM, which stands for one payment monthly, focuses on the provision of finance to small businesses. Its core product lines are lease finance and hire purchase for SMEs, enabling them to buy value-adding capital items such as office equipment, computers, furniture, security systems and other forms of basic business equipment. Business is done through a network of brokers who earn commission on agreed deals, with 1pm taking all business on its own book. Reflected in bad debt rates of just 1.64%, the company has developed a strong reputation for making sure that customers have good credit histories and a proven ability to repay their borrowings.

The business was significantly expanded in 2015 following the £12 million acquisition of equipment finance and vehicles broker Academy Leasing, with several other smaller deals completed since then. Further, in 2013 the business added business loans to its line of products and earlier in 2017 formalised a Loans division consisting of £14 million worth of existing loans along with the acquired business of iLoans, a brokerage engaged in the packaging of secured bridging loans, second charge loans and commercial mortgages.

1PM’s own recent fundraising was completed at the beginning of June, the company raising a total of £13 million via a placing and over-subscribed open offer at a price of 45p per share. Of the net proceeds £5.25 million has been used to acquire Tracx Finance, an invoice finance provider based in Oxford which trades under the Gener8 Finance brand. This is in line with a stated strategy for the company to introduce additional products to its UK SME customers.

Gener8 has approximately 140 clients and typically lends between £50,000 and £500,000, with an average of £90,000. It charges a range of fees and interest on loans, with recurring annual service fees accounting for approximately half of revenue. In 2016 the business made revenues of £2.6 million and adjusted profit before tax of £0.9 million, lending £12 million on a receivables book of £30 million. Along with the deal a dedicated Commercial Finance division has been set up to offer invoice discounting and factoring, providing additional complementary products to the existing asset finance and business loans.
From Acorns to Oak Trees

“OVER THE FIVE FINANCIAL YEARS TO 2016 1PM GREW EARNINGS FROM 0.71P TO 5.87P PER SHARE.”

The rest of the net fundraising proceeds will be used to strengthen the balance sheet and also to fund initial consideration for another possible acquisition in the invoice financing sector that has been identified. The un-named business made revenues of £4.1 million in 2016, with adjusted profit before tax of £1.1 million, a loan book of £23 million and receivables of £46 million. Heads of terms have been signed, with the £9 million deal expected to be completed in June subject to due diligence. 1PM believes that the two acquisitions will be earnings accretive within two years from completion.

**Slump provides buying opportunity**

Shares in 1PM have lost over a third of their value over the past two months, the main catalyst being the announcement of the placing and open offer, which were completed at a notable 19% discount to the previous day’s closing price. But with no specific negative operational news, and the company saying that trading for the year to May 2017 was in line with expectations, I see a good buying opportunity at the current share price of 41.75p.

Current market forecasts are for 6.95p of earnings in 2018, as the Gener8 acquisition makes a maiden contribution. That puts the shares on a low earnings multiple of just 6 times. There is also a modest dividend payment of 0.88p expected, which equates to a yield of 2.1%.

The markets might be concerned about the company’s acquisition strategy not working or increased credit risk on the back of the new products. But management have a good track record of integrating deals and have specifically said the latter will not be compromised. In any case, I believe that these risks are more than discounted in the current valuation. I would argue that a valuation of at least 10 times earnings looks reasonable for a growth company such as 1pm. That would imply a May 2018 price of 69.5p and upside of 66%.

1PM is a buy.

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About Richard Gill

Richard Gill is an investment analyst with over a decade’s experience of analysing small/mid cap equities. Richard qualified with the Chartered Financial Analyst (CFA) designation in 2012 and was awarded PLUS Markets Financial Writer of the Year at the 2008 PLUS Awards. He has been a judge at the Small Cap Awards from 2013 to 2017.
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The value of investments can go down as well as up and you may get back less than you invested originally.
Here is what I’m looking at as being crucial to my trading in the near term and where I stand on each of the major pairs to which each input relates.

Before we get started, a quick note on my strategy: I primarily use price action to signal entries and exits, with simple candlestick patterns (a pin bar, for example) dictating my trigger pulling. Concurrent to this price action/technical analysis type strategy, I use fundamental analysis to dictate my risk strategy.

If I am bearish on a particular currency at the time of a signal, and the signaling question suggests a sell entry, I will be a little more aggressive in my downside targeting than I might otherwise have been if the signal suggested a buy. It doesn’t mean I won’t enter a trade against my bias, but just that I will go after a little more reward and be willing to take on a little bit more risk (as defined by take profit and stop loss placement) than in the reverse scenario.

The economic inputs I’m about to discuss are what I use to inform the fundamental side of my analysis.

So, with that out of the way, let’s get to the detail.

From a euro and a sterling perspective, the big input, of course, is the Brexit negotiations. The strength of both currencies relies heavily on said negotiations running smoothly, and both parties (Britain and the EU) being able to close out on an amicable resolution to the divorce.

In previous coverage, I have noted that I felt the UK was slightly stronger in this regard than was the EU, in the sense that I felt the negotiations’ impact on the two regions’ respective currencies would favour sterling. This gave me a near-term bearish EURGBP bias.

With the recent election in the UK, however, this has reversed. I believe Theresa May is heading into negotiations in a far weaker position than she expected, based on the lack of an outright majority domestically, and that this tips the scales for the euro, at least in the near term.

In the previous edition of Forensic Forex, I highlighted the potential for some near-term volatility in the markets based on a variety of economic and geopolitical inputs. Subsequent to that release, we saw a number of these inputs hit press and do so in a way that is likely to induce far more volatility than I initially expected across the coming few months. This has impacted my currency market operations in a few key ways, especially as regards to some of the major pairs in the markets.
“I EXPECT A NUMBER OF STERLING-WEAKNESS INDUCING REPORTS OVER THE COMING WEEKS AND MONTHS.”
I’m not saying that her position is necessarily bad for the UK as a whole once the negotiations wrap up, but from a headline perspective, I expect a number of sterling-weakness inducing reports over the coming weeks and months - reports that will put pressure on the pound when considered against its European counterpart.

Near to medium term, then, I am bullish EURGBP.

On the other side of the Atlantic, things are just as uncertain. The Federal Reserve just raised rates (as was expected) and reiterated its intentions to raise again before the end of the year.

There are many that feel the US economy isn’t strong enough to absorb even one hike, and many more feel the same way about two, so the reiteration, while it was expected to a degree, has resulted in some real volatility in the markets - both currency and equities.

I suspect, then, that while a rate hike like this would generally boost the US dollar - and the potential for a September or December hike would do the same - risk-off sentiment might temporarily taper any potential appreciation in the greenback against its major global counterparts.

This is where things get a bit complicated.

I don’t expect the dollar to weaken, as the above noted risk-off sentiment will ultimately translate to dollar buying. However, I also don’t expect it to revalue considerably to the upside, except perhaps against sterling. Over the coming months, therefore, I am flat to bearish on the dollar-yen, similar on the EURUSD, and bullish cable.

Of course, if we do see a September rate hike, my bias will lean towards slightly more US dollar strength than at present. Again, however, uncertainty over the ability of the US economy to absorb the hike without dipping into correction mode puts a cap on my overarching aggression towards long US dollar positions.

As a closing note, my yen bias remains the same as previously outlined. Japan is very unlikely to start tightening its monetary policy anytime soon, a position recently reiterated by the Japanese government, and this - for me - translates to yen weakness for the foreseeable future. We may see some manipulation driven bounces here and there, but nothing that’s going to change the course of the currency from a long-term perspective.

About Sam

Having completed his Economics BSc Degree in Manchester, Samuel Rae quickly discovered that the retail Forex industry was for him. His personal trading style combines classic candlestick analysis with a simple, logical and risk management driven approach to the financial markets - a strategy that is described and demonstrated in his best-selling book, Diary of a Currency Trader.
BY DAVID JONES

Using Stop-Losses to Maximise Profits

This month we will continue with the real world, practical use of charts and look at a couple of ways they can help when it comes to taking profits on a longer-term investment or shorter-term trade. In my opinion, investors/traders don’t spend enough time on putting together a strategy that helps them decide when to get out of a profitable position. All of the effort gets channelled into finding a perfect system for where to get in – which of course doesn’t exist! But where you finally get out is what dictates your ultimate profit or loss, so let’s redress that balance. We will start off with the simplest approach, using previous levels to identify logical places to book profits.

Let’s use a trading example to identify the first method. The US Dow Jones index is always a popular one with those who use products such as spread betting for their trading. It’s a market that most people have heard of, and even on a dull day, it will travel through ranges in excess of 50 points – and frequently an awful lot more when really moving.

Since the US Presidential Election, American stock markets have been strong and regularly setting fresh all-time highs. The strategy of “buying the dips” – waiting for the market to recover and push higher still – has worked well. The middle of May saw the Dow sell off. In historical terms it was not a major fall, but as we had got used to the market grinding higher for months, it did come as a bit of a shock to some. Our savvy trader may have decided that this was just another buying opportunity, so got in on 18 May as the market showed the first signs of stability.
Now we come to using the chart for setting our profit objective. We will assume our trader bought at 20,700 on 18 May. The previous major high for the Dow, where it had dropped down from, was around 21,050. So that gives a very reasonable 450 points of potential upside for this idea. Being sensible, the trader places a stop loss, choosing to put it the other side of the day’s low of 20,550, taking the view that if the market breaks below this then the timing is slightly out. This gives a trade with a risk of just over 150 points, for a potential profit of 450 points – a sensible balance between risk and reward.

One approach with this trading idea is to set an order to automatically take profits at 21,050, and an order to sell and take a loss if the market drops below 20,550. These orders are usually free of charge to place. When doing this the trader can effectively just walk away and leave it to see what level gets hit first. In theory, there is nothing wrong with this approach – but how frustrated would you feel if the Dow got within 10 points of your target, only to reverse all the way back down and then take out your stop loss! You gave back all of that profit, ended up with a loss, all for the sake of trying to achieve an extra 10 points of profit. It is clearly not a perfect solution but gives us a base to start from and adapt the approach to find something possibly more suitable. Let’s look at another way of doing this.

We will use the same trade entry, stop loss and target, but also utilise the chart to help decide when to take profits. The Dow was bought at 20,700 with a stop loss just over 150 points away. Now, one of the regular mistakes made by the inexperienced is to start moving that stop loss far too early, as the trade moves into profit. This is all to do with the fear of giving back unrealised profits – but it really is a novice psychological error. Many traders – and investors, too – are happy to snatch at small profits whenever they appear – and let losses run far too long. It is very difficult to have a positive record with that sort of approach. So let’s take a step back and look at this Dow trade.

Our trader is happy to risk around 150 points at the beginning of the trade. I would suggest it is therefore sensible to let the market move at least 150 points in the trade’s favour before thinking about moving the stop loss. So in this example, there is nothing to do until the market gets to 20,850 (20,700 entry point +150). This does happen after a couple of days.
The stop loss can now be moved to a break-even position at 20,700. The trade now needs a little more attention when it comes to monitoring how the profit is building up, but with a stop loss at 20,700 the trader has now taken away the risk of loss, and the market has moved a decent amount in the right direction.

One simple approach now, if the market keeps moving in the trader’s favour is to use a simple “manual” trailing stop loss. Trailing stop losses are so-called because they trail the price higher if you are long (i.e. want a market to go up) or conversely trail the market lower if you are short (wanting to profit from a market fall). There are a few reference points that can be used, but let’s stick with a simple one. If the Dow continues to move higher and gets closer to the target then the stop will be moved to the low of the previous day. Then, if the market pushes higher the next day, at the close of trade the stop will be moved to the low of that day. This way, if the market reverses and takes out the previous day’s low the trade will be exited for a profit. But, if the market just keeps on pushing higher, the trader sticks with the position and clocks up the profits. This is what it looks like a few days later, with each day’s low highlighted by a horizontal line.

This has been quite the strong move, and as each day has progressed the low of the previous day has not been threatened. On the last day shown on this chart the market has traded as high as 21,110 – so actually 60 points

“MANY TRADERS – AND INVESTORS, TOO – ARE HAPPY TO SNATCH AT SMALL PROFITS WHENEVER THEY APPEAR – AND LET LOSSES RUN FAR TOO LONG.”
above the initial profit target of 21,050. The trader may be content to just take profits up here and close out the trade manually. Or maybe the trader feels that there is still momentum left and moves the take profit stop below the current day's low. Another option is to take partial profits here and leave some money on the table should the Dow push higher still.

Over the course of the next couple of days, the Dow does start to run out of steam and slips below the previous low. The chart looks like this.

Using the trailing stop under the previous day's low, the trade would have been exited at around 21,050 – coincidentally the original target. A healthy profit has been booked and, by using a sensible trailing stop, the trader has been able to stick with the trade and not snatch at an early and much smaller gain.

This trade evolved over a ten day period and did need some monitoring of course to see where the market had been, and whether the stop should be moved up. But there is no reason why a similar approach could not be used for longer term investments. In my experience I am seldom right straight away for long-term share purchases. If I am using a 10% stop loss then I want the share to move at least that in my favour before I move that stop to breakeven. This can take months, sometimes longer. One possible approach the investor may want to take then is to trail the stop loss up to the low of the previous month. This gives a fair amount of "wiggle room" to ride out the day-to-day volatility we often see for our shares – but it also helps lock in profits along the way as a trend develops.

Just as when coming up with a strategy around when to buy a share, there is also no perfect system to highlight the precise time you should be cashing in and taking your profits. But having a more mechanical and systematic approach like this can help in a couple of ways. It can avoid the all-too-common mistake of taking profits too early and allows a trend to develop. And it can then help calm the emotion of thinking a trend is going to go to the moon – and provide an actionable way of getting out if momentum starts to falter.

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

UNDEFINED BENEFITS

WHY YOU SHOULD THINK TWICE BEFORE TRANSFERRING OUT OF YOUR FINAL SALARY SCHEME

If you’re a typical Master Investor reader there’s every chance that at some stage you’ve been a member of a Final Salary Pension Scheme with a former employer. Or maybe you’re still in the job. Whatever the case may be, it’s likely the scheme doesn’t take any payments from staff anymore or allow new employees to join. So what? I hear you ask.

Well unless you’ve been living in a cave for the last few years, you will have noticed that these “antique” group savings schemes are allegedly in trouble, thanks to a long history of poorly thought-out legal changes and years of mismanagement. And that’s just for starters.

As if that wasn’t bad enough, the previous Chancellor of the Exchequer, George Osborne, faced with a shortage of tax revenues, decided folks sitting in pension plans worried about retirement income were an easy target. So he enticed them out of their “straightjacket” pension plans and/or their final salary schemes by allowing them to cash up their lifetime pension rights and deposit their “winnings” in standalone plans where you don’t have to buy a “useless” annuity. And he attracted the attention of you and me by calling it “Pensions Freedom”. Sounds good eh?

Now you might have stumbled across all this in the news if you recognise the terms DB and DC. Ring any bells? Have you noticed the financial services industry has a penchant for confusing us by using jargon words and odd acronyms? Which other industry would try to entice you with a “Section 32 Buy Out”, a “SSAS”, “SIPP” or “Phased Annuity”? How do you fancy a Without Profit Endowment or a Collective? Err, no thanks.

Well DB stands for Defined Benefit; DC for Defined Contribution. Any the wiser? DB is shorthand for a Final Salary Group Pension Scheme. Remember how that used to be “Gold Plated” and “the Envy of Europe”? Well not anymore, judging by the fact that so many schemes are deep in debt, and that 80,000 folk have already left them in only two years, dumping their guaranteed pension rights in exchange for one-off huge cash sums then put under their own "control". Gulp.

Why is it that policyholders think they’ve won the lottery while scheme trustees and employers are high fiving each other for having got shot of their onerous liabilities?

DB or not DB?

If Shakespeare’s Hamlet were alive today he’d no doubt be pondering...

“DB or not DB? That is the question. Whether ’tis nobler in the mind to suffer The slings and arrows of outrageous fortune, or keep my pension rights where they are?”
“WHY IS IT THAT POLICYHOLDERS THINK THEY’VE WON THE LOTTERY WHILE SCHEME TRUSTEES AND EMPLOYERS ARE HIGH FIVING EACH OTHER FOR HAVING GOT SHOT OF THEIR ONEROUS LIABILITIES?”
“THANKS TO THE POLITICAL SITUATION IN THE UK RIGHT NOW, THOUSANDS ARE IN LIMBO WONDERING WHETHER THEY CAN CONTRIBUTE TO THEIR PLANS OR NOT.”

But to understand why we are now in this confused pension mess, it’s worth looking back at the halcyon days of “Gold Plated” Final Salary Group Schemes. Was it really all so perfect?

I started working in 1969 after leaving university hoping to become an actuary. Fortunately I didn’t make it, thanks to having a personality. But the work gave me a good grounding enabling me to understand the nuances of financial products and translate industry jargon into meaningful explanations.

In 1972 I was given the Herculean task of improving the productivity of the pensions department in a mutual assurance office. I surrendered after only a few days. It was all too bewildering for mere mortals like me.

Fortunately my boss had previously wandered up and down the UK convincing employers to provide benefits to their employees via “Gold Plated” DB schemes. So he understood the jargon and complexities. Sitting down with a sheet of paper he drew a water tank shape with an inflow pipe above and a tap at the bottom. Let’s call this a DB scheme, he said.

The inflow pipe pours money into the tank and the idea is that enough money is in there to pour out sufficient to buy benefits (income and some tax free cash) when the oldest member of the scheme retires. So how do they know how much money to pour in every year I wondered? Easy he replied…

You do an analysis of all those joining at the start – dates of birth, salaries, marital status, male/female mix etc. – then assume rates of yearly salary increase, rates of inflation, rates of return on investments, mix in mortality statistics, work on assumptions the scheme lasts for infinity, throw all that into a computer and out pops a funding rate. A what? That’s the percentage of staff salaries that’s needed to be paid in by employer and employees to keep the scheme on track. And that’s easy?

I looked at him in astonishment. That can’t possibly work, I said. Shh! he replied, don’t tell anyone!

And that was the best it got. But over the following thirty-odd years all that changed. New legislation meant that all pensions now had to be revalued in real terms, all past employees needed to be protected, and scheme asset surpluses were frowned upon by governments (tax evasion they said) so contribution holidays were encouraged. Legal changes were accelerated by successive governments, especially during Gordon Brown’s vindictive tax onslaught from 1997.

There used to be something called “Legitimate Expectation of Benefit” under Law of Contract. Applied to pensions it was upheld religiously throughout all the restrictive changes introduced from 1988 onwards. You could rely on there being no restrictive legislation reducing your rights. Then in 2006 Brown tore it all up, applying caps to benefits retrospectively. It was all illegal but few cared. Our Judges did and threatened to resign en masse, so were exempted. As was the Prime Minister, Chancellor of the Exchequer, and Leader of the House of Commons. Surprise surprise.

I’ll not bore you with all the details but we now have umpteen regimes of lifetime caps retrospectively applied creating tax traps on income and capital for the unwary. And as for the damage already caused, the CA magazine calcu-
late that the unfair retrospective imposition of capped benefits has already led to a sixth of GPs between age 55 and 59 leaving their profession thanks to it. And in turn that led to 265,000 patients having their GP practice closed. And that’s probably just the tip of the iceberg.

And now thanks to the political situation in the UK right now, thousands are in limbo wondering whether they can contribute to their plans or not, and whether it’s worth it or not. And remarkably, despite the obvious benefits of having your pension position checked out by folk who really can guide you through this mess, only 10% of those asked in a survey saw the value. Doh!

Think it over. Think it under.

But to those tempted to join the lemming-like rush out of their secure and guaranteed lifetime income plan (DB Schemes) alongside the 80,000 who feel confident enough to manage their income and asset value perhaps for the next 40 years (assuming longevity experts are right), maybe ask yourselves a few questions first, such as...

If this transfer had been available to you 10 years ago, at the age you are now, with a similar transfer value of up to 40 times your DB pension level, and you’d invested in a UK stock market about to fall by as much as 50% over the following year thanks to the financial crisis, how would you have felt, and what would you have done next? Is that something you’d be able to handle?

If you transfer out to your own plan do you know whether you’re going to increase your liability to taxes given you’re leaving a benign tax area to move to a more highly taxed one?

Why do you think you’ve won the lottery with the transferred amount while the trustees and employer left behind are high fiving each other? Any idea how much it costs on the open market to buy a £20,000 guaranteed indexed pension plus two thirds pension for life guaranteed for a surviving partner? It’s probably 50% more than your “lottery win”.

And are you convinced the adviser who helped you transfer and select investments for your income for life is best placed to guide you through all the complexities and fears over your retirement?

Why is it that in surveys 80% of those heading into retirement say they want guaranteed income for themselves and their partner for life, yet the same percentage say they don’t want to buy annuities or something similar?

This all sounds very confusing to me. Please don’t make a decision like this without pondering questions like these.

As Winnie the Pooh said, “Think it Over. Think it Under.” In other words, due diligence has never been so important. Take time. Lots of it!

**“IF YOU TRANSFER OUT TO YOUR OWN PLAN DO YOU KNOW WHETHER YOU’RE GOING TO INCREASE YOUR LIABILITY TO TAXES GIVEN YOU’RE LEAVING A BENIGN TAX AREA TO MOVE TO A MORE HIGHLY TAXED ONE?”**

About Alan

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

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

A profitable and reliable investing activity is always centred on being able to unlock value from the market. That involves being able to remove sentiment from the investment equation; avoiding "adrenaline markets" driven by momentum; and seeking out the unloved and overlooked equities with decent prospects. Only those who have the guts to go against the crowd for long periods of time – sometimes during periods that stretch into decades – can beat the market consistently. Those others following the crowd can only achieve market averages less any commissions and fees spent in the process, because, by definition, that represents a convergence towards the mean.

Over the last fifteen editions of the Master Investor magazine, we have been looking at how investment gurus deploy their profitable strategies. Of particular interest are value investors, who are always digging deep to find unloved and overlooked value. All value investors have in common an ability to think on their own and to avoid the herd. But they differ in the exact approach they use to pick the winners. Some, like Joel Greenblatt (issue 24 – March 2017), make extensive use of statistics to build a well-diversified portfolio that is expected to beat the market on average, attaching less importance to the more specific fundamentals impacting any particular company. Others, like Ben Graham (issue 13 – April 2016), are extremely picky, digging deep into financial statements and crunching every single number they find to reduce risk to a minimum.

These investors also differ in terms of the main tools they use to unlock potential value. Greenblatt’s magic formula ranks stocks by mixing EBIT yield with return on capital employed; Geraldine Weiss (issue 27 – June 2017) concentrates on building a rank of dividend yields; and Ben Graham prefers companies with a very low price-to-net-current-asset-value. Given these investors’ impressive performance records, nobody should doubt that there is more than one way of consistently unearthing value from the market, which is a major blow for the defenders of the efficient market hypothesis but good news for those who want to learn the craft of value investing.

The most important part of value investing is to develop a sound strategy, to be consistent in applying it, to have the necessary patience to wait for value to be unlocked, and to be disciplined. In the end, the exact methods used are not the keys to success.

In this instalment of How to Invest Like..., we’re going to look at the strategy used by living legend John Neff, who managed the Vanguard Windsor Fund for 31 years, consistently beating the market. Unlike Greenblatt, Neff believes a deep fundamental analysis to be more valuable than statistics, and because of it, his portfolios have always been more concentrated than portfolio theory would recommend. Neff’s investment philosophy is rooted in a forward-looking low price-to-earnings methodology, which identifies value from evaluating how much an investor is paying for expected earnings growth and dividend yield. A point of divergence in Neff’s strategy relative to other value investors comes from his added macro perspective. He always

"It’s not always easy to do what’s not popular, but that’s where you make your money. Buy stocks that look bad to less careful investors and hang on until their real value is recognised".

— John Neff
in John Neff on Investing, 1994

HOW TO INVEST LIKE...

JOHN NEFF

BY FILIPE R. COSTA
“A POINT OF DIVERGENCE IN NEFF’S STRATEGY RELATIVE TO OTHER VALUE INVESTORS COMES FROM HIS ADDED MACRO PERSPECTIVE.”
“AFTER A FEW YEARS, THE FUND HAD TO BE CLOSED TO NEW INVESTORS: SUCH WAS THE VOLUME OF NEW MONEY IT WAS ATTRACTING.”

places weight on predicting markets, global trends and the economy, in order to better time his entries and exits. Most value investors prefer to stay away from predicting macro events. A good example of such sentiment is reflected in Walter Schloss’s answer to what he thought would happen to the market or the overall economy: “I’ve got no idea; your guess is as good as mine”.

The road to success

John Neff, 85, was born in Ohio in 1931. He is notable for his contrarian and value investing styles and for heading one of the most important Vanguard funds – the Windsor Fund – for 31 years. His success was so significant that not only individual investors but also professional managers were handing their money to him.

Neff graduated in the University of Toledo and soon started working at the National City Bank of Cleveland, as a securities analyst, where he spent eight years. While working at the bank, he obtained his MBA from the Business School Case Western Reserve University in 1958. Later, he headed to Wellington Management Co. where, after three years, he was appointed portfolio manager of Windsor, Gemini, and Qualified Dividends funds.

During his tenure as manager of Windsor, the compound annual growth rate of the fund was around 13.7%, which compares with 10.6% for the S&P 500. This performance was always very consistent, as Neff beat the market in 22 of the 31 years in question.

Some readers may be thinking that the 3.1% annual outperformance is not all that much. But in fact it is for a mutual fund, which usually runs on many more investment constraints than a hedge fund does. And there is the compounding effect as well. Over the course of 31 years, what seems like a small outperformance becomes a huge difference in total profits. An investor placing £100,000 in the S&P 500 and reinvesting any dividends during the period between 1964 and 1995 would have £2.72 million at the end of the period. The same amount invested in the Windsor Fund would amount to £5.35 million in 1995, which is roughly double the S&P investment. Compounding turns small differences in annual returns into huge outperformance over the years, making every penny count.

The Windsor fund is a mutual fund, which was created by Wellington Management Co. in 1958. Six years after its inception, Neff assumed management of Windsor, giving it a new lease of life. After a few years, the fund had to be closed to new investors: such was the volume of new money it was attracting.

Such a step was very unusual for a mutual fund but was necessary in order to maintain its profitability. Windsor wasn’t the most diversified of funds. It used to concentrate 40% of the portfolio in its top 10 holdings. More often than not, these top holdings weren’t even in the top 50 market capitalisations. With the fund growing in assets under management, it would become very difficult to purchase shares without engendering significant movement in prices. For this reason, the fund closed to outside money in the early 1980s.

In 1995, and after 31 years managing Windsor, Neff retired. The Windsor fund still exists, now part of Vanguard (mainly due to the departure of John Bogle from Wellington in 1974 and his subsequent foundation of Vanguard). The fund shows an annual return of 11.4% on record since inception and net assets of $18.3 billion. But, while the original philosophy of investing in stocks that are temporarily out of favour is still present, the bets are less risky and more diversified as of today. Currently, the fund shows a positive tilt towards consumer discretionary, healthcare, and IT, while being underweight in consumer staples, energy, telecommunication services and utilities. But it currently holds 140 stocks with an average price-to-earnings ratio of 25.2x, versus 24.5x for its benchmark, the Russell 1000. Such a figure would be unacceptable under Neff’s tenure. It is the consequence of the increasing difficulty fund managers have in finding value in a market that has been rising for eight years.

Setting the strategy

Neff’s strategy was once described by himself as one of just buying “good companies, in good industries, at low price-to-earnings prices”, or in other words, a strategy of buying companies with good growth prospects and financial strength that are currently unloved by the broad market and therefore trading at prices below their real value.

But of course, determining what constitutes a good company is not an easy task, as it depends on a thorough fundamental analysis not only of the target stock but also of its peers to de-

How Much Was £100,000 Invested in 1964 Worth in 1995?
determine how it stands up against competition. As Ben Graham highlighted in his books, a good strategy means not only buying cheap but also getting a few layers of protection against a potential fall in price. Neff defined a few criteria to screen potential investments in order to maximise the chances of future price convergence to fundamentals and then usually concentrated his positions, timing them with macro analysis. His average holding period was around three years, which highlights the fact that value investing is a game of patience, often a solitary one.

Neff always believed that the broad market doesn't act in a rational or systematic way at all times. Human behaviour suffers from cognitive bias and the market as a whole suffers from poor judgement. Investors often just follow one another, using momentum strategies that are self-fulfilling without an accompanying improvement in fundamentals. When that happens, prices start rising too fast, as investors expect unreasonably high growth in earnings. Price-to-earnings ratios start increasing, or at least rely on forward earnings that are too optimistic. The chances for deception are huge. At the opposite corner lie those unloved stocks, which are at the bottom of the cycle and trading at very low price-earnings ratios due to pessimistic projections of future earnings. Any small improvement in earnings would lead to substantial price rises. The good news is that there's always a "steady supply of out-of-favour candidates".

Neff analysed the market and found that stocks with lower price-to-earnings ratios tended to outperform the broad market as stocks with higher price-to-earnings ratios tended to underperform. This observation enabled him to build a strategy. One option is to build a well-diversified portfolio of low price-to-earnings stocks and expect it to, on average, deliver returns above the market. This is the path followed by Greenblatt and Dreman, as they use statistical laws extensively. There's no need to evaluate each stock in the portfolio because the law of averages will do what is needed to get an edge over the broader market. Another option is to apply a thorough fundamental analysis on a rigid screening process. In this case concentration is preferred over diversification. John Neff always opted for this second alternative.

In his book "John Neff on Investing", written in 1994 (with more recent editions also available), Neff explained his strategy in detail. We can summarise it as a screener with eight main criteria, as detailed below:

1) Low price-to-earnings ratio

The whole strategy is grounded on a low price relative to earnings for investors to be able to pick the more unfavourable stocks that offer more upside potential. Neff was often just purchasing stocks on bad news to take advantage of investors' over-reaction. Usually, he sought for a price-to-earnings ratio that is below the market or below the industry average. In general, he was looking for a discount of 40% to 60% or for a ratio in the single digits. This criterion is important to pick up value but it is not enough in itself. A very low price-to-earnings ratio could just reflect very poor fundamentals. Other checks needed to be made.

2) Cheap profile

The sources of return for an investor are earnings and dividends. The second should never be ignored. Because of its importance, Neff used to look at what he called the total return ratio, which is the ratio of the sum of the expected earnings growth rate plus the dividend yield on the price-to-earnings-ratio. Neff was seeking for ratios above 2x the market or industry.

3) Substantial earnings growth

Potential stocks should command high, but not excessive, expected earnings growth. Earnings growth is an important source of return for investors, but when the future projections are excessive they're often unsustainable, and expose the stock to a high risk of collapse upon the realisation of lower earnings than those expected. In general, substantial earnings growth means something between 7% and 25%.

4) Substantial sales growth

While earnings are the key driver of investors' profits, they can be managed and manipulated. That's one of the reasons why Greenblatt uses the EBIT yield in his magic formula, instead of EPS. Still, apart from fiscal issues and the choice of financing between debt and equity, a company can sometimes improve its bottom line without improving its top line; that is, increasing its earnings through cost-cutting and nonrecurring sales. In the following year, the potential for the same would be more limited and in the end growth in earnings must come from growth in sales. The best scenario is for sales and earnings to be growing simultaneously. Sales should at least have been rising 7% per year for the last five years.

“NEFF’S STRATEGY WAS ONCE DESCRIBED BY HIMSELF AS ONE OF JUST BUYING ‘GOOD COMPANIES, IN GOOD INDUSTRIES, AT LOW PRICE-TO-EARNING PRICES’.”

HOW TO INVEST LIKE...
5) Positive free cash flow

Liquidity is crucial in order to take advantage of opportunities. Companies with positive free cash flow can expand their operations and reinvest in their own businesses with ease. At the same time, such cash generated may be used to pay dividends and repurchase shares. Neff favours companies showing positive free cash flow over the last two years.

6) Good operating margins

Operating margins should be better than current industry medians over the last two years.

7) Good dividend yield

"A superior yield at least lets you snack on hors d’oeuvres while waiting for the main meal". Neff believes the market usually ignores dividends and doesn’t price them, so investing in a company which pays dividends, would mean getting the dividend for free. Neff once said that two-thirds of Windsor’s outperformance mostly came from dividends. He liked to pick stocks with a yield between 4 and 5%.

8) Good return on equity

Like many other value investors, Neff emphasises return on equity as being the best single measure of management effectiveness. In building his magic formula, for example, Greenblatt uses a measure of return on capital employed in conjunction with the earnings yield to highlight the importance of getting a number to evaluate how management is using capital. The number should be as high as possible, keeping in mind the fact that too high a number may just be unsustainable.

While the above screening provides a good basis for investment, it doesn’t constitute the final purchase list. Neff still conducts due diligence to verify the financial strength of the screened companies.

“NEFF EMPHASISES RETURN ON EQUITY AS BEING THE BEST SINGLE MEASURE OF MANAGEMENT EFFECTIVENESS.”

---

"You need to probe a whole raft of numbers and facts, searching for confirmation or contradiction. Fundamentals consistent with benchmarks usu-
ally reinforce the unrecognised virtues of low price-to-earnings stocks; fundamental shortfalls may expose gaps that cripple prospects for price-to-earnings expansion”.

**Developing a strategy in the real world**

Applying John Neff’s strategy is not an easy task because his original view would have to be slightly adapted to the current market reality: otherwise one would be at risk of not selecting any stocks at all. The investment philosophy should be preserved, but some decisions still need to be made regarding the thresholds to use. For example, Neff was looking for price-to-earnings ratios that were below the market and in the single digits, but the Windsor fund currently exhibits a ratio around 25x. A more rigid screener wouldn’t provide the fund with the 140 stocks it is currently invested in.

A simple example is depicted below. A screener was applied to 623 stocks from the FTSE All-Share index. A filter requiring price-to-earnings ratios to be on single digits reduces the filtered stocks to 70. Requiring earnings growth of at least 7% further reduces the number of shares to 28. Requiring the same for turnover further trims the database to 13. Then only 10 of them have positive free cash flow for the last two years. Finally, only six show a total return that is positive, based on expected earnings and the current dividend yield and price-to-earnings ratio.

The above data and selection process is just an interpretation of Neff’s strategy to show how difficult it may be to develop a real strategy from it and how an investor needs to adapt it for present circumstances.

**Final remarks**

John Neff’s strategy is not much different from other value investors’ strategies in its essence. The main idea was always to buy good companies at depressed prices. A successful investor must be able to avoid buying with the crowd when everyone is euphoric, to instead pick the underappreciated stocks from industries that are somewhat lagging in terms of sentiment.

Momentum stocks coming out of ”adrenaline markets” have their price-to-earnings ratios “invariably pushed up to ridiculously expensive levels. This greatly increases the risk of a sudden collapse in the share price”.

Investors need to focus on buying companies with moderate growth prospects and high dividends while they’re out of favour. Inflated prospects are highly priced and have a great likelihood of turning in negative surprises; moderate growth at the bottom of the cycle has the prospect of turning in positive surprises and delivering great profits. Investors need to have the guts and the money to oppose the market during prolonged periods of time. For that to be possible, it is crucial to uphold a tight screening process that can selectively pick only those stocks that are out of favour due to a changing trend and not those with structurally deficient prospects. For Greenblatt and Dreman, this is accomplished through statistical rules of diversification and averaging; for Neff it is accomplished through a deep scrutiny of a company’s fundamentals. Each investor should evaluate his own style and resources and maintain a proper strategy that can pick out value over time. Patience is ultimately the investor’s major asset.

**Example Application of Neff’s Strategy on FTSE All-Share**

<table>
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<tr>
<th>Asset</th>
<th>Market Cap (£m)</th>
<th>PE Ratio</th>
<th>PEG Ratio</th>
<th>Div. Yield (%)</th>
<th>Total Return Ratio</th>
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**About Filipe**

Filipe has been a contributor to Master Investor since the earliest years. His specialisation is monetary policy, macro issues and behavioural finance where he allies the practical experience of several years of trading with academic credentials. Filipe in fact teaches courses on Financial Markets and Monetary Economics at the University of Oporto Faculty of Economics, helping traders maximise profits and better manage risk.
Aftermath: The millennials are coming after your money

Raking over the smouldering embers of the UK general election, there is one salient theme that speaks to the future. The deep socio-political-demographic divide between the Elders and the Millennials has reached a tipping point. A youthquake has struck. Society – not just in the UK but across the West – is about to change in a way that has massive implications for politics, the economy and investment.

Despite their bitter disappointment at losing their majority, the Tories should celebrate this fact. In 2015 David Cameron secured 11.33 million votes – 36.9 percent of all votes cast. In 2017 Theresa May got 13.66 million votes or 42.5 percent. So Theresa got 2.3 million more votes than Call-Me-Dave. (Not quite as good as John Major’s 14.1 million votes in 1992 – the largest electoral mandate in UK history – but not bad either.)

Another 70 votes and Mrs May might actually have made it
A YOUTHQUAKE HAS STRUCK. SOCIETY – NOT JUST IN THE UK BUT ACROSS THE WEST – IS ABOUT TO CHANGE IN A WAY THAT HAS MASSIVE IMPLICATIONS FOR POLITICS, THE ECONOMY AND INVESTMENT.”

(Kensington – Labour majority of 20; Perth - 21; Dudley - 22...).

What happened this election is that we reverted to a two-party system, with Labour getting 40 percent – an astonishing achievement by Mr Corbyn: many more votes than Tony Blair’s victories of 2001 and 2005. And the Tories took 13 seats in Scotland. Indeed, this new Tory government – assuming it will be working with the DUP – has significant representation in all parts of the UK, which is good news for Unionists.

But Mr Corbyn has much more to celebrate than Mrs May. And there is one thing that comes out of the numbers which suggests that they now have momentum towards a future victory...

By Victor Hill
How to protect your wealth against currency debasement

The 2008 financial crisis may seem like a distant memory, but the ongoing ramifications are still a massive threat to your wealth. Concerted intervention by the world’s most powerful central banks managed to avert an immediate global meltdown, although we’re all going to pay the price in the form of higher inflation.

The historically low interest rates and massive programmes of Quantitative Easing in the UK, US, Japan and the Eurozone were designed to stimulate economic growth and inflation so as to make it feasible for these governments to continue to service their debts.

It has taken the best part of a decade, but in the UK – helped by the fall in the pound following Brexit – we are now beginning to see the impact in the form of higher inflation that is now around 3%. This may not sound much, but if your cash is in a deposit account and you spend the interest it is enough to reduce your capital’s purchasing power by about 14% over five years.

If you want to protect your wealth against this slow but deadly form of erosion you need to move your money out of reach of the central banks. One way to do this would be to invest in alternative currencies that cannot be debased in the same way.

The most obvious example is gold. Unlike a paper currency, gold has an intrinsic value and acts like a store of value as there is limited supply. The central bank can easily reduce the value of the pound in your pocket just by printing more of them, but it can’t conjure up more gold.

By Nick Sudbury

Are these the top 3 gold stocks in London?

Gold may not have a practical value as an alternative currency. It’s not possible to enter a shop and pay for any product or service in gold. However, the precious metal may have value as an alternative to cash or other assets due to its scope to help protect against rising inflation.

In the UK, CPI inflation has already reached 2.9%. It is forecast to move higher, with the recent general election result making this even more likely. A period of political uncertainty caused by a minority government which is seeking to conduct Brexit negotiations may lead to reduced confidence among investors and business leaders. The result of this could be a further depreciation of the pound following its loss of value versus a basket of major currencies in the last year.

Higher inflation may also become present in the global economy. After a decade of deflation which has allowed ultra-loose monetary policies to be pursued, an end of austerity is on the horizon. Higher spending in the US is planned by the current President, while quantitative easing continues apace in Europe.
Gold has historically been a popular asset during times of high inflation. It provides a store of value which is difficult to match among other assets. The gold price has historically responded positively to periods of above-average inflation, as well as during periods of uncertainty. With political risk in the UK and EU, as well as in the US, being relatively high, gold could therefore become a more attractive asset to own on a relative basis.

However, the process of buying and storing gold can be somewhat challenging in terms of logistics, as well as being expensive. Owning gold also means a lack of income, which can make it less appealing for investors seeking at least some kind of income return.

By Robert Stephens, CFA

The Isle of Man: A place where you can

If you ever wanted to get an idea how life could be if there were more pragmatic regulations, a simple tax regime, and a wide range of options to access capital, you should visit the Isle of Man. It offers a unique combination of possibilities to entrepreneurs, investors, retirees, and anyone else who tries to live a life less complicated and more lucrative.

Over the past decade the island has successfully repositioned itself as an International Business Centre. Global tax transparency, driven by an international alliance led by the OECD, has changed the face of global finance, so the countries that will thrive in this new world are those that can offer an efficient and stable operating environment.

Dealing with changing times is something in which the Isle of Man Government has a long pedigree. Rather uniquely within northern Europe, it always kept the fiscal flexibility to deal with changing circumstances.

With over 30 years of uninterrupted economic growth, the Island avoided taking on long-term debt and instead built up total reserves to a current value of GBP 1.6billion (source: Isle of Man Government Budget 2017/2018). The overall amount seems small compared to the sovereign wealth funds of countries like Qatar, Singapore or Norway. However, since the Island only has 84,000 inhabitants, it’s equivalent to a reserve of GBP 19,000 per person (compared to the UK’s national debt of GBP 25,000 per person). Additionally, the Isle of Man Government is obliged to budget for a surplus annually.

The changes to international tax reporting were without doubt a huge challenge to the Island, and continue to be although the Island’s financial services industry has risen to the challenge. Banks, fund managers, trust companies and similar service providers are managing the bureaucracy caused by new compliance and reporting regimes.

By Swen Lorenz

“DEALING WITH CHANGING TIMES IS SOMETHING IN WHICH THE ISLE OF MAN GOVERNMENT HAS A LONG PEDIGREE.”
READ TO SUCCEED

THE DIY INVESTOR
2ND EDITION

HOW TO GET STARTED IN INVESTING & PLAN FOR A FINANCIALLY SECURE FUTURE

BY ANDY BELL

The asset management industry is in trouble. This statement was recently summed up superbly by Abhijit Rawal, Director at advisory business PwC, who argued that the profession is being hit by a number of problems he calls the “four Rs”.

Firstly, with stock markets at all time highs and bond yields at record lows, decent returns are hard to come by. Secondly, revenues are being squeezed by fierce competition in the industry which has driven down fees. Next, the regulators retain a keen eye on the sector, often changing the rules in favour of the retail customers they seek to protect. Finally, advances in technology have seen a number of robot driven, low cost offerings launched into the market.

In light of these trends, the publication of the 2nd edition of The DIY Investor comes at a pertinent time.

Author Andy Bell is an entrepreneur and former actuary. After graduating with a first-class degree in Mathematics in 1987 he joined a large insurance company as a trainee. However, like so many in the industry, he became disillusioned with financial services and took three years off to coach football and tennis in America. When he came back to the UK he resurrected his actuarial career and then in 1995 founded the investment business AJ Bell, funded with just £10,000 of personal loans. As CEO he has seen the company grow to have over £36 billion of assets under administration and 152,000 retail clients, many of whom embrace the DIY investor ethos.

Do Invest Yourself

Part One of the book covers what being a DIY investor is all about. The basic idea is that anyone can learn how to manage their finances in order to meet their financial goals, rather than pay someone else to do it. This approach can have a number of advantages. To start off with, investing for yourself can eliminate a layer of unnecessary fees which would otherwise be paid to the professionals. While often small, over time these can build up and seriously erode your investment pot. Secondly, who better to manage your wealth than yourself? After all, there probably aren’t many people (except your partner or children) who care what happens to your money more than you do.

Over the past decade or so the ability to become a DIY investor has increased massively, with the rise of the internet being crucial to this.

The internet is to DIY investors what B&Q is to those keen on home improvement. Both have revolutionised their respective industries, making it easy for anyone to have a go themselves. But before starting it is important for investors to set down their own specific investment objectives and time frames – perhaps having a certain amount of money by retirement age or building up £10,000 within five years to pay for a round the world cruise.

Setting objectives is exactly what a professional advisor would do for a client when taking them on-board. On that note, Bell does suggest that if you
really don’t understand a certain area in investment then you should be willing to take and pay for advice from a professional if necessary, just like we would call a plumber to fix a faulty boiler rather than try to fix it ourselves.

“THE DIY INVESTOR IS AN EXCELLENT BOOK FOR ANYONE LOOKING TO TAKE CONTROL OF THEIR FINANCIAL FUTURE.”

Part Two covers those aspects of an investor’s toolkit which enable investment in specific investments to be made. In other words, investment platforms. We kick off with a discussion of ISAs, the ever popular tax free investment “wrapper”, which as at the end of the 2015/16 tax year had a combined market value of £518 billion. This amount was split pretty much equally between the Cash and the Stocks & Shares ISAs, two popular products which Bell discusses in detail. Other recent additions to the ISA stable are also reviewed, including the Lifetime ISA, Help to Buy ISA and the Innovative Finance ISA, with their benefits and potential downfalls analysed. Next up are SIPPS, or Self Invested Personal Pensions. Bell covers this area in a lot of detail, but this is understandable given the tax advantages of SIPPs and their importance to increasing long-term wealth.

Part Three looks at the various investments which can be bought through the investment platforms, including funds, investment trusts, equities, bonds, gilts and cash. However, there is no discussion of how to value investments or any stock tips – you’ll have to stick to Master Investor Magazine for that! Bell also includes a small section on alternative investments for those who are willing to add a little more risk to their portfolio. This covers buy-to-let property, stamps, wine, art, commodities and even vintage cars. Finally, Part Four looks at putting all the information together in order to create an efficient and focussed portfolio, including guidance on tax efficiency, what to do when things go wrong, accounting for risk and investment strategies.

Nail down for your library

The DIY Investor is an excellent book for anyone looking to take control of their financial future. For beginners, it provides a thorough and insightful view into the sometimes confusing worlds of personal finance and investment, offering a multitude of practical tips on how to make the best of their savings.

It is also useful as a reference and planning guide for those more familiar with the markets. Since this is the second edition of the book, more experienced investors might find the updates regarding recent developments in the markets especially useful, particularly the section on the new types of ISA products and the benefits they bring.

All in all buying this book should be a no brainer for those who want to nail down plans to go on a self investment journey. Costing less than £20, this is a mere fraction of the potential thousands of pounds that some investors might find they end up paying to the professionals over the course of their investment careers.

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About Richard

Richard Gill is an investment analyst with over a decade’s experience of analysing small/mid cap equities. Richard qualified with the Chartered Financial Analyst (CFA) designation in 2012 and was awarded PLUS Markets Financial Writer of the Year at the 2008 PLUS Awards. He has been a judge at the Small Cap Awards from 2013 to 2017.
Perhaps the most remarkable thing about Berkshire Hathaway is not the extraordinary wealth that the business has created for its shareholders, although those fortunes are certainly remarkable. What is perhaps most impressive about Warren Buffett and his right-hand man, Charlie Munger, is that they have made no secret about what they do and why they do it. Buffett tends to attract most of the credit, but it is his friend and associate Charlie Munger who is arguably the more cerebral and articulate of the pair. Munger is especially fond of reading. While we can learn from our own experience, he points out, it is a far more efficient use of our time to learn from the hard-won experiences of others. Reading assists that process. Reading books, he observes, is like conversation with the finest minds of past centuries. And he’s typically self-deprecating about it:

“You’d be amazed at how much Warren reads – at how much I read. My children laugh at me. They think I’m a book with a couple of legs sticking out.”

The most insightful things I’ve come across during the course of my career in the City were not taught to me, but then I never read Economics. I encountered them in books, under my own steam.

The first is from Peter L Bernstein’s magisterial Against the Gods, which happens to be a biography of risk. Even today risk is not widely understood, and the asset management industry tends naively to associate it simply with volatility, but the study of risk has progressed in leaps and bounds since man’s earliest experiences with trading and gambling.

Within Bernstein’s book there is a quotation by a true Renaissance man, the 18th Century Swiss polymath Daniel Bernoulli. Bernoulli will be familiar to anyone who has specialised in physics on account of the Bernoulli principle, which deals with fluid dynamics. But Bernoulli was also one of the first behavioural financiers. When managing money for wealthy people, Bernoulli wrote, “the practical utility of any gain in portfolio value inversely relates to the size of the portfolio.”

— Joseph Marshall Wade
“THE MOST INSIGHTFUL THINGS I’VE COME ACROSS DURING THE COURSE OF MY CAREER IN THE CITY WERE NOT TAUGHT TO ME, BUT THEN I NEVER READ ECONOMICS. I ENCOUNTERED THEM IN BOOKS, UNDER MY OWN STEAM.”
The dry language doesn't help, but in plainer English: if you’re managing money for wealthy people, just don’t lose it. The more wealth people have, the less they need – and after a certain point, capital preservation becomes a lot more important to them than further capital growth.

I came across these words and these sentiments in the late 1990s, and the focus on capital preservation (in real terms) seemed just right for someone offering wealth management services to the well-heeled. Even now, too many wealth managers (i.e. asset gatherers) are distracted by irrelevant indices and benchmarks when what most of their clients really want is some form of disciplined capital preservation. In fact, recent research, notably by Kahneman and Tversky, whose story is well told in Michael Lewis’ new book, *The Undoing Project*, suggests that it is not just the rich who value capital preservation. We all do. Human beings are loss averse creatures: the pain of losing money is felt roughly twice as intensely as the pleasure of gaining it.

The other major influence on my own investment philosophy is one of the most highly and widely recommended books on trading that exists. It is Jack Schwager’s *Market Wizards* and, strictly speaking, in the interests of completeness, its sequel, *The New Market Wizards*. These are interviews with some of the best traders and investors in the world. Like Messrs Buffett and Munger, Schwager’s interviewees give freely of their time and experience. If I could only recommend one or two books to people just starting out in investment (either on their own part or for managing the wealth of others) these would be those books.

You might think that the world’s most successful traders would be unwilling to part with the strategies that have made them billionaires. Think again. One of the reasons they’ve achieved their level of wealth is that they’ve managed to thrive on the unchanging human nature of the rest of us. Richard Dennis, for example, one of the most successful commodities traders of all time, makes the following point:

“I always say you could publish rules in a newspaper and no-one would follow them. The key is consistency and discipline.”

(Dennis, incidentally, is behind the great experiment of “the turtles”, which sought to prove that great traders could be made, just by teaching people with no former experience some critical trading rules, best summed up as “systematic trend-following”, which is the only hedge fund strategy I now invest in. Dennis won his bet, making a handful of neophyte traders into multimillionaires in the process.)

That you can learn from industry practitioners as widely dispersed in their methodologies as Warren Buffett and Richard Dennis says a lot about the business of investing and trading. There is no single best process. There are multiple roads to riches. What matters, I think, is to find an investment approach that best fits your own personality. Personally, I like to play a good defence. Others will doubtless have a higher tolerance for risk-taking.

What’s interesting is that whether one is trading or investing, that focus on capital preservation tends to remain. Take Buffett, again:
“Rule Number One: never lose money.

Rule Number Two: never forget Rule Number One.”

And then take Richard Dennis:

“You have to minimize your losses and try to preserve capital for those very few instances where you can make a lot in a very short period of time. What you can’t afford to do is throw away your capital on suboptimal trades.”

Whether you choose to concentrate on trading or investing, what’s important is that when you’ve found an approach that clicks with your own personality, don’t muck about with it. As Dennis says, the key is consistency and discipline. As many successful fund managers have discovered, the business of successful investing is simple but not easy.

There is another book that has had a profound influence on my own investment outlook, namely Eric Beinhocker’s The Origin of Wealth. I mentioned earlier that I never read Economics, and reading Beinhocker’s book gave me a profound sense of relief at the fact. I would go so far as to say that if the world had fewer economists, and their influence was much less than it now is, the Global Financial Crisis either might never have occurred, or would have been far less painful. As it is, we continue to live beneath its shadow.

Beinhocker offers a potted history of economic thought. Things get really interesting, though, when it comes to the late 19th century and the story of the Frenchman Leon Walras. Walras had failed as an engineer, novelist, journalist and banker. In desperation, Walras Sr. took his son for a walk, and advised him to try his hand at the then exciting new discipline of economics.

“Prior to Walras, economics was not a mathematical field. Walras and his compatriots were convinced that if the equations of differential calculus could capture the motions of planets and atoms in the universe, these same mathematical techniques could also capture the motion of human minds in the economy.”

Unfortunately, there was one tiny flaw in Walras’ assumptions. They were all rubbish. The economy, as the great classical economists understood, is far too complex to be reduced to simple equations. As the great Austrian economists like Ludwig von Mises appreciated, the economy is us: seven billion people all interacting, with all our collective hopes and fears and vanities and irrationality. Good luck modelling that.

But it hasn’t stopped economists from trying.

So there is much to be learned from books, and not all of it is dry theorizing. But books like Beinhocker’s have also helped in preventing me from going down blind alleys – those now crowded with confused economists wondering why none of their theories ever seem to work in the real world.

Against the Gods. Market Wizards. The New Market Wizards. And The Origin of Wealth. Four of the finest books on risk, investing (and economics) that you will ever read. Take notes – there’ll be a test later.

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About Tim

Tim Price is manager of the VT Price Value Portfolio (www.pricevaluepartners.com) and author of ‘Investing Through the Looking Glass: a rational guide to irrational financial markets’.

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## MARKETS IN FOCUS

### JUNE 2017

#### GLOBAL EQUITIES

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#### CENTRAL BANKS - RATES & MEETINGS

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<td>Jul 20</td>
<td>Sep 07</td>
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<td>Jul 10</td>
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<td>SNB</td>
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<td>Dec 14</td>
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<td>RBA</td>
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<td>RBNZ</td>
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<td>Jul 03</td>
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<td>Oct 26</td>
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MARKETS IN FOCUS

FTSE 350 TOP

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<tr>
<th>Sector</th>
<th>Last Month %</th>
<th>YTD %</th>
<th>Proximity to 52w High</th>
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<tbody>
<tr>
<td>Ferrexpo PLC</td>
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<td>Capita PLC</td>
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<td>Berendsen PLC</td>
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FTSE 350 BOTTOM

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<td>Crest Nicholson Holdings</td>
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FTSE 350 SECTORS TOP

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<td>Life Insurance</td>
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FTSE 350 SECTORS BOTTOM

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<th>Last Month %</th>
<th>YTD %</th>
<th>Proximity to 52w High</th>
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<tbody>
<tr>
<td>Gas, Water &amp; Util.</td>
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<td>Automobiles &amp; Parts</td>
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<td>Food &amp; Drug Retailers</td>
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<td>Mobile Telecom</td>
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